Financial inclusion: An enabling environment for economic development

Usha Thorat

It is being increasingly realised that the trickle-down effect is not automatic and in deeply unequal societies, such as India, has to be facilitated by policy. For the Commonwealth and others, inclusive growth is seen as essential for social and economic development, and financial inclusion (FI) is perceived as an integral part of this.

This article seeks to look at the Indian experience of financial inclusion and analyses the approaches from the perspective of the role of the state, regulators, banks and non-governmental organisations (NGOs). Lessons are then drawn from each of these perspectives. Briefly put, the Indian experience shows that the right kind of partnerships between the state, regulator, financial sector and NGOs — in a variety of approaches — can be successful in achieving greater financial inclusion. It also shows that political attitudes towards interest rates can be counterproductive and may deter the emergence of a sustainable business model.

The role of the state

From nationalisation to ‘priority sector’ credit

Financial inclusion is a buzzword that is now a part of the global vocabulary in development. Even though the term FI only entered the Indian lexicon in 2004–05, the country has a long history of implementing policies that extend formal financial services to marginalised populations and areas of the country.

The Indian experience in the immediate post-independence decades shows that state ownership and control of banks’ resulted in the spread of banking into remote areas with the outcome that banking coverage is now significantly more sophisticated than in other similar countries.

Further, governments at the centre and state level have adopted policies to transfer all welfare and other benefits to the citizens through bank accounts (direct benefit transfers). This has given a huge push to FI and has brought greater transparency to the system. It has provided banks with a revenue source that can justify the investments they need to make payments infrastructure available to all the beneficiaries of government schemes and welfare payments. It has also minimised leakages and fraud.

However, financial exclusion in the country continues to be quite high. This suggests that state control of banking does not automatically achieve financial inclusion, rather, that in the absence of the state, ownership exclusion is likely to be higher.

As per extant public policy, all banks in India, whether in the public or private sector, have to ensure that 40 per cent of their loans are made to priority sectors, including agriculture, small industry and small business, smaller housing and education. Of this 40 per cent, ten per cent of total loans have to be made to the weaker sections within these priority sectors. Foreign banks are required to loan 30 per cent and, in their case, export credit is counted as a priority sector. These prescriptions have been in force since the early 1970s — initially, the amount required was one-third, but this rose to 40 per cent in 1985.

The mandating of credit for priority sectors has had the beneficial result of ensuring adequate credit to agriculture, small housing and education. In the case of the small industry and small business sectors, however, the impact on exclusion is not significant and a large share of the borrowing of this sector is still from informal sources. Within priority sectors, there is preference towards larger ticket loans to minimise transaction cost. The lesson here is that, although priority sector lending rules can have a positive impact on access to finance for some sectors, mandated lending is not sufficient to ensure adequate finance for the small industry and small business sectors. Further, cases of misclassification in the country are prevalent as banks try and avoid the penal provisions for not achieving the mandated requirement.

A subset of schemes, including credit-linked subsidy poverty alleviation, in which public sector banks provide the loans and the governments provide capital subsidy to improve the bankability, are also present in India. It was found that, while such schemes may yield some positive outcomes, they tend to suffer from similar defects, partly due to political patronage and misdirection of subsidy.

As such, it was concluded that integrated area planning often lacks proper implementation and subsidy schemes linked to individual loans are often miss-allocated and misused.

Credit guarantee schemes

Initially, India’s central bank, the Reserve Bank of India (RBI), administered a credit guarantee scheme through one of its subsidiaries giving partial but significant guarantee cover against credit default in the small-scale industrial, professional, self-employed and small business sectors. The scheme was not sustainable and had to be wound down. After some years another credit guarantee scheme for the small-scale industry and services sector was started by the government to encourage banks to make collateral-free loans. So far the scheme has been successful in encouraging collateral-free lending to the small industry and services sectors, but it is too early to comment on its sustainability.

The role of the regulator

Branch licensing policy

Under the banking law in India, banks require the specific approval of the regulator to open branches. This regulation has been used as an instrument of FI in India. For many years the policy required
banks to open one branch each in a rural and semi-urban centre for every license given for an urban centre. Currently, banks have to open at least 25 per cent of their branches in rural areas. This policy has led to an element of cross subsidisation as banks are required to open branches in unprofitable areas in return for permission to locate in profitable areas. This policy has enabled better spatial coverage of bank branches in India relative to many other comparable countries.

**Interest rate policy**

While in the early years the RBI prescribed interest rate caps on all priority sector loans, the caps were removed as part of the general liberalisation of interest rates for all loans. However, ceilings were still applied at the base rate for loans below US$1,000. Since 2010 all caps have been removed. Despite this, the political environment does not allow public sector banks to make loans to priority sectors at rates far above their base rates. This, coupled with high transaction costs, inhibits banks from lending to the smaller ticket size borrowers even within priority sectors. Instead, banks prefer to fulfil their priority sector obligations by lending to non-banking companies through assignment or securitisation of loans qualifying as priority sector; as such, indirect loans are also treated as priority sector. It seems to be the case that greater political sensitivity is needed to the fact that the poor and excluded need timely credit and currently they assist 26.8 million such groups all over the country. MFIs leverage private equity funds to get funding from the financial system for their activities. Currently, banks have also made loans to MFIs also and currently they assist 26.8 million such groups all over the country. MFIs also lend to SHGs despite such groups lacking official registration. Banks have also made loans to the groups using group guarantees as collateral. The experience with recovery in such groups was very good and bank support to such groups grew significantly between 1998 and the mid-2000s. Another group that has experienced significant growth is private microfinance institutions (MFIs) especially after the RBI registered them as non-banking companies and allowed bank lending to these companies to be treated as priority sector lending. MFIs also lend to SHGs or joint liability groups (JLGs) against group guarantee and currently they assist 26.8 million such groups all over the country. MFIs leverage private equity funds to get funding from the banking system for their activities.

**The role of the financial system**

Competition from new players in the private sector entering the banking system in the 90s has made both state and foreign banks more efficient and conscious of the need to modernise in order to preserve margins. In the FI space, banks follow a board-driven policy and are free to adopt any delivery model they choose. A huge number of basic banking accounts have been opened by banks that have increased their number of points of delivery significantly in the last five years. These accounts show low levels of usage and do not seem to be demand driven. Banks have not yet found a business model in the mass retail sector and this could be due to the implicit ceilings on rates of interest and charges for small customers.

**Mobile banking**

Unlike in many African and some South East Asian countries, mobile banking has not taken off in India. Many ascribe this to the policy followed by the regulator, which has insisted on a bank-led model and in which telecom companies have not shown much enthusiasm.

**Urban co-operative banks**

Another segment of the banking sector whose main clientele are those who do not access mainstream banks is the urban co-operative banking sector — small community banks, like credit unions, catering to local people. Poor governance and dual regulation plagued the sector for years. The crisis in the early 2000s promoted the RBI to bring in a tighter regulatory framework that has now brought stability to the sector.

**Microfinance**

Two important initiatives in the financial system that have facilitated FI in India are the direct bank self-help group linkage model and the rise of non-banking micro-finance companies. Self-help groups (SHGs) are groups of 15 to 20 poor women, from fairly homogeneous and cohesive backgrounds, who save regularly and use the savings to lend to members of the SHG. The RBI has permitted banks to open bank accounts for SHGs despite such groups lacking official registration. Banks have also made loans to these groups using group guarantees as collateral. The experience with recovery in such groups was very good and bank support to such groups grew significantly between 1998 and the mid-2000s. Another group that has experienced significant growth is private micro finance institutions (MFIs) especially after the RBI registered them as non-banking companies and allowed bank lending to these companies to be treated as priority sector lending. MFIs also lend to SHGs or joint liability groups (JLGs) against group guarantee and currently they assist 26.8 million such groups all over the country. MFIs leverage private equity funds to get funding from the banking system for their activities.

**The role of NGOs**

NGOs have played a very important role in FI by showing that the financial needs of the poor, if approached through an appropriate institutional mechanism, can be met to their advantage and can

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**Figure 1: Key indicators for financial inclusion**

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<tr>
<td>Commercial bank branches per 1,000 km²</td>
<td>23.17</td>
<td>35.68</td>
<td>8.45</td>
<td>9.32</td>
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<tr>
<td>ATMs per 1,000 km²</td>
<td>5.93</td>
<td>38.96</td>
<td>23.16</td>
<td>55.75</td>
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<tr>
<td>Outstanding deposits with commercial banks (% of GDP)</td>
<td>47.3</td>
<td>69.98</td>
<td>45.92</td>
<td>156.62</td>
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<tr>
<td>Deposit accounts with commercial banks per 1,000 adults</td>
<td>611</td>
<td>1,197.57</td>
<td>1,153.52</td>
<td>40.44</td>
</tr>
<tr>
<td>Commercial bank branches per 100,000 adults</td>
<td>9.02</td>
<td>12.16</td>
<td>47.7</td>
<td>7.85</td>
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<tr>
<td>ATMs per 100,000 adults</td>
<td>2.31</td>
<td>13.27</td>
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<tr>
<td>Outstanding loans from commercial banks (% of GDP)</td>
<td>31.2</td>
<td>55.14</td>
<td>47.15</td>
<td>101.38</td>
</tr>
<tr>
<td>Loan accounts with commercial banks per 1,000 adults</td>
<td>100.99</td>
<td>147</td>
<td>2,358.2</td>
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*Source: IMF, no date.*
lead to a sustainable FI model. NGOs have played a very important role in the promotion of SHGs and their linkage to banks. The National Bank for Agriculture and Rural Development has supported such grass-root institutions through grants. Many micro-finance institutions in the country started as NGOs and morphed into micro-finance companies, and many have set up not-for-profit schemes to provide other non-financial services.

Conclusion
India has experimented with a variety of models for FI – given the vastness and the heterogeneity of the country, this is inevitable. The government, regulator, financial system and NGO sectors have all contributed to these achievements. The lessons learnt are plentiful, yet there remains a lot which can be improved upon.

Endnotes
1 The State Bank of India was created in July 1955 following the nationalisation of the Imperial Bank of India. The plan to nationalise the Imperial Bank, and subsequently the major commercial banks, in 1969 became part of a wider effort to direct the funds of the banking system into certain neglected, but important, sectors of the economy.
2 The country also experimented with regional rural banks sponsored by local government, federal government and public sector banks.
3 Even today 72 per cent of the assets of the banking system are with public sector banks and these banks are expected to play a leading role in any state-sponsored programme.

References

USHA THORAT recently retired as the director of the Centre for Advanced Financial Research and Learning (CAFRAL), an institution established by the Reserve Bank of India (RBI) for research and learning in banking and finance. She established CAFRAL’s identity as a unique platform for debate and discussion among industry, regulators and academics on policy and strategic issues, locally as well as globally. Prior to her role at CAFRAL, Thorat had a career of nearly four decades with the RBI, where she was deputy governor for five years. Her responsibilities included banking regulation; supervision of commercial banks, regional rural banks and co-operative banks; and currency management. At this time she also chaired the Deposit Insurance and Credit Guarantee Corporation, as well as representing the RBI on the Basel Committee on Banking Supervision (BCBS) and in national structures.