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Expanding Access to Financial Services – Where do we go from here?

by

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Introduction

1. At a recent conference on micro finance[1] Mr. P. Chidambaram, the Finance Minister, acknowledged that almost 60 to 80% of enterprises and individuals within the country lack access even to basic financial services such as savings and credit. And, while he did not mention it, a similar set of numbers in all likelihood will emerge for basic insurance services. In a country as vast as India this translates to a very large number of (potentially over 500 million) "un-banked" people – two times the entire population of the United States of America. This situation obtains even after over half a century of independence and over three and half decades of nationalisation of banks – the express aim of which was to address this very problem.

2. Claessens (2005) in a recent review paper points to the growing body of evidence that suggests that while access to financial services is not a panacea, there are definite causal links between access and growth and poverty reduction. Given the massive scale of the failure of access within India it may even be possible to conjecture that this is indeed the "missing link" between the 6 to 8% growth rate that we have and the 8 to 10% that we need[2].

3. In our attempts to address this issue we have built a massive infrastructure, including an apex institution and dedicated regulator for this sector, the National Bank for Agriculture and Rural Development (NABARD), over 30,000 rural branches of scheduled commercial banks, a vast network of Regional Rural Banks, Post Offices which offer basic banking services and co-operative institutions of all kinds[3]. We started to build a micro finance movement within the country in 1992, having learnt from the efforts of Grameen Bank in Bangladesh[4] and Bank Rakyat Indonesia (BRI)[5] in Indonesia, and have successfully built our very own versions of this movement[6]. However, even after over a decade of micro finance, we have been able to cumulatively disburse barely Rs.39 billion[7], against an annual estimated demand of Rs.450 billion[8]. In comparison, countries such as Brazil and South Africa, which started much later, have succeeded in providing basic access to financial services to a large proportion of their population.

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1 SIDBI Sa-Dhan Policy Conference on "Financial Services Accessibility and the Poor: Need for Facilitating Regulatory Environment", 19-20 January 2005, India Habitat Centre, New Delhi.

2 Mor (2005) takes this line-of-thought a little further.

3 Srinivasan, R & Sriram (2003)

4 For details please visit www.grameen-info.org

5 For details please visit http://www.bri.co.id/english/index.html

6 NABARD (2004)

7 As of March 31, 2004, NABARD (2004)

8 Mahajan (2001)

4. When faced with this extent of failure, despite all this effort, it becomes very urgent to explore what has gone wrong and to try and determine where we go from here.

Bias for Action

5. At an overall level, as I compare our experiences with other countries, specifically that of Brazil and South Africa, one thing that strikes me is the sharp difference in our approach to the problem. It is possible that, in our eagerness to address this problem quickly, the government, by setting aggressive targets, nationalising banks when they failed to deliver, providing vast amounts of subsidies[9], loan waivers and more recently having discovered the Self-Help Group (SHG), treating it as the panacea and pushing the public sector banks and other governmental departments to form and link groups at break-neck speed[10], has been at the root of our failure to achieve real progress.

6. The Brazilian and South African governments seemed to have approached the issue by working in a collaborative manner with the banking system, have focussed less on 'doing' things and much more on preparing the ground so that systemic forces are unleashed. Perhaps their approach, while initially much more slow, has produced more enduring and eventually more substantial results. The following table gives some examples that illustrate this difference in approach.

Problem	Indian Response	Other International Responses
Banks have been unwilling to expand their presence in rural areas.	• Bank nationalisation with a pressure to expand rural reach. • Branch licensing designed in part to control the ratio of rural and urban branches. • High priority sector lending targets.	• Permission to appoint Banking Correspondents (S. Africa & Brazil). • Encouraging non-traditional providers (such as Community Development Financial Institutions (CDFIs), in U.S.A[11] and TEBA Bank in S. Africa[12])
The poor pay high rates of interest on their loans.	• Imposition of interest rate caps on individual loans under Rs. 2 00,000. • Provide refinance from NABARD at reduced rates.	• Development of a credit bureau so that the higher quality borrower can signal to the system her/his credit-worthiness and attract lower rates (National Loan Register, S. Africa[13]).

9 NABARD for example provides refinance to Banks at low rates of interest for several of these assets. This refinance distorts the overall interest rate structure and makes it difficult for a consistent risk-return regime and for a commercial market for these assets to emerge.

10 Though the SHG-Bank linkage movement has only recently started to show some real growth there is a concern that serious compromises may be made on the quality dimension because of basic incentive mismatch between those that are forming the groups and the banks that are providing the loans. Also, the success metric for the SHG-Bank Linkage programme seems to be the number of groups formed and not the quality of linkage as measured by average size of loans or number of repeat loans.

11 Community Development Financial Institutions (CDFIs) broadly referred to as LFIs have been servicing the financial needs of the unorganised sector in USA. This CDFI Fund's mission is "To promote access to capital and local economic growth by directly investing in and supporting CDFIs and expanding financial service organisations' lending, investment and services within underserved markets". The Fund is a wholly owned government corporation within the United States Department of the Treasury.

12 TEBA Bank, South Africa uses wireless connections at grocery shops and provides debit cards to its members for accessing banking services. The ATMs are located around the mines and are connected to more than 10,000 ATMs using the Saswitch network. It uses satellite connectivity between its branches for real time transaction processing. (Source: Hoffman, Jenny, CEO, TEBA Bank, S. Africa, "Extending Banking Outreach" Mumbai, India 5-6 March, 2004.

13 The Micro Finance Regulatory Council, South Africa maintains the National Loans Register (NLR) a credit bureau where all micro loans made by registered as well as unregistered micro financing institutions are maintained. The Bureau has been formed as a unique collaboration between the public and the private sector. The structure of the NLR includes eight private credit bureaux which manage the data under

		• Creation of the MFRC[14] so that formal providers may be exempted from the Usury Act but would have to be much more transparent in the rates they charge (S. Africa).
The poor need access to comprehensive financial services.	• Focus on credit to the exclusion of other services. • Other than for very narrowly defined special schemes make it impossible to offer savings services except through a licensed branch based model.	• Allow Banking Correspondents (providing all financial services) which require formally licensed banks to take complete responsibility for their conduct (Brazil). • Allow multiple channels to provide banking services by using technology in a sophisticated manner to address issues of privity of contract (S. Africa).

7. While the precise steps that we take would necessarily have to be tailored to our environment, if we are to make real progress we will need to go back to the drawing board, internalise the lessons from our past and from other countries and then develop our own unique set of responses to these problems.

8. In my view there are three broad areas of action that present themselves:

   1. Increased sophistication in the regulation of Banks
   2. Development of basic financial services infrastructure
   3. Build an adaptive regulatory framework

9. The following sections attempt to explore each of these areas in some detail.

Increased Sophistication in the Regulation and Supervision of Banks: Overcoming the Psychological Barriers to Access

The current approach to regulation and supervision of banks has a very strong focus on development of detailed guidelines by the RBI and strict monitoring to ensure adherence to them when inspections are carried out. However, to the best of my knowledge, the following key questions are never really asked and therefore not answered:

1. What is the current exposure of the bank to credit risk and does it have sufficient capital to cover its exposure to this credit risk[15] ?

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agreement with MFRC. It is mandatory for all MFRC registered lenders to share data with the NLR. Till date it has responded to more than 8 million enquiries and gets traffic of more than 5 lakh enquiries per month. While it is maintained by NLR the data is owned by MFRC.(Source: Motshegare, Nomsa, Manager, MFRC, S. Africa, "Financial Services Accessibility & the Poor: Need for Facilitating Regulatory Environment" New Delhi, India 19 - 20 January, Organised by Sa-Dhan, 2005)

14 Micro Finance Regulatory Council, South Africa (www.mfrc.co.za)

15 The current approach that is followed requires each bank to provide for bad-loans on its books using a mechanical days-overdue based definition. This provision is deducted from the capital base of the bank (through its profit-and-loss account) and thus impacts its capital adequacy. The capital adequacy computed in this way bears no relationship to the current credit risk profile of the bank. Some recent guidelines have now started to specify the non-performing asset (NPA) ratio as an independent parameter along with the capital adequacy ratio as a performance parameter. Since, if the provisioning policy is appropriate, the NPA ratio is really the "good" part of the "bad" asset (the "bad" part having been provided for), it is hard to see what, particularly if the bank is already adequately capitalised, other than discouraging banks from venturing beyond zero-risk assets, this new approach seeks to achieve. Even at a very basic level the capital adequacy guidelines do not even cover all the risk classes – for example committed cash-credit limits which are not drawn are completely ignored in the current guidelines.

2. At a higher level of detail, what is the manner in which, on a day-to-day basis, the bank addresses the issues of risk in its decision making? Does it have formally defined Risk Quantification Methodologies, Capital Attribution Methodologies and Portfolio Management Strategies through which it prices this risk and manages its credit portfolio?

3. What is the current exposure of the bank to market risk (on a balance sheet wide basis) and does it have sufficient capital to cover its exposure to this risk[16]?

4. At a more detailed level, what would be the impact of a defined set of interest rate shocks on the overall solvency and liquidity of a bank? How does it manage its interest rate risk on a day-to-day basis and factor it into individual decision making while acquiring assets or liabilities?

5. How does the bank calculate its cost of funds when pricing its loans? Has it implemented formally defined transfer pricing methodologies?

6. On a business-by-business basis, if capital is attributed correctly and funds are priced correctly, what is the return on this capital that the bank makes? How can reporting on this be made mandatory?

7. On a business-by-business basis, if the NAV (net asset value) of the business (market value of assets less market value of liabilities) is calculated, how would it move from quarter to quarter?

10. Mor and Maheshwari (2004) have argued previously that answering these questions will require banks to fundamentally re-engineer themselves in terms of how they are managed. However, the basic "technology" to answer these questions is very old, easily available and has been implemented by a number of banking systems around the world[17]. In the context of this article, it would be legitimate to ask that while this may be a desirable direction, how is this linked to the issue at hand – improving access to financial services?

11. It is my belief that because banks are not supervised, governed and regulated in this manner, they can continue to stay within their "comfort zones" and pursue the most obvious businesses of corporate banking, up-market retail banking and trading in the financial markets. Businesses such as improving access to financial services to the poor are much harder to pursue but because of the inherent diversification benefits that they provide, if carried out in a commercially consistent manner, have the potential to offer a much higher risk adjusted return on capital (RAROC) relative to many of the business that the banks traditionally seek to pursue[18]. Requiring banks to disclose all this information will not only improve corporate governance and overall performance of banks (both private and public sector) but will create strong incentives for managements to pursue new markets and new customers in a sustainable manner. The 500 million un-banked present an obvious opportunity and as I have attempted to argue elsewhere[19], this provision of basic financial services has the potential to provide the much needed boost to Indian economy.

16 The current approach requires banks to label a part of its general reserve as an investment fluctuation reserve (IFR) and to treat that part of the general reserve as tier II capital. The IFR is expected to grow to 5% of the nominal value of a part of the bank's investment portfolio by March 31, 2006 with no link to the actual risk profile of the investment portfolio. A newly issued capital for market risk guideline, quite separately from the IFR guideline, does try to address the issue of risk profile for the part of the investment portfolio that is dealt with by the IFR but by completely ignoring most of the balance sheet of the bank once again produces a completely inaccurate picture of the capital for market risk. Patnaik and Shah (2002), with a great deal of difficulty (because of very limited data that is publicly available on this issue), make an estimate of the actual exposure of banks to interest rate risk and produce quite alarming results.

17 Colombia is the most recent example of this.

18 In this context it would be useful to study the performance of BRI during the Asian Financial Crisis.

19 Mor (2005) Op.cit.

12. In my view, without the changes in regulation that have been suggested above, privatisation of public sector banks or easier entry of international banks to operate in India, is unlikely to have any impact on the economic performance of the country. And perhaps even more strongly, with these changes, the steps of privatisation and international entry and ownership, may not really be required, if viewed from a narrow perspective of enhancement of growth and development through improved access to financial services.

Development of Basic Financial Market Infrastructure: Overcoming the Physical Barriers to Access

13. India is geographically a vast country with over 1 billion people living in over 600,000 villages. While very small pockets of consumers have started to use modern tools such as credit cards, the largest proportion of even those customers that have full access to all these technologies prefer to use cash and cheque[20]. Most of the un-banked are very poor and more often than not, other than meagre quantities of gold that they may have inherited, do not have any tangible collateral. They are often landless and do not have access to any kind of steady wage employment. Their exposure to systemic shocks such as adverse health events and failure of rainfall is very high and often could be the principal driver of return to poverty[21].

14. Serving such a customer base presents an extremely difficult physical challenge even if the psychological barriers to entry (discussed earlier) have been overcome. If one is to provide anywhere near a semblance of complete financial services, then there is a need to systematically build the basic infrastructure, which is in the nature of a set of public goods.

- Highly distributed and modern, cash and cheque handling capability – this is one of the most important bottlenecks outside the major metros.
- If machines (ATMs for example) are to provide at least a part of the answer to access[22], then a rapid improvement in (a) quality of the currency note so that it can be used in ATMs multiple times; (b) availability of ATM-fit notes; (c) cash clearing and handling capacity, both in big cities as well as in more remote locations; and (d) machine readability of currency notes.
- Every citizen to have a unique identification number which records basic biometric data (photograph and finger print for example)[23].
- Development of a specialised rural credit bureau. NABARD could own and manage this bureau and issue standardised, machine readable, smart[24] cards to every rural individual that seeks any type of financial service for the first time.
- Development of a comprehensive network of real-time weather stations[25].
- Development of a comprehensive network of health diagnostic centres[26].

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20 Bekier and Nickless (1998) argue that it is the heavy usage of cash and cheques that is the biggest driver of costs, not branches.

21 Krishna (2003)

22 Standard Bank, South Africa uses ATMs with simple graphic interface where costs are 30 % lower than traditional banks. The ATM access is complemented through card based access to accounts.

23 This would be a pre-requisite for the establishment of a rural credit bureau.

24 If cost is an issue, even laminated paper cards with bar-code and encoded thumb print information would be sufficient.

25 This is particularly important for index based weather insurance.

26 This will be extremely important for development of need based health insurance products for the poor. Existence of reliable data on health status will also help in pricing the insurance products

- Roll out of comprehensive always-on internet connectivity at the village / slum level, perhaps even prioritised over voice (minimum 50 kbps speed)[27].

Evolution of an Enabling Regulatory Framework: Overcoming the Regulatory Barriers to Access

15. Even if the desire to serve this community of customers is established and the basic infrastructure for it has been put in place, there are several steps that need to be taken on the regulatory side to facilitate this access[28].

1. Expand the mission of the RBI, IRDA and SEBI to include an explicit goal of universal access to financial services[29].
2. Complete domestic deregulation of interest rates including removal of all caps (on lending rates) and floors (on interest rates) on all types of bank accounts.
3. Removal of the maturity ceiling of ten years on fixed deposits[30]
4. Complete removal of the distinction between the advances and investments[31] on the books of a bank and detailed segment reporting requirements on all banks – including capital attribution and RAROC (Risk Adjusted Return on Capital) report using internal models[32].
5. Freedom given to reputed banks to appoint Banking Correspondents in a manner similar to Brazil and South Africa to extend financial services.
6. Overall, a much higher degree of financial innovation (credit derivatives, commodity options, etc.) to be permitted in the system and approval given to banks to participate in them. Rather than regulate through setting interest rates (savings rate, caps on lending rates, etc.) and participation in markets (bond markets, futures markets, etc.), regulation should be much more focussed on aggregate level solvency, liquidity and capital adequacy of the bank.

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27 While, due in part to an extremely far-sighted telecom policy, the country does have optic fiber terminations at the block level, the bulk of its population lives in villages that are far away from these terminations. Making financial services (and other services) available to the un-banked requires crossing the last mile (or more likely last 20 miles), the fixed costs of which are far too high for any single service provider to bear.

28 Refer Ananth and Mor (2005) for a detailed discussion on regulatory aspects of universalising access to financial services

29 Claessens (2005) makes the point that there is no specific reason to prefer banking as a vehicle for the provision of these services. For example, a Money Market Mutual Fund (MMMF) which invests in short-dated Government of India securities provides better risk cover as well as higher returns, relative to a savings account. Unfortunately it currently suffers from two problems: (a) SEBI regulations require that all redemptions go to a bank account and (b) RBI prohibits banks from offering a general purpose savings (with sweep) account that is linked to a MMMF. A universal access mission will ensure that these kinds of issues are deliberated with a great deal of care before regulation is formulated.

30 While Banks are permitted to lend money for as long as 30 years (there is no mandated maturity limit), on the liabilities side a limit of ten years has been set – making it impossible to offer old-age long-term savings products to customers.

31 Under current regulation a bank is free to make any loans subject only to internal guidelines and is required to provide a standard amount of capital. However should the bank choose to document this credit facility as a bond, despite the fact that, except for an additional measure of liquidity, there is no difference between the bond and the loan, the bank is required to seek an external rating, limits are placed on its aggregate holdings of these bonds and in addition to the standard capital it is required to provide capital for market risk. This strongly signals to banks that they should stay away from market based instruments and therefore builds an environment in which the only way to diversify risk and raise resources is to directly originate all types of assets and liabilities. A more neutral regulatory treatment would allow some banks (and non-banks) to focus on the poor but diversify risk and raise resources through an active process of securitization. This would also encourage the development of the Local Financial Institutions (LFIs) that are referred to later.

32 See Mor and Maheshwari (2004), Mor and Sharma (2002) and Padhye and Sharma (2001) for a more detailed discussion.

A Vision for the Future

16. Even after bringing about the suggested changes, the actual delivery of these services would require supporting growth of two sets of complementary channels[33].

1. Several, privately owned, Local Financial Institutions (LFIs), essentially unregulated (or lightly so) and focussed exclusively on the business of local credit delivery[34] – very tightly regionally focussed in terms of geography and with skills to deal with the complex problems of adverse selection and moral hazard, to begin with for poor individuals but eventually moving up the chain to local enterprises and infrastructure The Community Development Finance Institutions (CDFIs) in the United States of America provide a close parallel to these LFIs[35]. These LFIs would work in close partnership with national level financial institutions and wherever possible capital markets.
2. A very large number of hybrid direct access channels in the form of internet kiosks, Banking Correspondents (similar to the Brazilian model) and bank and insurance franchisees which complement the LFIs (and may even be embedded with them). These would bring the products and services of national and international (not local) and carefully regulated institutions within reach of the poorest of the poor.

17. The LFIs would get to know their customer bases intimately and take the standardised product and service offerings of the national institutions and transform them into much more tailored ones for their clients. Wherever possible they would take the variety of loans that they make, aggregate them into standardised portfolios and offer them directly to capital markets[36]. These institutions while potentially full-service institutions as far as their clients are concerned, would act as principals only for the credit transactions but act as agents for all the other financial services instruments. The reason for this is that while seeking products such as savings and insurance the depositors and the insured respectively most require these instruments to pay-off in those states of the world when their own immediate lives are experiencing adverse shocks. Savings that are invested in the local community and insurance that diversifies only over the local community suffers from the inherent problem that the very same idiosyncratic shocks that have the potential to most affect their lives (for example the failure of the local monsoon) will also adversely impact the local community and therefore the LFI. On the credit side the LFI can seek to protect itself in a variety of ways (including through securitisation), it would be much more difficult for it to do that for savings and insurance without reaching a certain critical size.

18. While, with the reduction of the physical and regulatory barriers to entry discussed earlier, the direct access channels would be relatively easy to establish, creation of LFIs would require several more steps to be taken:

1. Entry of privately managed venture capital funds[37] which are engaged in the critical task of identifying suitable entrepreneurs and then mentoring them until they reach a certain threshold.

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33 Refer Ananth et al (2004) for a much more detailed discussion on this. In their paper a detailed blue-print is offered for expansion of financial services to the very poor.

34 In giving out credit the entity takes risk on the borrower and a local entity is perhaps best equipped to do that. In the case of insurance and savings the individual is taking the risk on the entity and perhaps national level and much larger entities are needed here.

35 The US has over 600 of them. Refer www.cdfi.org for more details.

36 Economist (2004)

37 Lok Capital, Aavishkaar India Micro Venture Capital Fund (AIMVCF) and Mr. Vinod Khosla are early examples of this. The "Lok Capital" (or People's Capital) initiative was launched in 2001 with an objective to mobilise and direct equity to fund micro finance activities in India. Aavishkaar aims to take venture capital and entrepreneurship to the 'bottom of the pyramid' to transform rural India through funding of initiatives that have remained unincubated due to lack of capital. For more details please visit www.lokcapital.com, http://www.aavishkaar.org and http://www.microfinancegateway.org/content/article/detail/19096 for more details on each.

2. Partnership between mainstream banks and such funds for "take-out" finance as well as for the future growth of these LFIs[38] once the LFIs cross a mutually agreed threshold.

3. Mentoring and training services for these fledgling LFIs to grow into full-grown and well managed financial institutions[39].

Conclusion

19. These sets of steps, if taken, do not guarantee immediate universal provision of financial services. However, in my view, it is absolutely imperative that the steps outlined above be taken without any further delay, if we are to make real progress in that direction. Many of these ideas would not only address the question of access to basic financial services for the very poor but improve the overall functioning of the financial system in the country – benefiting all segments of individuals and businesses[40].

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38 Ananth (Forthcoming).

39 Training and Mentoring programmes are necessary for nascent LFIs and individual entrepreneurs who are interested in setting up a micro finance operation to provide financial and technical support to them. These MFIs will thus be able to cater to the vast micro financial needs of households hitherto underserved by existing channels. Such programme requires specific expertise in the Identification as well as Incubation phase. Centre for Micro Finance Research (CMFR), Chennai will provide some such specialized training programmes for the sector.

40 A CFO of a large multi-national company once told me that it was a matter of great concern to him that simple tasks like clearing an out-station cheque takes anywhere up to a month in India while in a country like Brazil the period is much shorter. Even Vietnam, a country that emerged from a very damaging war has succeeded in a nation-wide implementation of a Real Time Gross Settlement system (RTGS) well ahead of us.

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