

## Financial Inclusion in India: Industry Trends and Policy Beyond Microfinance

I was recently in Bombay visiting a company that provides technology solutions to extend financial services to the poor, specifically to MFI clients of private Indian banks. It does this by providing smart cards for clients and a banking infrastructure for MFIs. The visit offered a perfect opportunity for me to understand the Indian banking system, and the place of microfinance in it.

To prepare, I did some background research, speaking to colleagues at ICICI, YES Bank, and ABN Amro. The most significant take-away for me was the extent to which 'rural and micro-banking' was now an industry in India – with each bank having a dedicated Rural, Agricultural, and Micro-banking (RMAG) division. This article shares my learnings on the financial services industry, how it is moving on from microfinance, and how this relates to development and economic growth.

For those interested, I quote often from the paper [Economic Growth, Financial Deepening, and Financial Inclusion \(PDF here\)](#), by Dr. Rakesh Mohan, Deputy Governor of the Reserve Bank of India, and highly recommend it.

### Microfunding: Current Industry Trends

In the Indian context, microfinance is no longer the purview of development institutions. While the rhetoric of development has been retained, banks have embraced it as an extremely profitable business, for two reasons.

First, Indian banks are required to lend a certain percentage (currently 40%) into priority areas – called priority sector lending – which includes agriculture, SMEs, and government securities. Compared to returns on government bonds of 6-7%, MFI lending provides returns of 10-14%. Banks, therefore, have expanded investments in these areas.

Second, microfinance lending - as it is currently practiced - is simply not very risky. In the absence of individual credit assessments, MFIs lend to groups or through referral, leading to repayment rates of 95% or more. Banks then get the best of both worlds - higher rates of return with very low risk.

The result is massive expansion in microfunding. ICICI Bank, the largest private bank in India, had [1.2 million microfinance](#) clients in 2005 and a portfolio of \$227 million. A year later, ICICI has [multiple partnerships](#) and 3 million clients, targeting 25 million in 3 years. Other banks, such as ABN Amro, and YES Bank have smaller but still sizable operations that generate [goodwill benefits](#) for their entire operations (both featured on FT's sustainable banking awards last year).

Public sector banks usually operate as integrated micro-lenders, creating self-help groups (SHG) to which they disburse loans directly rather than through an intermediary. Private sector banks, by contrast, operate through a partnership model, contracting with existing MFIs to function as the bank's retail arm to acquire and manage micro-clients. In return, MFI's retain a percentage of the interest earned on loans. Many MFIs are now financially independent of such funds, but high effective rates (of over 30%) have also led to a [regulatory backlash](#).

### Mismatch between Credit and Deposit Growth

This expansion of rural credit tracks a more general expansion of *retail* credit in India. In 2006, non-food credit expanded by over 30%, up from a growth rate of 28.8% in the 3 years prior. Simultaneously, the share of retail credit in overall credit stood at 46% in 2005-06, up from 6.4% in 1990-91.

Interestingly, this growth has not been accompanied by growth of deposits, particularly in rural areas. As a result:

Banks have been financing much of the incremental credit expansion by unwinding their surplus investments in government securities. What deposit growth that has been observed is, moreover, concentrated in the larger cities...[this] could also mean that financial inclusion may have suffered.

The implications of this mismatch are important to understand some of the constraints faced by an expanding microbanking industry. In the absence of deposit growth banks face a liquidity problem which limits further credit expansion. This problem is evident in recent [policy changes](#) to reduce the [statutory liquidity ratio](#) (SLR) of Indian banks.

In other words, the banking system will be expected to increasingly provide larger quantum of funds to existing and emerging enterprises. And without adequate deposit growth, however, credit expansion might not be sustainable over the medium-term, without putting immense pressure on real interest rates and impacting the overall stability of the financial system.

### **Financial Inclusion: Consequences and Benefits**

The preceding discussion does not distinguish between rural and urban markets. However, the expansion of financial services to all sections of society (financial inclusion) is important, in order to leverage development and growth benefits. There are obvious reasons to encourage such financial inclusion and deepening:

Countries with low levels of income inequality tend to have lower levels of financial exclusion, while high levels of exclusion are associated with the least equal ones. In Sweden, lower than two per cent of adults did not have an account in 2000...[while] in Portugal, about 17 per cent of the adult population had no account of any kind in 2000.

The [Gini index for Sweden](#) was 24, and for Portugal 37 in 2001 (lower is better). [Sweden ranked 119](#), and Portugal 59 in income inequality in 1996.

At the macro-level a well-developed and widespread financial system accelerates growth “through expansion of access to those who do not have adequate finance themselves.”

In its absence, the sources of finance available to individuals and enterprises are limited. The [McKinsey Quarterly reports](#) that companies in emerging markets demand further development of financial systems, and remain limited in their ability to access external finance. This results in fewer economic activities being financed, resulting in lower growth potential. Further, financial exclusion is self-propagating and limits growth prospects:

It is the incumbents who have better access to financial services through relationship banking. Moreover, incumbents also finance their growth through internal resource generation. Thus...growth is constrained to the expansion potential of incumbents.

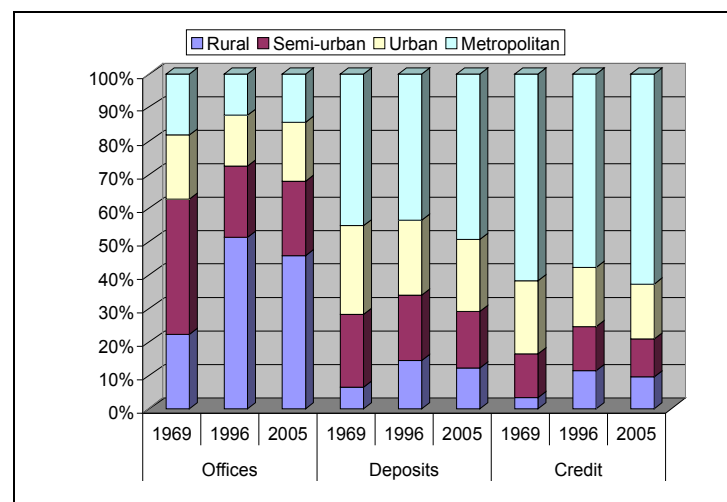
At the individual, micro-level, however, the consequences of financial exclusion are very different. Exclusion results in a susceptibility to cash flow disruptions, inability to benefit from interest rates, and lack of long-term financial security and planning through saving opportunities.

It is very important to note the distinction between the enterprise level macro benefits and the individual micro benefits, as the two are often confused in development literature. In the former, the benefits of inclusion are productivity and higher trend growth. These are benefits commonly ascribed to microfinance, yet microfinance as it is currently practiced is targeted not at enterprises but at individuals. The benefits that accrue therefore are smoothening

consumption and safeguarding assets from major disruptions (e.g. disease, natural disaster). Recent studies seem to suggest as much.

## Policy Responses to Financial Exclusion

Despite the massive growth in micro-credit mentioned previously, Dr. Mohan expresses serious concern over financial exclusion in India, backing those concerns with data. For instance, spatial distribution of banking services indicates that rural credit, deposits, and offices as a share of overall services decreased between 1996 and 2005, with most expansion restricted to metropolitan areas.



There are two obstacles to greater financial inclusion. The first is simply commercial. Transaction costs for both banks and clients remain high, particularly in disbursing credit, which is essentially a high cost, distributed business. Further, interest rates remain high in the absence of structured credit assessments. The second obstacle is policy requirements such as know your customer (KYC) procedures that limit the geographical reach of financial services beyond physical bank branches.

Yet, the importance of financial inclusion becomes important, particularly in the context of doubling agricultural productivity, targeted for India's 11<sup>th</sup> five year plan. Consequently, the RBI has moved to enforce multiple policy and industry changes:

1. Banks have been asked to voluntarily make available a 'no-frills' account, and all printed bank material has to be made available in regional languages.
2. KYC procedures have been simplified for low income groups.
3. Significantly, since January 2006 banks can provide a full range of banking services through 'business facilitator and correspondent' (i.e. MFI partnership) models. Previously, MFIs could only provide credit, but not open bank accounts.
4. The Credit Information Bureau Act, 2006, will eventually establish a credit bureau that makes available credit histories of individuals and small businesses. This should lower risk for banks, in extending credit further.

## Conclusions

This has been an inordinately long post, but an eye-opening one. Most microfinance literature has seen credit expansion as an end in itself, with productivity benefits magically accruing from such expansion.

This discussion, however, debunks that belief without denying the importance of microcredit. However, microcredit must be part of micro-banking, which must be seen as a viable and important business within the financial sector.

Contrary to popular belief, the reach of microfinance in India remains limited. Both market and policy reforms are necessary in order to correct this, expand microcredit, and sustain it through deposit growth. The resulting industry and policy moves may prove important for other countries on a similar trajectory.

**Referred Reading:**

1. [Economic Growth, Financial Deepening, and Financial Inclusion](#). Address by Dr. Rakesh Mohan, Deputy Governor of the RBI at the Annual Bankers' Conference 2006, at Hyderabad on Nov 3, 2006. ([PDF here](#))
2. [An executive perspective on global capital markets: A McKinsey Survey](#). The McKinsey Quarterly, January 2007.