Financial Inclusion for Sustainable Development : Role of IT and Intermediaries

My topic today is financial inclusion for sustainable development and how IT and community based organisations including NGOs can be leveraged for expanding banking outreach so as to meet the needs of the underserved population.

Financial inclusion has become a buzzword internationally – even in developed financial markets there are concerns about those excluded from the banking system especially migrant workers. The barriers to access to formal banking system have been identified as relating to culture, education (especially financial literacy), gender, income and assets, proof of identity, remoteness of residence, and so on. Efforts are being made by the authorities- especially banking regulators- to improve access to affordable financial services through financial education, leveraging technology, and generating awareness.

I would like to illustrate by quoting some recent developments. The FDIC Board of Directors in US approved on November 2, 2006 the establishment of an FDIC Advisory Committee on Economic Inclusion, a committee to provide the FDIC with advice and recommendations on important initiatives focused on expanding access to banking services for underserved populations. This may include reviewing basic retail financial services such as cheque cashing, money orders, remittances, stored value cards, short-term loans, savings accounts, and other services that promote asset accumulation by individuals and financial stability. Financial inclusion is thus being seen as part of ensuring financial stability.

In a recent speech at the Opportunity Finance Network's Annual Conference at Washington DC on November 1, 2006, Chairman of the Fed Reserve Board Ben. S. Bernanke referred to the role of community based financial institutions in minimizing neighbourhood and information externalities and other types of market failure that tend to prevent competitive conditions from maximizing social welfare. He spoke about the role of community development financial institutions in solving collective action problem and countering information externalities by developing financial products and services that better fit local needs and provide coordinated development activities and community specific information. In dealing with scale and using technology, banks tend to adopt highly standardized and automated processes. But financial inclusion requires substantial efforts in understanding the needs of the customer, counseling, financial literacy, screening & monitoring. In his speech the Chairman focused on role of the local organizations in acting as information brokers and facilitators.

There is also a news item that applications made by Wal-Mart to cash cheques at its 44 stores has been approved by the Division of Banking in Massachusetts mainly on grounds of providing facility to the unbanked. In some jurisdictions, non bank entities are being allowed to provide payment and account maintaining facility without bank account - through e-money- to meet the needs of the unbanked.

In developing countries, the added dimension, and the main difference is that the focus of financial inclusion is on promoting sustainable development and generating employment for a vast majority of the population especially in the rural areas.

In yesterday's address in BANCON, Deputy Governor Dr. Rakesh Mohan has elaborately laid out the position for India and the data analysed by him speaks for itself. Rather than repeating the figures, let's just take a look at a few facts. In March 2005, commercial banks had 338 million savings and current accounts as against 290 million in 2000. Rural accounts went up from 172 million to 200 million – representing an increase of 28 million, while urban accounts increased by 20 million from 118 million to 138 million. The rate of growth annually was around 3 % just a little over the population growth- State wise data would show certain areas where there is hardly any increase. The number of loan accounts increased from 54 million in 2000 to 77 million in March 2005 (7.3 % CAGR). However the higher growth rate was on account of urban areas. In rural areas, the number of loan accounts went up from 40 million to 47 million (3.3%) whereas the urban areas showed a stronger growth from 14 million to 30 million loan account or growth rate of 16.5%. The growth in the number of small borrower accounts in rural areas was even lower at 2.5 % whereas the growth in the number for urban areas was 13.8 % between 2000 and 2005. There has been hardly any increase in outreach or scale in the last five years except for some growth in branches and loan accounts in urban areas. Number of bank offices in rural areas remained more or less the same - 47253 in 2000 to 47586 in 2005- while they rose from 19808 to 22383 in urban areas. Current and savings accounts per branch in rural areas rose from 3650 to 4202 and from 5965 to 6155 in urban areas. The number of loan accounts per branch rose from 844 in 2000 to 1003 in 2005 while in urban areas the number increased from 731 to 1335. These data bring out the spurt in urban retail lending in recent time –but this has not been matched by similar growth in savings accounts in both rural and urban areas or growth in loan accounts in rural areas.

On the other hand, there are 93 million mobile users today –the CAGR since 1999 is 85 %. The number of mobile phones currently is more than the number of borrowers from the banking system. There is a clear need to increase the outreach and scale up operations at existing outlets.

Use of technology

The use of IT is inevitable to improve the usage of existing branch infrastructure. Increasing outreach and up scaling number of accounts at each branch will require bankers to move out of their branches and source clients and then look at low cost delivery alternatives once the account relationship is established. Opening a no frills account with a small overdraft or GCC is only the first step in building the relationship which would require sustained efforts to ensure that the banking relationship with the customer is fashioned to meet his needs. IT can reduce cost and time in processing of applications, maintaining and reconciliation of accounts and enable banks to use their staff at branches for making that critical minimum effort in sustaining relationship especially with new accountholders. In rural areas customers cannot be expected to come to branches in view of opportunity cost and time and hence banks will have to reach out through a variety of devices such as weekly banking, mobile banking, satellite offices, rural ATMs and use of Post offices. In urban and even in rural areas where mobile phones have penetrated, banks could use mobile technology for facilitating banking transactions. Mobile phones can be used to transfer funds real time from and to bank accounts and could make remittances and payments at very low cost. Once the data base and track record is established, a multitude of financial services can be offered including savings, remittance, transaction banking such as receipt of salaries, pensions and payments for utilities, loan including home loans, insurance and MF products. Here the branches can render more business and variety of products to existing clientele as also source new customers within the area of operation. Financial inclusion offers a huge potential for business in terms of resources and assets and banks therefore need to take aggressive steps to use technology, business processes and personnel to be able to exploit this potential in innovative and creative ways.

In a branch banking model, local community based organizations or respected persons could be used to deal with the information asymmetry problem by leveraging the knowledge about customers available with such entities /persons to reduce credit risk and transaction cost. Even if post offices and post men are not used for actual delivery of services, they can be used for the invaluable information and data they possess for direct marketing. There are a number of such organizations and delivery channels- including retired bankers and school teachers- who can be used for such credit enhancements in the form of reliable information.

In fact use of technology is critical in building up a reliable credit information system, build up data base on customers for a variety of purposes, thereby reducing the transaction cost involved in checking encumbrances and collaterals and also facilitating better pricing of risk.

A South African IT initiative worth emulating is the ‘MZANSI’ account. This account, a National no frills Bank Account (NBA) product that caters to the needs of the un-banked population of South

Africa was established to use existing distribution networks of banks, government and other bodies. It was envisaged that NBA will attract 4 million potential customers over period of 5 years. In its first year of operation itself, it garnered nearly two million accounts.

Salient features of the MZANSI Account are:

- The product is card based and launched at a very affordable price
- It is first of two 'first order savings / transmission products' aimed at extending penetration of banks into first order markets.
- Access to the NBA product is provided through a combination of existing service point outlets & physical branch outlets including own and shared ATMs, Post offices, and merchant POS devices.

There is a money transfer service associated with the MZANSI account which makes it possible to transfer money between un-banked / banked customers from any participating bank or South Africa Post Office. All banks in South Africa are participants in this unique venture. As it is a very technology intensive product, the transaction costs are very low and thus, what were thought to be as 'too costly to serve areas and people' have became attractive propositions.

State Governments such as in Andhra Pradesh are actively looking at making pension payments as also disbursals under REGP through use of smart cards linked to bank accounts. The same card could be used for social security programs as also banking transactions and can act as a unique identifier card. All relevant details relating to the person can be stored on the card with bio-metric identification. Experiments are under way for low costs ATMs with biometric identification for withdrawal of cash that could enable a low cost and therefore a more sustainable way of financial penetration and outreach while ensuring safeguards against foul play.

RBI is setting up an Advisory Group on IT solutions for financial inclusion and it is hoped that collaborative effort between banks governments and post offices will be facilitated by the deliberations of this Group.

Use of intermediaries

A recent paper by the CGAP refers to the potential for increasing outreach through branchless banking where two models have been detailed, viz., the bank-agent model and the e-banking model where without a bank account a variety of financial transactions can take place through e-money. The paper outlines “agency risks” and “e-money” risks and issues for regulators.

In India, branchless banking has to be able to ensure effective penetration into underserved areas –an example of this is the SHG-Bank linkage program. Up-scaling this program for financing productive activities and synergizing local entities for providing ancillary and collective services required for improving bankability of activities has to be the focus. While up scaling the SHG –bank linkage program, care must be taken to ensure integrity of accounting and protection of member's interest. In addition up scaling requires knowledge enhancement and capacity building. For example Village knowledge centers set up by a public sector bank at some of its rural branches has enabled more productive lending and increased good business at such branches.

The use of intermediaries such as post offices and others raises the issue of agent related risks. Most of the agent related risks detailed in the CGAP paper have also been spelt out in the report of the Khan Committee and the RBI guidelines on use of business correspondents and facilitators and the final outsourcing guidelines released yesterday. Use of intermediaries is helpful where the intermediary actually enables reduction of risk, such as use of SHGs where the group discipline and social capital act as credit enhancements. The use of MFIs which engage in capacity building of the group members and also in providing "credit plus" services enable banks to minimize credit risk by improving viability while expanding outreach to large number of poor customers. There are concerns arising out of allowing agents to accept cash repayments and deposits and that is why online biometric devices linked to bank accounts real time are preferable to offline models. Other risks that need to be addressed are operational risk, reputation risk, legal risks, liquidity risk, consumer protection, including resolution of consumer grievances as also those relating to AML.

Finally what are some of the lessons for leveraging existing branch network, IT and intermediaries for financial inclusion?

Firstly, there should be clear focus on relatively unbanked and underserved areas rather than competing aggressively in already well served areas. There is a clear need to vastly increase the numbers served by existing branches for savings loan and remittances. It is hoped the new KYC norms for small value accounts will go a long way in ensuring this.

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Secondly, financial inclusion should be led by understanding the needs of the customer rather than achieving targets. In rural areas banks should reach out rather than expect playing a numbers game. A well planned strategy should focus on customising products for transactions, remittances, savings, loans and insurance. Improving financial literacy and credit counseling in fact should precede delivery of financial products. In fact a localized approach would require banks to rethink their policy on having uniform products for the entire country. Communication should be in local language and in tune with local culture to remove barriers.

Third, technology can be leveraged to increase delivery channels at lower cost, have better internal control systems and MIS, enhance the efficiency safety and integrity of the payments and remittances system and develop a reliable credit information system. A well functioning payments system itself improves economic activity and its efficiency.

Fourth, for rural areas, financial services will need to be supplemented by organising support for ancillary activities and knowledge dissemination. Farmers training centers, village knowledge centers, RUDSETIs set up by a few banks will need multiplication for ensuring sustainable development.

Fifth, the SHG program has become quite widespread. As at March 2006, 2.2 million SHGs were linked and Rs 11400 crore credit provided to them. There is need for up scaling to cover productive loans while ensuring that the process of group formation and capacity building is given sufficient time to allow social capital and democratic processes to take root. Transparency in accounting and book keeping and financial education of members should be part of due diligence undertaken by banks.

Sixth, the real value of NGOs and MFIs lie in their role as providing “credit plus” services and not just functioning as an intermediary for onlending. Banks with their resources and scale have greater cost advantages but linking with community based organisations and local persons /entities would help them get over the information gap and access barriers.

Seventh, while using agents, customer’s rights need to be safeguarded to ensure there is no mis-selling or deficiency in services. .

Eighth, RRBs and well functioning cooperatives can be supported by banks to increase outreach. Sponsor banks have a specific responsibility in this regard and need to take ownership for their sponsored RRBs. Unlike other parts of the financial system, the RRBs with nearly 14500 branches are concentrated in the regions that are relatively backward and populous but where the incremental prospect for business and banking penetration is high. HR, technology and processes and leadership issues need to be addressed if RRBs are to fulfill what is expected from them.

Last but not the least, the role of the State Governments in facilitating financial inclusion is critical. Land settlement rights, computerization of land records, and providing economic and social infrastructure with pro-active agricultural extension machinery will greatly help in using financial inclusion for sustainable development. Also leveraging the use of IT by collaborative efforts between banks and State Governments can prove to be a win win situation.

Thank You