BANCON 2011

Gateway to a defining decade

Financial Inclusion and Financial Stability: Are they two sides of the same coin?

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Financial Inclusion and Stability: Are they two sides of the same coin?

- Two dimensions of economic issues have shaped the tone and tenor of financial sector policies over the last decade or so……………
  - Financial inclusion based on the principle of equity as…
    - *The glass remains half full!*
  - Financial stability
    - With its implications for growth and welfare…
    - …. Especially for people with low levels of income having little headroom to bear downside risks

Financial Inclusion and Stability: Are they two sides of the same coin?

- Pursuit of financial inclusion and of financial stability
  - No longer policy options but policy compulsions.
- **The key challenge**: Achieve the goal of financial inclusion without compromising the stability of the financial system.
- **The key question**: Does increased access to formal financial services work in tandem with policies enhancing financial stability or does it work at cross purposes and jeopardize financial stability ….
- ***Are inclusion and stability two sides of the same coin?***

Financial Inclusion & Financial Stability : Are they two sides of the same coin?

- **Mandatory co-existence**
- **Working in tandem**
- **Working at cross purposes**
- **Facilitating Financial Inclusion & Stability through Regulation and Literacy**
- **The Indian experience**
- **Concluding remarks**

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Mandatory Co-existence ....(1)

- Financial inclusion and financial stability must coexist*…
  - Increasing financial inclusion difficult unless
    - Banks and other financial service providers are sound;
    - Financial markets are functioning normally; and
    - Financial market infrastructure is robust.
  - Continuing financial stability is difficult to envisage when chunks of the socio-economic system remains financially excluded.

**The transmission channels and potential feedback loops between financial stability and inclusion could be a subject of further research.*

Mandatory Co-existence…….(2)

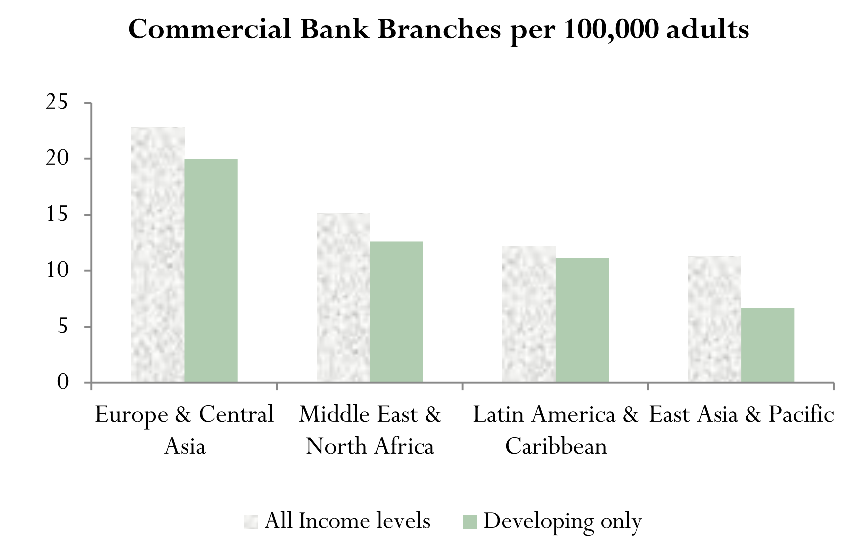
- Benefits of financial inclusion are well understood
  - Inclusion can uplift financial conditions and standard of living
  - Increase economic activities and employment opportunities
  - A higher disposal income and hence a wider deposit base
  - Greater business opportunities for the banks in volume and range of products
  - Increase efficiency of social welfare schemes & reduce leakages
  - Lead to "**complete markets**"

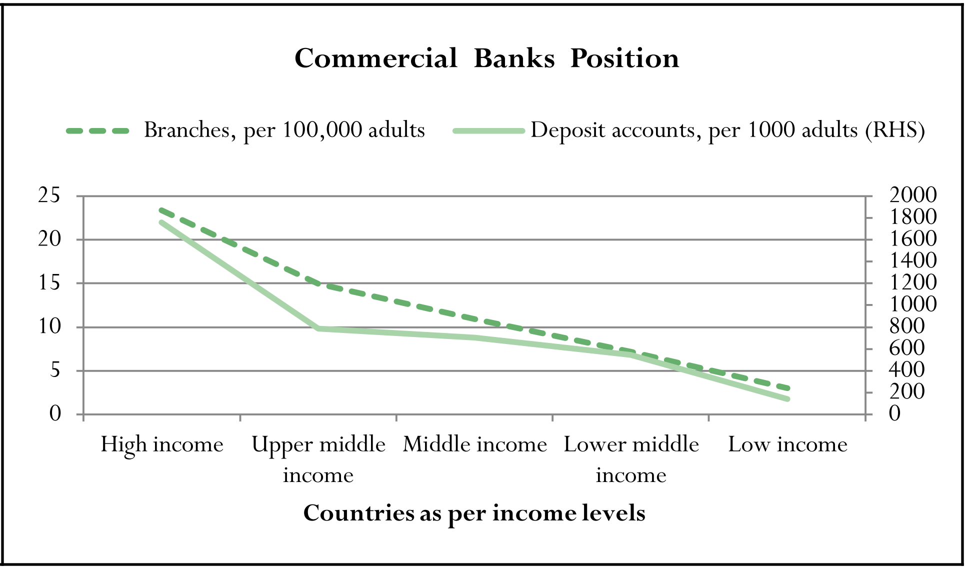
- Link with stability is dialectic…
  - Stability, poverty and backwardness cannot coexist in the long term
  - Difficult to sustain economic growth void of social development

Financial Inclusion and Stability

Mandatory Co-existence…….(3)

- An analysis of World Bank Development Indicators implies a strong link between financial access and development
- Empirical evidence* suggests a distinct rise in income level of the countries with higher number of branches and deposit accounts of commercial banks, i.e., with higher financial access





**Could be subject of further research*

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Working in Tandem……….(1)

- Improve the efficiency of the intermediation process
  - Changed composition of the financial system leading to a diversified and more resilient financial sector
    - Low income savers and borrowers tend to maintain steady financial behaviour throughout the crisis both in terms of deposit keeping and repayments (**Small customers: Stable market**)
    - Thus, during systemic crisis, a steady deposit base is ensured even as other sources of funds are affected……
      - ….in the absence of which, the credit channel may be affected heightening the impact of the crisis on the local economy
- Movement from the informal "cash" system to the formal banking system
  - Improves transmission of monetary policy
  - Facilitates implementation of AML/CFT guidelines

Financial Inclusion and Stability

Working in Tandem ………..(2)

- Enhanced financial stability through
  - Improved health of the household sector
    - Improved economic linkages
    - Reduced reliance on the costly informal sector
    - Improved ability to make payments
  - Improved health of small businesses
    - Improved access to financial system and the quality / cost of credit
  - Improved health of the corporate sector
    - A more resilient corporate sector through reduced cost of credit and a more congenial environment for business expansion
- Greater financial innovation facilitates cost reduction and increases the overall efficiency of the economy
- Greater financial inclusion fosters financial stability through greater social and political stability

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Working at cross purposes…….(1)

- Over extension of credit – Sub prime borrowers?
  - Affects the quality of credit portfolios
  - Regulatory/governmental forbearance could vitiate the prevailing credit culture
  - Could sow the seeds of financial fragility and instability

- Financial institutions catering to the less developed, low income markets face…
  - A greater degree of information asymmetries associated with customers typically without collateral or a credit history
  - The large number of low ticket transactions are associated with higher operating costs and lead to lowered efficiency

Working at cross purposes……..(2)

- Financial innovations
  - Add elements of uncertainty under stressful conditions (e.g. for the transmission of monetary policy)
  - Are typically susceptible to risks of vendor concentrations especially in the early stages of the innovation
  - *Bank led models, however, provide regulatory comfort*
- Outsourcing of financial inclusion services poses risks some of which could have a systemic impact
  - Reputational, financial and fidelity risks
  - *Requiring assessment and management by principals e.g. banks….*
  - *And careful design of compensation structures to ensure the success of the model and to prevent its misuse*

Working at cross purposes…….(3)

- Specialized (non-bank) institutions which cater to the financial needs of the low income group (e.g. micro finance institutions)
  - Face concentration /funding risks… and can contribute to overall systemic risks
  - *Greater involvement of banks in initiatives for financial inclusion can play a role in mitigating these risks*
- Increased access to financial services increases risks of the services being used to launder illegally obtained funds and to fund terrorist activities
  - Person to person remittance is a high risk activity in this context
  - Regulatory forbearance in the form of relaxed KYC guidelines could pose risks in this context
  - *Again, bank led models provide regulatory comfort*

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Facilitating Financial Inclusion & Stability through Regulation and Literacy

- A facilitative regulatory and supervisory environment can help in exploiting the synergies between greater financial inclusion and financial stability
  - Soundness of financial institutions
  - Robust consumer protection guidelines
  - Greater financial literacy and education
  - Effective credit information bureaus
  - Promoting new lines of businesses with idiosyncratic risk profiles whose contribution to systemic risk is relatively low
- But… regulation needs to be commensurate with risks to ensure that it does not contribute to financial exclusion (e.g. through too rigorous KYC norms)
  - …The regulatory framework for basic financial services needs to be calibrated according to contribution to systemic risks

Summing Up……..

- The twin objectives of financial stability and financial inclusion
  - Two sides of a coin….. but can work at cross purposes unless…
  - …….A risk-mitigating framework to exploit the complementarities while minimising the conflicts is adopted and
  - Greater awareness and literacy are encouraged.

- Achieving sustainable financial inclusion will require a systemic effort which leverages technology, business models and an appropriate regulatory framework which fosters financial stability.

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The Indian experience……… (1)

- Financial Inclusion
  - Policy objective almost since the outset … though the term financial inclusion has come into vogue more recently
  - The Reserve Bank is perhaps the only central bank in the world which attempts to reach the remotest locations of the country in a bid to create awareness and promote inclusion!

- Financial Stability
  - Pursuit of financial stability has always under-scored policy decisions of the Reserve Bank and especially since the BOP crisis of the early 1990s…
  - … and has been adopted as a formal policy objective since 2004.

Financial Inclusion and Stability

The Indian experience……… (2)

- The objective of financial inclusion has been pursued….
  - Through a framework which is largely bank led and banks are closely regulated and supervised entities in the Indian context
  - Importantly, the broad compulsions of the health and resilience of financial institutions have not been lost sight of.

- The policy thrust has been on promoting financial inclusion within an enabling regulatory environment without losing sight of the underpinnings of financial stability

Financial Inclusion and Stability

The Indian experience……… (3)

- Branch licensing policy…
  - Based on the principle of encouraging penetration of bank branches in un-banked areas has…
  - Provided banks in India with a strong base of stable core deposits
- Mandated priority sector lending
  - To encourage flow of credit to the less privileged…
  - Without any interest subvention
  - Usual prudential norms of capital adequacy, asset classification and provisioning applicable…
  - ….To ensure that quality portfolios are built up

The Indian experience……… (4)

- Non-banking and non-financial entities permitted to offer payments and limited remittance services
  - Payment services operated by non-banks brought under regulation after the notification of the Payment and Settlement Systems Act, 2007
  - The broad approach is that these entities will provide fee based services without accessing customer funds (e.g. through the mechanism of escrow accounts)
- Outsourcing in the form of the Business Correspondent/ Facilitator (BC/BF) model has been permitted
  - Guidelines are in place for banks to manage the risks arising from such outsourcing
- The Malegam Committee has recently made a spate of recommendations
  - For putting in place a regulatory framework for the micro-finance industry
  - Some of the recommendations have been implemented and will aid in ensuring that the industry plays a facilitating role in financial inclusion

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Concluding remarks…

- The Indian experience evidences that financial inclusion can work within the framework of financial stability
- Enabling this is a combination of……
  - Viable business models targeted at the bottom of the pyramid;
  - Lower transaction costs with technological innovations; and
  - A strong but enabling regulatory environment.
- The wide range of initiatives have yielded rich dividends
  - Over 50,000 villages with a population of over 2000 are covered by banking services and nearly 75 million no frills accounts have been opened till March 2011.
- However, a lot needs to be further achieved in order to realize the dream of inclusive growth without sacrificing stability.
- *The relationship between financial inclusion and financial stability is largely unexplored and present several areas of further research!*

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Thank you