*The Changing Paradigm for Financial Inclusion**

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Thank you for inviting me to address this seminar on equity, access, and inclusion. Financial inclusion is about (a) the broadening of financial services to those people and enterprises who do not have access to financial services sector ; (b) the deepening of financial services for those who have minimal financial services; and (c) greater financial literacy and consumer protection so that those who are offered financial products can make appropriate choices. The imperative for financial inclusion is both a moral one as well as one based on economic efficiency. After all, should we not give everyone access to the services we all in this room enjoy? Moreover, if everyone had the tools and resources to better themselves, would this not increase output, growth, and economic prosperity?

It would be fair to say that while we have made tremendous advances since independence, we have still some way to go to ensure widespread financial inclusion. What are the economic impediments to greater financial inclusion?

Perhaps the most important is the economic condition of the excluded. World over, the poor, the small, and the remote are excluded. It is not just because the financial system is underdeveloped, but because they are hard to service profitably. Nevertheless, this is not a reason to abandon hope, but to ask how we can overcome the impediments in the way of inclusion. The best way to characterise the impediments are through the acronym IIT: Information, Incentives, and Transaction Costs.

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IIT

The excluded may live in remote areas or may belong to communities or segments of society that undertake economic activity informally – they do not maintain records or have signed contracts or documentation. They often do not own property or have regular established sources of income. As a result, a banker, especially if as is typical, he is not from the local region, will have difficulty getting sufficient information to offer financial products.

A second concern is incentives. For example, loans are easily available only if the lender thinks he will be repaid. When the legal system does not enforce repayment quickly or cheaply, and when the borrower does not have any collateral to pledge, the lender might believe that he will find it difficult to get repaid.

The third impediment is transactions costs. Since the size of transactions by the poor, or by micro farmers or enterprises is small, the fixed costs in transacting are relatively high. It takes as much time helping a client fill out the forms and to provide the necessary documentation if he is applying for a loan for ₹10,000 as it takes to help another one borrow ₹10 lakhs. A banker who is conscious of the bottom line would naturally focus on the large client in preference to the tiny one.

How does the moneylender manage?

One of the primary motivations for the country to push financial inclusion is to free the excluded from the clutches of the moneylender. How does the moneylender boldly lend where no banker dares to lend? Because he does not suffer the same impediments! Coming from the local community, the sahukar is well informed on what everyone's sources of income and wealth are, and how much they can repay. He is quite capable of using ruthless methods to enforce repayment. Moreover, the borrower knows that if he defaults on the sahukar, he loses his lender of last resort. So the borrower has strong incentives to pay. Finally, because the sahukar lives nearby and uses minimal documentation – after all, he is not going to use the courts to force repayment -- loans are easily and quickly obtained. In an emergency or if the poor need to borrow on a daily basis, there are few more readily available alternatives than the moneylender. No wonder he has so many in his clutches.

How then should public policy approach this problem? I will now describe three approaches: mandates and subventions, transforming institutions, and moving away from credit.

Approach 1: Mandates and Subventions

One approach is to push formal institutions into reaching out to the excluded, even if it is unprofitable. This is why, for example, we mandate that banks allocate a certain fraction of their loans to the 'priority sector' and that they open 25 per cent of their branches in unbanked areas. There are also interest subventions that are made available for loans to particular sectors. Furthermore, banks have been urged to open bank accounts for all under the Pradhan Mantri Jan Dhan Yojana (PMJDY), while today they are being exhorted to make loans to small businesses under the Mudra Scheme.

Because there are positive social benefits to financial inclusion that are not captured by the service provider (what economists call 'externalities'), such mandates are reasonable from a societal perspective. For instance, the higher familial and community status a farm worker gets from starting her own poultry farm and contributing to the family income may, on net, outweigh the costs the bank incurs on making the loan. The bank cannot monetise the status benefits, but a government can decide those benefits are worth generating and mandate them.

In a similar vein, there may be network benefits from universal access – for instance, direct transfer of benefits is easier when the vast majority of beneficiaries have a bank account, and the accounts themselves will be used heavily when account to account transfers are made easier through mobile phones *via* the soon-to-be-introduced Unified Payment Interface (UPI). Mandated account opening essentially creates the universal network with its associated positive network externalities.

There are, however, a number of risks emanating from mandates. The first is that there is no market test of usefulness, and indeed, these may not be possible – how does one measure the value of the enhanced social status of the poultry farmer? So mandates are driven by the beliefs of the political leadership, and may persist a long time even if they are not effective. Furthermore, some vested interests may benefit from specific mandates and push for their perpetuation long after they have ceased being useful. Bankers themselves, seeing little profit in obeying the mandate, will try and 'achieve' it at least cost by targeting the most accessible and least risky in the eligible category, and even mislabeling normal activity so that it fits in the eligible list. Finally, some mandates fall primarily on the public sector banks. As competition reduces their profitability, their capacity to carry out mandates and still earn enough to survive diminishes.

So while acknowledging the value of mandates at the RBI, we have tried to make them more effective. For example, the list of sectors eligible for priority sector treatment has been revised, with an emphasis on targeting the truly excluded. Specifically, the share of adjusted net bank credit (ANBC) that has to go to small and marginal farmers (including share croppers) is set at 8 per cent for March 2017, and that for micro enterprises set at 7.5 per cent. At the same time, the scope for banks to meet priority sector norms without lending to the truly excluded has been reduced. For example, large loans to firms producing agricultural products no longer qualify. Also, banks are now required to meet their targets at the end of every quarter, rather than at the end of the year, which reduces the scope for window-dressing with short-term end-of-year credit. Finally, Priority Sector Lending Certificates, which allow a lender to 'sell' any over-achievement in particular categories to others who are deficient, are now being traded, thus encouraging those who have a better capacity to make such loans to do so. All in all, the priority sector mandate is now not only better targeted at the truly excluded, but will be delivered more efficiently.

Mandates are not costless. Rather than forcing banks to recover costs by overcharging ordinary customers, or by demanding recapitalisation by the government, better to bring the costs into the open by paying for the mandate wherever possible. So, for instance, accounts or cash machines opened in remote areas could attract a fixed subsidy, which would be paid to anyone who delivers them. Not only will the cost of the mandate become transparent and will be borne by the authorities, thus incentivising them to make sensible decisions about how long to impose the mandate, the mandate can be delivered by the most efficient service providers, attracted by the subsidy. This is why the RBI today explicitly subsidises cash recyclers set up in underserved areas, and why central and state governments are paying banks for maintaining and servicing specified accounts. Going forward, narrow targeting of mandates to the truly underserved and explicit payment for fulfilling the mandate so that they are delivered by the most efficient should be the norm.

Approach 2: Creating the Right Institutions

As I argued earlier, the moneylender is particularly effective because he knows the neighbourhood and its people, and can make a good assessment of who is credit worthy. A large national bank with a local branch suffers from two infirmities. First, the branch manager has typically been recruited through an all-India exam, is from a different state, and typically is not intimately familiar with the local people. While many good branch managers do indeed learn about the community, some do not. The higher socio-economic status of bank officers also creates a distance with the poorer segments of the community, and their high salary makes many branches in remote areas economically unviable even if they could solicit business intelligently. Finally, given that the excluded do not have formal documents, bank managers in large banks with bureaucratic centralised procedures find it hard to provide effective service – how does one convey to head office the rationale for a loan to an intelligent enthusiastic tribal who wants to set up a small shop, but who has no formal education or track record?

Local financial institutions, with local control and staffed by knowledgeable local people, could be more effective at providing financial services to the excluded. HDFC Bank, for example, has been very successful growing its loan portfolio in Kashmir by recruiting local youth as loan officers. Certainly, this is also the obvious lesson to be drawn from the success of micro finance institutions, who combine their local knowledge with stronger incentives for repayment through peer pressure and frequent collection of repayments. Indeed, this was also the rationale for local area banks, regional rural banks, and is a strong feature in the cooperative movement.

Yet, while there have been some grand successes among these institutions, each form has some deficiencies. Micro finance institutions do not have access to low cost deposit financing, though securitisation of loans has been a growing avenue of finance. Local area banks could not expand out of their local area, exposing them to the geographical concentration risks. Regional rural banks agitated for parity in salary structures with parent scheduled commercial banks, and having achieved parity, find that their costs are not optimally suited for the clientele they need to service. There are some very successful cooperative banks, on par with any universal bank, but far too many suffer from governance problems. The RBI has been engaged in bringing stronger governance to urban cooperative banks, but split supervision with state authorities limits how much it can do.

To provide an alternative institutional avenue for these categories of institutions to fulfil their mission, the RBI has created a new institution called the small finance bank, where 'small' refers to the kind of customer the bank deals with, not its size. With 75 per cent of the loans mandated to be below 25 lakhs, the small finance bank is intended to provide services to the excluded. Thus far, the licenses have been largely given to micro-finance institutions and one local area bank, but there is no reason why these cannot be given to regional rural banks and co-operatives in the future. The hope is that these institutions will maintain a low cost structure, augmented by technology, to provide a menu of financial services to the excluded.

New institutions can also help ease the flow of credit. For instance, credit information bureaus have helped tremendously in solving both the information and incentive problem in retail credit. When an individual knows that a default will spoil their credit rating and cut off future access to credit, they have strong incentives to make timely payments. In rural India, we need to expand the reach of credit bureaus, including by bringing borrowing under Self Help Groups into their ambit. The use of Aadhaar in identifying individuals will also help eliminate duplicate records, while making existing records more accurate. Going forward, by the end of the year, the Credit Information Bureau of India will start providing individuals with one free credit report a year, so that they can check their credit rating and petition if they see possible discrepancies. An important proposal by the government is to give small businesses 'Udhyog Aadhaar' numbers, which are unique IDs tied to both the entity as well as the promoter. Such IDs could allow small firms to build credit histories with credit bureaus, especially as the histories are tied to specific promoters.

Land is often the single most valuable source of wealth in rural areas. The digitisation of land records, accompanied by a guarantee of certificates of final ownership by the state government, as proposed in Rajasthan, will ease the use of land as collateral against which funds can be borrowed. Even a formal recognition of share cropping agreements, as in the *pattas* registered by the state government in Andhra Pradesh, could ease access to credit for share croppers.

As a final example, MSMEs get squeezed all the time by their large buyers, who pay after long delays. All would be better off if the MSME could sell its claim on the large buyer in the market. The MSME would get its money quickly, while the market would get a claim on the better rated large buyer instead of holding a claim on the MSME. All this will happen as the three Trade-Receivables Discounting Systems (TReDS) which the RBI has licensed, start later this financial year. The key is to reduce transaction costs by automating almost every aspect of the transaction so that even the smallest MSMEs can benefit.

Approach 3: Don't Start with Credit

We have been trying for decades to expand credit. We have focused much less on easing payments and remittances, on expanding remunerative savings vehicles, or on providing easy-to-obtain insurance against crop failures. In the emerging financial inclusion paradigm, the Government and the RBI are trying to expand inclusion by encouraging these other products, allowing credit to follow them rather than lead. Indeed, many successful organisations working with the poorest of the poor try to get them to put aside some money as savings, no matter how little, before giving them loans. Some of our self-help groups (SHGs) work on this principle. Not only does the savings habit, once inculcated, allow the customer to handle the burden of repayment better, it may also lead to better credit allocation.

Easy payments and cash out will make formal savings more attractive. Today, a villager who puts money into a bank has to either trudge the 'last miles' to the bank branch to take out her money, or wait for an itinerant banking correspondent to come by. We are engaged in strengthening the network of banking correspondents; by creating a registry of banking correspondents, giving them the ability to take and give cash on behalf of any bank through the Aadhaar Enabled Payment System (which will also give them adequate remuneration), and requiring that they are adequately trained in providing financial services. Cash-in-cash-out points will expand soon as the Postal Payment Bank and telecom affiliated payment banks make post offices and telephone kiosks entry points into the financial system. Perhaps most interestingly, transfers from bank account to bank account will become easier in a few weeks *via* mobile through the Unified Payment Interface. A villager needing to pay a shopkeeper only needs to know the latter's alias – say Ram@xyzbank.psp. He feeds that into his mobile app, writes the payment amount, puts in his password, and presses 'send' and the payment is made, with both getting messages to that effect. Neither needs to visit the bank to take out or deposit money, no point of sale machine is needed. With the price of smartphones falling sharply, we are on the verge of solving the last mile problem.

With the power of information technology, perhaps the analysis of the savings and payment patterns of a client can indicate which one of them is ready to use credit well. Small businesses, which use the services of an on-line internet platform to sell, can establish a verifiable record of revenues that can form the basis for loans. Indeed, we are encouraged by the emergence of full service entities that help the small business with marketing and logistics, while tying up with a finance company to provide the business with credit. This will help the carpet seller from Srinagar advertise his wares to the world, even while expanding his business. We also propose to encourage peer-to-peer lending platforms with light-touch regulation, anticipating that they may have innovative approaches to gathering the information necessary to lend.

Some Issues

Having highlighted the various approaches to expand inclusion, let me now focus on some important issues that arise in managing the process. These are 1) Know your customer requirements 2) Encouraging competition to prevent exploitation 3) Ensuring some flexibility and forgiveness in financial arrangements 4) The need for skilling and support 5) Encouraging financial literacy and ensuring consumer protection.

Know Your Customer

Missing basic documentation is often an impediment to obtaining financial services. Knowing this, the Reserve Bank has steadily eased the required documentation for basic financial services. For instance, recognising that proof of address is difficult, especially for those moving location, the RBI requires only one document showing permanent address be presented. Current address can be self-certified by the account owner, preventing the considerable problems customers face when they migrate inside the country. Unfortunately, the RBI's instructions sometimes do not percolate to every bank branch – which leads to unnecessary harassment for consumers, as vividly described by a columnist recently. Going forward, we have asked the Indian Banks' Association to devise common account forms, where minimum RBI requirements will be printed on the back of the form. It will, for instance, become clear, that a very basic account with some restrictions on amounts and transactions can be obtained with no official documents whatsoever.

Competition to Prevent Exploitation

As I have argued, the excluded are typically risky, as well as costly to service. At the same time, they are also liable to exploitation because they have so little access. Exploitation may come from a moneylender who charges usurious rates, or a banker demanding personal gratification for giving a government-subsidised loan. The fundamental way to deal with exploitation is to increase competition amongst suppliers of financial services. Regulation can help, but we should be careful that regulation does not shut out competition, thus enhancing exploitation.

Consider two examples:

Politicians are rightfully concerned about the poor being charged usurious rates. So they often ask regulators to set interest rate ceilings. Of course, a clever regulated lender can avoid interest rate ceilings through hidden and not-so-hidden fees for making the loan. But let us assume the even cleverer regulator can ferret out such practices (not always a valid assumption). Nevertheless, there is still a problem. The lender has to recoup not just the credit risk margin which compensates him for the higher default risk of lending to those on the economic edge, but also the fixed costs of making, monitoring, and recovering small loans. If the interest rate ceiling is set too low, the regulated lender will not bother to lend since it is not worth his while. With competition from the regulated stifled, the poor borrower is left to the tender mercies of the rapacious unregulated moneylender. So interest rate ceilings have to have a Goldilocks quality – not so high that they allow the uninformed poor to be exploited, and not so low that they kill any incentive the regulated might have to lend. This is the very thin line that the RBI has been following in setting interest rate ceilings for micro finance firms. As institutional frameworks develop to reduce risk in lending, and as competition amongst lenders increases, we can lower the maximum chargeable rate.

In a similar vein, our regulations sometime prohibit the taking of collateral for loans below a certain size to certain borrowers such as students or small businesses. However, if lenders are not forced to lend, the prohibition on taking collateral may lead to borrowers who can indeed offer collateral being denied a loan. The impossible trinity suggests that you cannot limit interest rates, prohibit the taking of collateral, and still expect the borrower to have the same level of access to loans. Put differently, unless a regulation mandates lending, which they rarely do, there is always a risk that ceilings on interest rates or prohibitions on taking collateral will cut off institutional lending to some of the eligible. Our regulations must be set bearing this in mind.

One reasonable compromise between protecting the poor and ensuring they have access is to allow only unsecured or collateral-free loans to qualify for priority sector treatment or interest subventions, but to also allow institutions to take collateral if offered on ordinary loans, provided they have a policy of charging lower rates on such secured loans. While this may force some who have collateral to pledge it even if they would not have to do so under current regulations (albeit with some compensation in terms of a lower borrowing rate), it mitigates the greater evil of those who have collateral to offer being denied credit altogether. This is certainly an issue we have to reflect on.

Flexibility and Forgiveness

When people complain about the high cost of credit to small businesses, they do not realise the biggest component of interest costs is the credit risk margin, not the real policy rate. The credit risk margin is not under the control of the central bank, it has to be brought down by focusing on improving the lending institutional infrastructure, as I have argued earlier. However, even though a system that allows for strong enforcement of repayment reduces the credit risk margin lenders charge, it also imposes larger costs on unfortunate borrowers. So, for example, should a student who chose the wrong college for studies and ended up having to pay back huge loans with only a mediocre job be penalised for life? We need a system that has some flexibility in repayment, so that those who make bad choices or have bad luck can get some relief. At the same time, they should not escape all responsibility, else we will see people borrowing excessively and misusing the proceeds, knowing they can get away scot free.

Keeping this in mind, our master circular on natural calamities allows banks to restructure agricultural loans without classifying them NPA, provided there are widespread crop losses in the local area. This prevents individuals from exploiting the system, while giving collective relief when the area is hit. Similarly, we have advocated that student loans be structured with an optional moratorium period, so that a borrower can survive periods of unemployment without being permanently labeled a defaulter. Going forward, we should accept the possibility of individuals, including farmers, declaring bankruptcy and being relieved of their debts, provided this remedy is used sparingly, and the individual chooses bankruptcy as a last choice, knowing he will lose assets and be excluded from borrowing for a period.

Skilling and Support

There is a widely perpetuated myth that access to financial services is all that is necessary to set a poor farm worker on her way to riches. This is simply not true. Clearly, access to institutional credit can help her pay back a money lender, and thus give her some relief. Access to a bank account can allow her to put aside some savings, which protects them from the demands of needy relatives. But to generate income in a sustainable way, she needs help – in acquiring the skills necessary to raise chicken or cows or grow flowers, in marketing that product, and in learning how to manage funds. Often, credit offered without such support simply drives her further into debt.

Sometimes, people learn from neighbours as clusters start undertaking an activity. Sometimes people already know a marketable skill and only lack credit to buy the necessary raw material to produce or expand. More commonly, however, those who want to encourage micro-entrepreneurship have to work on a variety of supporting actions other than just credit, especially skilling. Fortunately, in India we have a flourishing NGO movement that often works with the government to provide the necessary support – as in the Jivika rural livelihoods program in Bihar. Increasingly, some banks have adopted a holistic approach to support as they encourage micro-entrepreneurship. As the Government's Skill India program expands, it will produce more people who can use credit well. Stronger linkages between the program and financial institutions will have to be built.

Financial Literacy and Consumer Protection

Finally, as the excluded are drawn into formal financial services, they will encounter aggressive selling and in some cases, outright mis-selling. At the Reserve Bank, we are conscious of our need to expand financial literacy so that the consumer is more aware. In the coming weeks, we will be launching a nationwide campaign trying to impart some basic messages on sound financial practice. We are also looking to have financial education included in the school curriculum across the country. We need to make a special effort in rural areas. The RBI, in June 2012, advised banks to set up Financial Literacy centres (FLC) in all the districts of the country. Banks have been further advised to scale up financial literacy efforts through conduct of outdoor Financial Literacy Camps, at least once a month, both by the FLCs and also by all the rural branches. Banks have so far set up 1,329 FLCs as at the end of December 2015.

In 2015, the RBI came out with 5 principles that banks had to follow in dealing with customers. We asked banks to implement this Charter of Consumer Rights, and asked them to appoint an internal ombudsman to monitor the grievance redressal process. We now will examine how banks are faring, and whether further regulations are needed to strengthen consumer protection. We will especially focus on mis-selling of third party products such as insurance, as well as the extension of adequate grievance redressal to rural areas, including through the RBI's ombudsman scheme.

Conclusion

The country has come a long way in the process of financial inclusion, but still has a way to go. We are steadily moving from mandates, subsidies, and reliance on the public sector banks for inclusion to creating enabling frameworks that make it attractive for all financial institutions to target the excluded, even while the interests of the excluded are protected through education, competition and regulation. I am confident that in the foreseeable future, we will bring formal financial services to every Indian who wants them. Financial inclusion will be an important element in ensuring access and equity, necessary building blocks for the sustainable growth of our country. Thank you.