*Financial Regulation and Financial Inclusion - Working Together or at Cross-purposes**

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The case for financial inclusion is not based on the principle of equity alone – access to affordable banking services is required for inclusive growth with stability. Achieving financial inclusion in a country like India with a large and diverse population with significant segments in rural and unorganised sectors requires a high level of penetration by the formal financial system. Even in areas that are well covered by banks, there are sections of society excluded from the banking system. Political and social stability also drive financial inclusion. In the recent period, in countries like India, government has been encouraging opening of bank accounts by providing government benefits through such accounts. ICT solutions have made such initiatives possible at relatively low cost.

2. Financial inclusion is not merely providing reliable access to an efficient payments system. Many discussions – especially in the context of mobile phone – led retail payments system – seem to focus on this aspect of financial inclusion. Financial inclusion is also not just micro-finance. Financial inclusion represents reliable access to affordable savings, loans, remittances and insurance services. We in India believe that financial inclusion primarily implies access to a bank account backed by deposit insurance, access to affordable credit and the payments system.

3. The key question is – What is the kind of regulatory and supervisory mechanism that will ensure that the formal financial system delivers affordable financial services to the excluded population with greater efficiency without compromising on acceptable levels of safety and reliability?

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4. Hence, in this session on financial inclusion and financial regulation, drawing from the Indian experience, I am going to focus on the following issues :

- Is there a trade-off between financial inclusion and financial regulation – are they at cross-purposes or do they work in tandem?
- What have been the various regulatory interventions in India to facilitate financial inclusion?
- What has been the approach to regulating non-bank intermediaries and entities providing innovative and low cost solutions for financial inclusion?
- What are the important consumer protection issues in the area of financial inclusion and what has been the regulatory approach?

Financial regulation and financial inclusion – is there a trade-off?

5. The last year was the Platinum Jubilee year of the Reserve Bank of India. As part of the celebrations, several outreach activities were undertaken at remote unbanked areas. During these visits, we were often asked by the people about 'fly-by-night' operators who had vanished with their life savings. The distress to people and the damage to public confidence caused by such unscrupulous operators are something that no regulator can ignore. Sound and reliable deposit-taking entities, backed by deposit insurance for small deposits, accessible to all are, therefore, essential for financial inclusion. It is not possible to have sound and reliable deposit-taking entities and a deposit insurance system without financial regulation. Hence, in my mind, there is no doubt that financial regulation and financial inclusion work together – the former is a must for the latter.

6. Another reason why there is convergence between financial regulation and financial inclusion is that if financial intermediaries have to deliver affordable services they need to take advantage of technology and economies of scale – this requires them to grow to some optimal size. Such growth is not possible without capital. Investors and lenders are comfortable with providing more funds only if such entities are regulated. This was our experience with micro-finance institutions (MFIs) wanting to be registered as non-banking financial companies with the Reaserve Bank, but wanted us to reduce the minimum capital requirement below what we had prescribed for non-banking financial companies in general. We allowed them to register, on fulfilling the prescribed norms, without lowering the minimum capital requirement. The dramatic growth of MFIs in the recent period on account of support by lenders and investors owes in no small measure to their being registered with RBI as non-banking financial companies (NBFCs).

7. More recently, in the context of the global crisis, it is observed that undue reliance on borrowed funds can be a source of risk and a more stable retail base of deposits is good for both the bottom line and resilience. Similarly, a diversified asset portfolio lends to less volatility in earnings. Thus, financial inclusion which can promote such a retail and diversified portfolio – in assets and liabilities – also promotes financial stability.

Regulatory interventions for facilitating financial inclusion

8. In this section, I would like to highlight the various regulatory measures taken by the Reserve Bank to facilitate financial inclusion. The key message here is that the regulatory approach has not compromised with prudential norms for deposit-taking entities. We are of the firm view that only sound and strong institutions can deliver financial inclusion. Within the overall traditional prudential framework, what we have tried to do is to have a system of incentives and disincentives that further the financial inclusion objective and, while doing so, we have tried to balance the degree of the risk with the ability to achieve greater penetration.

Is small beautiful?

9. Looking at the success of credit unions and community banks world-wide in providing financial services to local communities, it could be argued that smaller regional banks could be the answer for financial inclusion. However, our experience with local entities such as co-operative banks, deposit-taking non-banking financial companies and regional rural banks highlighted the risks of poor governance, connected lending, geographic concentration leading to vulnerability to natural calamities and downturns. Small entities also tend to absorb disproportionate share of supervisory resources. Besides, the adoption of ICT solutions that are essential for accessing mainstream payments system requires larger investments and these often prove to be too onerous for small entities and render them uncompetitive. We have encouraged merger of non-viable entities and growth of banks that meet regulatory requirements. We have also followed a three-tiered regulatory approach – 'non-Basel' approach for regional rural banks and rural co-operatives with the objective of ensuring positive net worth, 'Basel-I' for urban co-operative banks and 'Basel II' for commercial banks. For non-banking deposit-taking entities, that don't enjoy deposit insurance or offer savings/ checking accounts, we have adopted a simpler regulatory framework *albeit* with higher capital ratios.

Allowing banks to open accounts for Self-Help Groups

10. An important regulatory dispensation that facilitated financial inclusion was given in the early, 90s, when banks were allowed to open savings accounts for Self-Help Groups (SHGs), which were neither registered nor regulated. An SHG is a group of 15 to 20 members from very low income families, usually women, which mobilises savings from members and uses the pooled funds to give loans to those members who need them, with the interest rates on deposits and loans being determined entirely by members. National Bank for Agriculture and Rural Development (NABARD) launched the SHG–Bank Linkage Program in 1992 to forge the synergies between formal financial system and informal sectors. Under this programme, banks provide loans to the SHGs against group guarantee and the quantum of loan could be several times the deposits placed by such SHGs with the banks. The recovery rates of such loans have been good and banks have found that the transaction cost of reaching the poor through SHGs is considerably lower as such cost is borne by

the SHG rather than the bank. Interest earned from group members is retained in the group. The penetration achieved through SHGs has been very significant. As per NABARD's report on status of microfinance (2008-09), about 86 million poor households are covered under the SHG-Bank Linkage program with over 6.1 million saving-linked SHGs and 4.2 million credit-linked SHGs as on March 31, 2009.

11. The initial phase of SHG movement saw concentration of SHGs in the southern parts of the country, but now the SHGs have spread more to the eastern and north-eastern regions where the extent of financial exclusion is greater. The Government of India has also been using the SHGs for subsidy-linked credit schemes for the poor. NABARD offers grant assistance to NGOs that promote SHGs and link them to banks.

Mandated priority sector lending

12. Priority sectors broadly include agriculture and allied activities, micro and small enterprises, education, housing and micro-credit. All domestic commercial banks are required to allocate 40 per cent of their lending to the priority sectors. For foreign banks, the requirement is 32 per cent and export credit is also included in their case. Credit extended by banks to SHGs, micro-finance institutions, to NBFCs for on-lending to priority sector, and to regional rural banks for agriculture and allied activities have been included in the definition of priority sector. Investments made by banks in securitised assets, representing loans to various categories of priority sector which are originated by banks and financial institutions, are also included in priority sector. A bank can also purchase priority sector lending from another bank though participatory notes. Any shortfall in priority sector lending is required to be deposited in special funds maintained by NABARD/SIBDI/NHB, which are used for funding rural infrastructure/micro-enterprises/housing sectors. As on March 31, 2009 the coverage under priority sector was to the tune of 51 million loan accounts. While it could be argued that mandated credit distorts allocative efficiency of the banking system, I would like to emphasise that no subvention is involved as interest rates are deregulated and all the usual prudential norms for income recognition, asset classification and provisioning, as also standard risk weights are applicable, which ensures that such loans do not add undue risk to the bank's balance sheet.

Linking branch licensing approvals to penetration in under-banked areas

13. Under the current laws in India, every bank requires a license from the Reserve Bank for opening a branch. This legal requirement has been used as a regulatory tool for furthering financial inclusion. Statutory approvals for branch licenses in more lucrative centres are linked to the number of branches opened in under - banked districts and States, as also other factors such as fulfilling priority sector obligations, offering no-frills accounts and other parameters to gauge achievements in financial inclusion and in customer service.

Opening of no-frills accounts by banks

14. Taking the view that access to a bank account can be considered a public good, in 2005, the Reserve Bank directed all banks to offer at all branches the facility of 'no- frills'

account to any person desirous of opening such an account. These accounts have nil or low minimum balances and charges, and have limited facilities. Since 2005, over 39 million no-frills accounts have been opened. However, there are certain barriers that inhibit the active operation of such accounts like the time and cost involved in reaching the nearest branch where the accounts have been opened. Hence, we have, as will be described below, allowed branchless banking to ensure that these accounts are more accessible to their holders.

KYC regulations for small value clients and transactions

15. One significant area, where we found that regulation could be a challenge in achieving greater financial inclusion, is in regard to Know Your Customer (KYC) norms. In a country where most of the low income and poor people do not have any document of identity or proof of address, it is very difficult to have KYC norms that insist on such documents. At the same time, to ensure integrity of financial transactions, it is necessary that each customer is properly identified before accounts are opened. In rural areas, this is addressed by asking for identification by local officials and requiring a photograph of the account holder. Drives for financial inclusion locally have been achieved through active involvement of government in the identification process. In big towns and cities where there are a large number of migrants who do not have any documents, fulfilling KYC norms and opening a bank account continue to be a challenge. As a proportional regulatory dispensation having regard to the degree of risk, the Reserve Bank has simpler KYC norms for small value accounts where the balances in the account do not exceed about $1000 and where the annual credits in the account do not exceed about $4000. There are similar dispensations for walk-in clients for small remittances and payments not exceeding US$ 1,000.

16. Recently, the Government of India constituted the Unique Identification Authority of India (UIDAI) to issue a Unique Identification Number (UID) with biometric recognition to every resident of the country. It is expected that by latter part of this year, the UIDAI will begin issuing UIDs and roll out 600 million UIDs in a phased manner by 2014. UID enrolment would be done with the help of State Government machinery and other Registrars. Banks could benefit by synchronising opening of bank accounts for those who will be enrolled through this exercise. Government is also looking into the possibility of converting food and fertiliser subsidies into cash payments which will flow through bank accounts. This project is a unique opportunity to leverage UID, bank accounts and mobile telephony services. Using UID for fulfilling KYC for small value accounts will facilitate financial inclusion. In a country with deep penetration of mobile phones, this is expected to give a boost to the financial inclusion while ensuring the integrity of financial transactions.

Branchless banking

17. With 600,000 villages in the country, we realised that it was impossible to provide access to a bank account for every household through branch banking. At the same time, electronic banking for such a populace where cash forms the dominant payment mechanism, is unlikely to become

a reality for quite some time. Keeping in view these ground realities, the Reserve Bank issued the business correspondent guidelines in 2006, which paved the way for branchless banking through agents. The guidelines allowed, for the first time, commercial banks to offer simple savings, loan and remittance products through agents, who were allowed to undertake banking transactions, including 'cash in cash out' transactions at locations close to the customer. Banks were advised as part of risk management to adopt ICT solutions including biometric identification of the customer. The agents are required to deposit bank's cash balances beyond certain limits with the bank's branches by end of day or the next day. Initially, the regulations restricted the entities that could act as business correspondents to 'not for profit' entities such as NGOs/co-operatives/post offices, *etc.* This was because we were concerned about the risk of reckless pushing of products by agents whose sole incentive was earning commission; it was also felt that local community-based organisations and NGOs had the trust and confidence of the local population. Over the last few years, the list of persons who can be appointed as business correspondents has been relaxed to include individuals such as retired government officials, school teachers, defence personnel as also 'for profit' local 'mom and pop' shops, petrol pump/public call office operators, *etc.* – entities that usually deal in cash in the villages. Another regulatory requirement was that the business correspondents appointed for direct contact with the customers should be within 30 km from a designated base branch of the bank to ensure proper oversight of such agents and minimise agency risk. The distance criteria can be increased in consultation with the District Consultative Committee, a forum for bankers and government officials that meets each quarter. Initially there was a restriction on the bank in recovering any charge from the customer for such doorstep service as it was expected that the savings in cost of setting up a branch would be sufficient incentive. Subsequently, following a comprehensive review of the business correspondent guidelines, we have relaxed this condition and banks are now allowed to recover reasonable charges from the customer for providing the service. Branchless banking illustrates an area where there have been progressive relaxations of the regulations for furthering penetration while ensuring consumer protection.

Deregulation of interest rates for small loans

18. Currently, interest rates for loans up to Rs.2,00,000 (about US$ 4,200) in the priority sector are capped at the prime lending rates of banks. The Reserve Bank has taken a decision to free the interest rates, which will come into effect from July 1, 2010. Thus, these interest rates would soon stand deregulated as long as banks ensure that the rates charged by them are reasonable and transparent. This change in policy was based on the view that financial inclusion can be viable and sustainable only if pricing is freed to cover costs even though some cross-subsidisation is possible.

Approach towards non-banking entities involved in financial inclusion

19. Non-banking entities can be either non-banking non-financial entities or non-

banking financial entities. In case of non-banking financial entities, we have had to deal with two issues. The first is the question of allowing non-deposit taking financial companies registered with the Reserve Bank, especially micro-finance companies, to provide savings facilities and deposit products for their clients. The argument put forth is that these entities are innovative and nimble-footed and have shown their ability to provide loan products to the poor. Considering the difficulties is ensuring effective supervision of large number of small deposit-taking entities and the constraints in extending deposit insurance to such entities, the regulatory approach in India has been to restrict deposit-taking activity to banks while promoting the branchless banking model for areas not served by bank branches. Hence, fresh approvals to NBFCs for accepting deposits are not considered, while capital, liquidity and leverage requirements have been tightened for those already permitted to do so.

20. The second issue is that of allowing non-banking financial companies especially micro-finance companies to act as business correspondents of banks for branchless banking. The argument put forward is that this would enable their clients to access insured deposits, national payments system and remittance services. There have also been demands that large 'for profit' companies having a wide network of outlets especially in rural areas, could be allowed to act as business correspondents of banks as there could be significant synergies if such networks are leveraged upon. This issue is currently under examination and in doing so the possible risks such as conflicts of interest, co-mingling of funds, misrepresentation and other agency – related risks would need to be weighed against possible safeguards for consumer protection.

21. Non-bank non-financial entities have emerged as active players in financial inclusion in that they have helped banks in offering customised payments and remittance services to their customers based on innovative ICT solutions. Any role enhancement of non-banks to become principals in provision of financial services implies that these non-bank entities would have to be brought under financial regulation and this could inhibit their other activities. Combining financial and non-financial business is also something the regulator may not be comfortable with as there could be conflicts of interest. Our concerns have also been on the access to and the use of float funds by such non-bank entities in the process of providing such payments services. Many jurisdictions have dealt with this issue by asking the service provider to maintain 100 per cent liquidity against float funds held by them and restricting the value of transactions. Whether the escrowed funds/ investments will be protected in the event of bankruptcy of the service provider depends on the legal provisions and there could be risks in such arrangements. In addition, there has to be clear regulatory authority over such companies. Hence, our preference is to have a bank-led system with non-bank players as partners and service providers, so that regulatory resources are focused on banks. Banks, in turn, take responsibility for their partners and agents as part of their risk management processes.

22. Subsequent to the notification of Payment and Settlement Systems Act, 2007,

the payment services have been opened up in India for non-bank service providers also. The broad regulatory approach of the Reserve Bank towards non-banks has been to permit these entities to provide payment services which are fee-based without access to funds of the customers. Indian regulations clearly spell out the role of telecom operators as service providers. However, keeping in view the penetration of mobile telephony in the country, they have been permitted to enable 'm-wallet' facilities up to Rs.5,000 (about US$ 100) in the interest of small retail payments.

Consumer protection issues

23. Amongst the various objectives of regulation, consumer protection should take priority in the context of financial inclusion. In 2005, the Reserve Bank took the initiative of setting up of the Banking Codes and Standards Board of India (BCSBI) in order to ensure that comprehensive code of conduct for fair treatment of customers was evolved and adhered to. The BCSBI is registered as a separate society and functions as an independent and autonomous body. The BCSBI has evolved two voluntary codes – one of which is a code of commitment setting out minimum standards of banking practices in dealing with individual customers. The other is a code of commitment to micro and small enterprises. Individual complaints about non-adherence to the code fall within the jurisdiction of the Banking Ombudsmen who also investigate individual complaints on non-adherence to the various the Reserve Bank guidelines on customer service.

24. Other areas of consumer protection are related to excessive interest rates and harsh recovery practices. In particular, the high rates of interest charged by non-banking micro-finance companies have attracted attention. Views have been expressed that with the lending to MFIs included in the priority sector, there should be a cap on the interest rates charged to the ultimate borrower. Efforts at financial inclusion can be sustained only if the delivery models are viable and interest rate caps can be a deterrent. From a regulatory perspective, we emphasise transparency, creating better awareness, customer education and effective grievance redressal systems.

25. Financial literacy has to be an integral part of financial inclusion and consumer protection. In fact, it should accompany and even precede the provision of financial services. Several countries have a very clearly articulated vision and programmes for financial literacy with initiative from the central banks and regulators. We too have a comprehensive financial literacy programme. At the grass-root level, financial literacy and grievance redressal is best delivered by arranging regular meetings of communities with people's representatives, local officials and bankers, NGOs and other stakeholders. The Banking Ombudsman for the region and the major controlling offices of banks attend such meetings and perhaps even hold on-the-spot conciliation meetings for complaint redressal. Ultimately, responsible borrowing facilitated by financial literacy and responsible lending by financial institutions are essential for consumer protection and financial stability.

Summing-up

30. Financial inclusion primarily represents access to a bank account backed by deposit

insurance, access to affordable credit and the payments system. The Indian experience demonstrates that financial inclusion can work within the framework of mainstream banking within a sound regulatory framework. Regulations have been used to facilitate financial inclusion without subventions or compromising on prudential and financial integrity norms. Regulations have been proportional to the risks. Innovative solutions like SHG – bank linkage, branchless banking, *etc.*, have been adopted after careful assessment of risks to the banks as also to customers. The preference has been to restrict deposit-taking to banks and non-bank financial companies are encouraged to focus on innovative approaches to lending under a lighter regulatory framework, with additional regulations for systemically important NBFCs. Non-banking non-financial players are encouraged to be partners and agents of banks rather than principal providers of financial services. Fair and transparent code of conduct enforced through an effective grievance redressal system and facilitated by financial literacy and education are the cornerstones for ensuring consumer protection which is an overarching objective of financial regulation in the context of financial inclusion.