I J A B E R, Vol. 14, No. 6, (2016): 4137-4147

FINANCIAL INCLUSION AND GOVERNANCE IN THE FINANCIAL SECTOR

Dilip Ambarkhane[*], Ardhendu Shekhar Singh[**] and Bhama Venkataramani[***]

Abstract: *The Government has been emphasizing on financial inclusionsince long time but the results have not met expectations. In a country, where 60% of the rural population is still unbanked, tireless efforts from all stakeholders are required. Inclusive finance has a critical role to play in the economic growth of the country. It helps in sustainable as well as socially inclusive growth.*

The Reserve Bank of India has constituted a Financial Inclusion Advisory Committee (FIAC) to spearhead the efforts towards greater financial inclusion. Issuing of new bank licenses, tweaking of priority sector lending, and passing of the microfinance bill are some of the recent steps in this direction. In addition, programs such as the Prime Minister's Jan DhanYojana (PMJDY), Insurance and Pension Schemes for the poor are indicators of government's commitment towards inclusion.

Evidence indicates that income is not the only deciding factor for financial access and it is vital to give equal if not more importance to other factors responsible for financial exclusion. Certain sections of the society are distinctly excluded from mainstream financial system, indicating some form of discrimination. This paper suggests a strategy for inclusion based on good governance practices.

Key words: *Financial Inclusion, Governance, India*

1. INTRODUCTION

Financial inclusion has attractedattention of stakeholders since independence. Still, majority of our population remains unbanked. For some financial players,thisis an opportunity and for others it may be asocial responsibility to fulfil.In either of the cases the question is about who will shoulder the responsibility ensuring inclusion. Do we have soft or hard infrastructure in place to support these imperatives and if not who will invest in it? All players have not shown equal

* Associate Professor, Symbiosis School of Banking and Finance, Symbiosis International University, Pune, *E-mail: dilipambarkhane@ssbf.edu.in*

** Assistant Professor, Symbiosis School of Banking and Finance, Symbiosis International University, Pune, *E-mail: shekhar.ardhendu@ssbf.edu.in*

*** Professor, Faculty of Management, Dean Academics and Administration, Symbiosis Society, Pune, *E-mail: bhama.venkataramani@gmail.com*

level of commitment towards the goal of reducing financial exclusion in the country. The public sector banks have implemented provisions like opening branches in rural areas, and mandatory rural postings for the employees. However similar provisions and actions are missing from other players.

Although Micro Finance Institutions (MFI) have done good work in this area, lack of adequate regulations have created some bad players in the industry leading to a crisis. The situation is bound to improve after passing of The Micro Finance Bill and with the Reserve Bank of India taking the charge.Accountability is another area, wherein efforts need to be channelized toidentify defaulters. In the present situation, there is no accountability attached to the players involved in the sector irrespective of the ownership pattern of organization structure.In addition, ambiguity in the provisions of priority sector has made the things worse and players take benefit of this and defeat the very purpose of financial inclusion.Against this background, it is imperative that a process is put in place to hold the financial players accountable.

The cooperative banks, which were set up for financing farmers, suffered from unsustainability due to their inability to deal with conflicting logics and undue interference by the government which remained supplier of funds, integrating them into the mainstream banking sector might improve the situation (Asher, 2007).

At the operational level, consumers are deterred with lengthy processes, behavioral aspects which inhibit them to access the formal system. Some of these issues can be easily overcome by the use of technology and by simplification of the procedures.

The proportion of unbanked population in India is highest amongst developing countries. In order to improve the situation PMJDY is launched. These accounts carry high transaction costs and low volumes. Even though sizable number of accounts have been opened under the scheme (estimated around 14 crores), large proportion of these accounts are dormant.As reported by Mishra (2015), in Gujarat, around 60% of the bank accounts opened under this scheme have no money. This has increased operational cost for the banks. This is one of the reasons banks are unwilling to implement financial inclusion agenda wholeheartedly.

The same is true of priority sector advances. High transaction cost is one of the reasons for tweaking of advances in this sector, defeating very purpose of financial inclusion. Banks are commercial organizations and are responsible for profitability and return on investment, to their stake holders. As such, banks are caught between profitability and social banking. Good governance will essentially require that the policy makers, both the Government and the Reserve Bank of India compensate the banks for the higher cost of social banking. This will ensure whole hearted participation of banks in the process and ensure high level of performance by the banks. It will be prudent as well as morally correct to enforce accountability after paying the compensation. For the same reasoning,compensationshould be paid to other financial institutions offering insurance and pension schemes.

There is large scale private money lending in India both in rural and urban areas, even though banks are lending at much lower rate as compared to local money lenders. This is because of easy access they have to money lenders as compared to banks. Banks need to simplify their documentation procedures and improve their delivery channels of small loans. This will involve higher risk and higher cost. Banks should be given some leeway in increasing the rate of interest on small lending.For the financial institutions, especially the banks, there is much room to relax lending norms, take higher risk, make access easier, and to improve trust. There is also some room to increase lending rates as a consequence of higher risk,at the same time keeping them much below the rates charged by the money lenders.

Technology can effectively reduce the transaction costs and mobile banking can revolutionize the reach of financial services in the country. The country has adequate mobile communication infrastructure,(Singh,Venkataramani, and Ambarkhane, 2014) and banks should leverage on the same.

In section 2 below, review of present strategy for inclusion is taken and its weaknesses are identified. Section 3 discusses the new strategy for making it a business opportunity. The last section brings out conclusions.

2. EVALUATING EXISTING STRATEGY FOR INCLUSION

The strategy for improving financial inclusion in the country after nationalization of banks primarily relies upon improving network of bank branches in the country especially of the public sector banks. Regional Rural Banks were set up with this objective. So also National Bank for Agriculture and Rural Development was established to strengthen the cooperative banking structure. Banks were given targets for extending credit to identified priority sectors. However all these strategies have not proved to be viable.

Regional Rural Banks have not been profitable and public sector banks have little interest in opening branches in rural areas because of high transaction costs, low volumes and poor infrastructure. The staff in PSBs is predominantly from urban areas and is posted in rural areas under mandatory postings. Even if some of them take interest, develop contacts and understand the rural environment, their short term tenure and central office controls leave little scope for initiatives. There are also other barriers such as lack of trust, inaccessibility and cumbersome documentation. As a consequence the poor continue to borrow from informal money market such as money lenders at a very high rate of interest.

The microfinance institutions have successfully moved into this area of financing the poor, but their success is constrained by several factors such as lack of well-developed management information systems and an adequate supply of trained management talent. In addition an unclear regulatory environment resulted into bad players damaging their credibility. These factors have made sustainable scaling up of MFIs difficult.

Earlier strategies for financial inclusion have met with limited success because of inefficiency and lack of transparency in pricing. The poor have remained outside the financial sector because the cost of providing services to the poor is high. The service providers think it as act of charity. The present approach of subsidizing the financing to the poor reinforces this view. The solution lies in reducing the cost of services. This will enable service providers to think financial inclusion as business opportunity and not a charity. In order to make it sustainable, inclusion has to be made more profitable as discussed in paras below.

3. FINANCIAL INCLUSION BASED ON GOOD GOVERNANCE PRACTICES

In this section, a strategy for inclusion based on principles of efficiency and transparency is suggested which will make it a profitable business opportunity It requires creation low cost structures and support services network which will reach out to the poor along with other supporting measures.

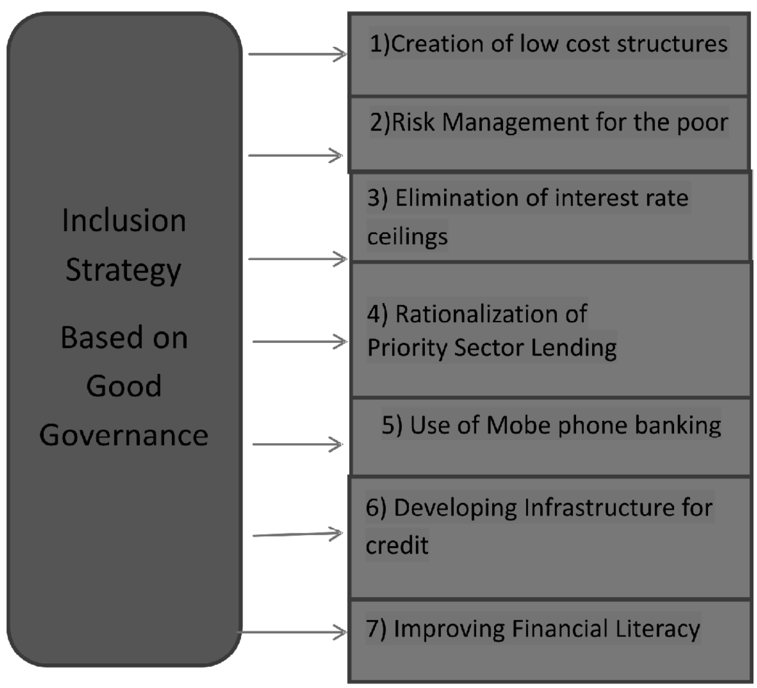

Figure 1: Suggested Inclusion Strategy

(Constructed by authors)

(1) Creation of Low cost structures: In India, low cost structures for serving the poor were attempted in form of cooperative banks and Regional Rural banks. It will be appropriate to examine as to why these are met only with a limited success.

The cooperatives in rural sector sponsored by the government have played important role in financing farmers. However these suffer from lack of good governance. The cooperative banks are plagued by excessive political interference, lack of professional management, poor credit quality and inability to manage risk. The inefficiency has crept into the system for number of reasons. As Vaidynathan committee (2004) has observed 'the cooperatives had become merely the agencies for credit dispensation'. The lendable funds of the cooperatives came from refinance rather than deposits of the members. The primary agriculture cooperative societies who finance the farmers get their refinance from District Central Cooperative banks which in turn are refinanced by State cooperative banks. This cascading system of lending adds cost of funds at each stage, putting highest burden on the poor farmers.

They also suffer from over staffing compared to their size of business consequently increasing the transaction cost and have little incentive in credit assessment and monitoring due to easy availability of refinance. So also the providers of refinance exercise very little control over loans. The loan waiver schemes by the government have totally vitiated the recovery environment resulting in mounting over dues adversely affecting profitability and further reducing efficiency.

The regional rural banks became unviable mostly because of cost structure when staff cost rose as consequence of parity allowed with their public sector counter parts. These factors need to be taken into account while developing low cost organizational structure.

However these should not discourage us from developing a case for small low cost local structures which have proved successful in US, Europe, the Philippines, and other countries (Rajan 2009). The committee on financial sector reforms headed by Rajan (2009) recommends low cost structure with following features and perceived advantages.

These features will make small loans business profitable. In fact, successful micro finance institutions and money lenders possess these characteristics. In addition, information technology can be used to reduce the cost and to improve transparency in working.

(2) Risk Management for the poor: Risk reduction as well as risk mitigation: The poor are the most vulnerable to various risks especially health and weather risks. The strategy for risk mitigation should be based on two pronged approach

Table 1
Features and perceived advantages of suggested low cost structures

Features	*Advantages*
Local	1) Better contacts and better credit information,
	2) Better understanding credit needs of rural poor
	3) Low cost structure due to local staffing at local rates.
	4) Improves accessibility
	5) Improves trust of the poor.
Small	1) Decision making near the credit delivery point. (Loan officer)
	2) Reduced loss of information in communication
	3) Quick decision
Private or voluntary (Manager has significant stake in the organization)	1) Flexible and hence customer specific handling is possible.
	2) Less documentation is possible.

Source: Rajan(2009)

based on risk reduction and mitigation through micro insurance products. Weather risk can be reduced by investments in irrigation, soil and water conservation. It can further be reduced through improved weather furcating and early warning systems. Health risk can be reduces by providing better health services.

The risk reduction strategy will help in bringing down the premium rates and bring them nearer the reach of the poor. This will in long run help in reducing the government support and the burden on the exchequer.

Micro Insurance for farmers: The Government has set up National Agricultural Insurance Scheme (NAIS) for farmers covering 16 crops. It is observed that payouts under the scheme have been higher than the amount of premium collected. This is obviously because of caps set up for oil seeds and food products. The major drawback of the scheme is inordinately long time of around 9 to 12 twelve months, required for claim settlement. The scheme can be improved by charging the premium on actuarial basis and the Government should give upfront support to Agriculture Insurance Company of India. It can be further improved by reinforcing data collection process for yields and by making part payments during crop cycle pending finalization of claims.

At present agriculture insurance is highly subsidized and true price remains outside the public knowledge. This has discouraged private sector initiatives in this sector. So also farmers view on agriculture insurance is distorted. These aspects come in the way of exploring market driven sustainable solutions. Thus improvement in efficiency and transparency in micro insurance can improve sustainability of financing farmers.

(3) Elimination of interest rate ceilings and interest rate subsidies: It is observed that around 40 developing countries in the world have tried to help the poor by using mandatory interest rate ceilings (CGAP, 2004) .These ceilings make it very difficult or at times impossible for micro finance institutions, to cover their cost of lending adversely affecting their profitability and efficiency. The interest rate ceilings retard the growth of micro finance institutions and some of them are driven out of the market. As a consequence the poor borrowers are forced to borrow from local money lenders even if they charge higher rate of interest. So also, interest rate ceilings discourage commercial banks from increasing micro finance business. The ceilings often reduce transparency in lending process. The microfinance institutions struggling to maintain their sustainability,charge different types of fees to the borrowers tocover their actual cost of lending. As such interest rate ceiling do more harm than good in promotion of financing the poor.

(4) Rationalization of Priority Sector Lending: In India, priority sector norms are prescribed for lending to underserved sectors. The setting up of targets has improved lending to these sectors in the sense that lending would have been much less in absence of norms. But none of the banks has achieved targets in respect of direct lending to agriculture sector and lending to weaker sections of society which are essentially the underserved sectors.

This was mainly because of high transaction costs and low volumes resulting into low profitability of this sector. The banks often look for the more profitable subsector amongst the priority sector. This enables them to achieve two conflicting objectives of profitability and priority lending with low returns. As a consequence, most of the agriculture lending went to indirect agriculture sector which is profitable. The regulator probably tried to strike the balance by diluting priority sector norms especially in case of agriculture and housing loans. In April 2015, the Reserve Bank of India merged the direct and indirect agriculture sectors with combined ceiling of 18%.The ceiling for priority sector housing loans was set at Rs 5.00 lacs in the beginning was increased to Rs20.00 lacs in 2006.In 2015,the celling was further increased to Rs28 for loans in metro areas. The annual income required for these housing loans will be around Rs4.00 to 5.00 lacs which is certainly not a poorer section of the society. This ambivalent approach of the regulator is coming in a way of enforcing accountability.

There is widespread feeling amongst bank officials that there is higher incidence of Non-Performing Assets (NPAs) in priority sector lending as compared to non-priority sector further reducing profitability of lending to this sector. The Reserve Bank of India studies (Reddy 2004) concluded that statistics may or may not confirm this. Against this background it is necessary, in view of transparency; that all banks should be directed to declare the percentages of NPAs in priority and non-priority sector.

The banks need to be directed clearly out of dilemma between profitability and priority sector lending which has lower returns. This should be done by introducing more transparency in priority sector lending. The solution lies in setting of strict norms for underserved sector and charging these borrowers with normal lending rates. The benefits to the poor should be directly transferred to their accounts by the government. This will not adversely impact profitability of the banks and will eliminate tweaking of priority sector norms and improve focus on financially underserved. In addition, it will enable the regulator in strictly enforcing accountability by the banks.

There is need to set up bank wise targets for priority sector lending. The present system of priority sector norms prescribes same norms for all the banks irrespective of their network or specialization in the area of lending. A bank with large rural network will have capacity to undertake agricultural lending whereas a bank with large urban and semi urban network can do well in financing small business enterprises. Moreover there can be more or less scope for a particular type of lending in area of operations of the bank. Banks with substantial network industrial areas can specialize in financing MSME or Small Scale Industries financing and are better equipped to achieve targets set for that sector. Thus instead of setting same targets for all banks for all sectors, there is need to rationalize the bank wise targets depending of network of a particular bank. There is need to adopt flexible approach on the part of regulator in setting priority sector targets for the banks.

(5) Reduction of transaction costs through mobile phone banking: Mobile banking in India is expanding very fast. The mobile technology though in initial stages is being successfully used Philippines, Kenya, South Africa and Japan. Banks in India should take advantage of expanding telecom network in the country, using it for banking transactions.The details of wireless telephones are given table below.

Table 2
Growth of wireless telephones in India during 2013-15

Year (On 31st Jan)	*Total no. of wireless Subscribers**	*Urban**	*Rural**	*Overall Teledensity (%)*	*Share(%)*	
					U	*R*
2013	862.62	528.88	333.74	70.57	61.31	38.69
2014	893.31	529.30	364.01	72.18	59.25	40.75
2015	952.34	553.45	398.89	76.02	58.11	41.89

• In millions
Source: Telecom Regulatory Authority of India, (2015)

Mobile network in India has increased by 3.56% and 6.60% during 2013-14 and 2014-15 respectively. Overall teledensity in the country has increased to 76.02%

from 70.57% during 2013-15.However the rural share in overall teledensity has increased from 38.69% to 41.89% whereas urban share has declined from 61.31% to 58.11%.

As such mobile network in rural India is expanding at faster rate as compared to urban India. It is likely that every family India will have at least one mobile phone. Thus financial transactions through mobile phone offer a good opportunity for taking banking to the poor residing at the remote locations in the country. This will reduce the transaction cost to a large extent.. Banking Correspondents with internet kiosks can be helpful in acquiring clients in large numbers. Authentication of transactions can be done through finger prints. There is a need to invest in development of this technology with emphasis on security aspects.

(6) Development of infrastructure for deepening of credit: The major constraints in deepening of credit in rural India have been lack of credit history and inability of small and informal borrowers to secure loans with collateral. There is a need to build up customer data base on credit history. Payment of mobile phone bills and payment of land revenue can be such a source of data for rural poor. This will motivate the people to build up their own credit history.

At present farmers can create mortgage of their land as collateral for securing their loans. This process is time consuming and costly. Moreover registration is merely a public notice of creating interest in the property and registering authority does not assure anything about title of the property. This leaves the lender in dark about his priority of his charge and also regarding title of the property. In view of this, as NachiketMor committee (2013) has recommended, it isnecessary that, the Government of India ,initiates a process of surveying, recognizing, validating, registering, issuing and guaranteeing land titles.

Financing against warehouse receipts is not popular amongst banks in India. It is a finance against security of harvested grains and is highly useful in improving cash flow of farmers when they need money during harvesting season. It also enables them to avoid sale when prices are low. However, this type financing could not be developed in the country mainly because of for lack of accredited warehouses. As such, total warehousing capacity available in public, private and cooperative sector in grossly inadequate. Thus there is urgent need for investment for building up warehousing infrastructure.

(7) Developing Financial Literacy: The level of financial literacy even in the developed countries is found to be low. It is expected to be low in India considering the standard of education in the country especially in rural areas. There is a need to improve financial literacy in rural areas. This will help in improving use of organized banking services and to that extent it will reduce prevalence of money lenders in the country.

4. CONCLUSION

Existing approach to financial inclusion has met with a limited success because it is not market driven. As such it is saddled with inefficiency and lack of transparency and consequently unsustainable. Mobile phone technology which has high density in the country is fast expanding in rural areas. Banks should take advantage of this and use mobile telephony as platform for banking.Considering size of the country and security risks involved, it is necessary to undertake extensive research in this area. Initially a pilot project can be launched with restrictions on size and number of transaction. The restrictions can gradually be relaxed with increasing experience and expertise. This will considerably reduce transaction cost as well as cost of client acquisition. In addition, it is necessary to take risk reduction as well as risk mitigation measures for the poor. In order to ensure that approach is market driven, interest rate subsidies or ceilings need to be eliminated. Benefits to the poor may be separately credited to account by the government. Instead of ad-hoc loan waivers in case of crop failures, risk mitigation system for the poor is required to be strengthened.

As such there is urgent need of policy shift in lending to poor on the lines mentioned above. This has to be backed by awareness or financial literacy drive emphasizing that lending by banks is cheaper and easily accessible (Singh and Venkataramani, 2014). The policy shift coupled with performance will go long way in improving inclusion.

Notes

1. All authors contributed equally.
2. Corresponding Author.

References

Asher Mukul G., (2007), "Reforming governance and regulation of urban cooperative banks in India", Journal of Financial Regulation and Compliance, Vol. 15 Iss 1 pp. 20 – 29.

CGAP, (2004), Interest Rate Ceilings and Microfinance: The Story So Far. Occasional Paper No. 9.

Mishra Piyush (June, 28, 2015), '60% of Jan Dhan accounts in Gujarat have zero balance', Times of India, available at *http://timesofindia.indiatimes.com/city/ahmedabad/60-of-Jan-Dhan-accounts-in-Gujarat-have-zero-balance/articleshow/47853488.cms*accessed on 3/7/2015.

NachiketMor committee (2013), Committee on Comprehensive Financial Services for Small Businesses and Low Income Households Report. Avaiable at *https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/CFS070114RFL.pdf* Accessed on 12/10/2015.

Rajan Raghuram (2009), A Hundred Small Steps Report of the Committee on Financial Sector Reforms.Planning Commission, Government of India.Available at *http://planningcommission.nic.in/reports/genrep/rep_fr/cfsr_all.pdf* Accessed on 5/10/2015.

Reddy, Y.V. (2004, March), Credit Policy, Systems, and Culture.Reserve Bank of India Bulletin.

Singh, Ardhendu Shekhar and Venkataramani, Bhama and Ambarkhane, Dilip (2014, August 23). Role of Mobile Banking in Financial Inclusion. Available at SSRN: *http://ssrn.com/abstract=2485777 or http://dx.doi.org/10.2139/ssrn.2485777*

Singh, Ardhendu Shekhar and Venkataramani, Bhama (2014), Financial Education: Institutes of higher education as delivery channel.*International journal of business and globalization*, Vol 12, No. 4, pp. 401-412.

Vaidyanathan, A., (2004). Draft Final Report of the Task Force on Revival of Cooperative Credit Institutions.Ministry of Finance, Government of India.

Telecom Regulatory Authority of India, (2015), Highlights of Telecom Subscription Data as on 31st January, 2015. Available at *http://www.trai.gov.in/WriteReadData/WhatsNew/Documents/PR-TSD-120315.pdf* Accessed on 15/10/2015.