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An Approach paper for the Delivery of Comprehensive Financial Services to the Informal and Unorganised Sector

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1 Introduction

A third of India's population[1] continues to live in conditions of abject poverty. Most of these people are either unemployed or are engaged in vocations that are insufficient to even meet their basic physiological needs. Studies[2] suggest that the largest number of this surplus labour will be absorbed by the tiny and very small scale enterprises, giving a big boost to the overall economy. These enterprises are diverse, in their size, employment opportunities, production of goods & services, and are spread out throughout the geography of the nation. These small enterprises are identified to be part of the informal, unorganised, or the "Residual Sector". The Planning Commission substantiates this by stating that the GDP will grow at rates upward of 8 per cent which will be sustained mainly through the unorganised sector.

Although the organised sector is clearly identifiable, it cannot be said of the informal and the unorganised sector. There are multiple overlapping definitions attempting to delineate the space for this sector.

The informal sector has been defined to include all enterprises that are not registered under any specific regulation (unincorporated enterprises), with no complete set of accounts and produce some market output[3]. This definition excludes all agricultural activities and all production for self consumption or for non market purposes. In the Indian context, the informal sector is a part of the unorganised sector, which also includes within its ambit enterprises solely engaged in non-market production, i.e. production for own final consumption and own gross fixed capital formation and all agricultural activities.

For the purposes of this note, the focus will, therefore, be on the more inclusive definition of the Unorganised Sector.

This note attempts to articulate a vision for a scaled, national, financial infrastructure aimed at delivering a complete suite of financial services to the unorganised sector. The note identifies the gaps and suggests strategies for creation of an "Enabling Environment" through investments in facilitative infrastructure for the growth of the sector. The key arguments for creation of a facilitative infrastructure are based on the following premises:

- Tiny enterprises boost the local economy, as they are considered to be labour intensive, accounting for approximately 92 per cent of the total working population of the country[4].

– It creates positive distribution of wealth because of the highly dispersed presence of the sector throughout the country. And,

– Existence of a vibrant financial infrastructure tuned to the unorganised sector, could catalyse its growth

The suggestions presented in this note draw upon successful Indian and international experiences in addressing the identified gaps.

2 The Unorganised Sector

The role of the unorganised sector in the economy of the country can hardly be underestimated. The unorganised sector employs approximately 92 per cent of the total workforce[5] and accounts for 58.5 per cent of the Net Domestic Product at factor cost[6] of the country[7]. The National Sample Survey Organisation (NSSO) Report in 1999-2000, found that the total employed workforce of India was estimated to be 397 million of which only 28 million[8] workers (8 per cent of the total workforce) were employed in the organised sector. The remaining 92 per cent of the total workers (369 million) make up the unorganised sector, comprising of 237 million workers in the agriculture sector (64 per cent), 41 million in the manufacturing sector (11 percent), 17 million in the construction sector (5 per cent) and 37 million workers each (10 per cent) employed in trade & transport and communication & services sector[9].

While the contribution of the organised sector to the GDP has increased only marginally, its contribution to the total employment has declined[10]. The total national employment during the same period has grown at the rate of 1.05 per cent p.a., attributable totally to the growth of employment in the unorganised sector.

The contribution of the organised sector in the GDP of the country will continue to increase gradually[11]. However, the employment in the formal sector, as the results of the economic survey 2003-04 show, may continue to fall.

On the other hand the absolute numbers of the persons employed in the unorganised sector have been steadily increasing. The largest number of new jobs will be created by small and medium enterprises (SMEs). This is also corroborated by the experience of more advanced economies such as USA, Japan and South Korea where the SME sector contributes to the majority of private sector jobs. International experiences also confirm that SMEs are better suited to respond to the demands of the fast-changing technology in the era of globalisation and is better insulated from external shocks[12].

Data published by OECD (Organisation of Economic Cooperation and Development) states that there has been a shift in the industrial sector away from large corporations towards SMEs during

the 1980s and 1990s[13]. While this was seen at a global level, in India three specific reasons have encouraged the growth of the small and the tiny enterprises:

- One, there has been a visible growth in the consumption needs of the lower income segment as well as a growth for personalised services at the high end of the market
- Two, the tiny enterprises also cater to the needs of intermediate goods and services for large industries
- Three, newer and smaller enterprises could bring in innovations into established sectors as "agents of change"

This sector got a boost in 1956 when the government announced the Second Industrial Policy which articulated the importance of the Small Scale Industries (SSIs) for the economy. The Policy highlighted that "Small Scale Industries provide immediate large scale employment, offer a method of ensuring equitable distribution of national income and facilitate an effective mobilisation of resources such as capital and skill which might otherwise remain unutilised"[14].

However, a variety of constraints limit small entrepreneurs from realising their full potential. Investments made towards providing a facilitative environment could very well be the engine for the country's growth.

3 Access to Financial Services and Growth of the Unorganised Sector

A free, multi-layered and well regulated national financial infrastructure is critical for the growth of the unorganised sector. It has been broadly observed that access to finance in the unorganised sector results in substitution of high cost debts by investment in productive assets, expansion of existing business and in value addition to the enterprise output with a direct positive impact on enterprise returns[15].

Similarly, access to finance also has links to improvement in individual productivity by permitting individuals to move to higher levels of consumption of basic items, investment in education and skill building that determines future earning potential, specialisation in a few activities instead of over-diversification and an overall improvement in risk taking ability.

Finally, improved access to customised financial services may also have a positive effect on the local economy through a general increase in wage labour opportunities and better utilisation of surplus labour[16].

Improved access in this context is defined as the ability of economic participants (individuals and enterprises) to access a broad range of financial services (including access to capital- venture funds, credit, banking, investment, insurance and hedging instruments against price fluctuations) suited to their specific requirements.

Raghuram Rajan and Luigi Zingales in their book "Saving Capitalism from Capitalists" state that

> *"An individual living in the most financially developed region is 33 per cent more likely to start out on her own than an individual with same characteristics in the least financially developed regions…*
>
> *…In the most financially developed countries entrepreneurs are on an average 5.5 years younger. Thus, financial development has a significant impact on economic mobility"* [17]

The unorganised sector is vast and includes, within its ambit, enterprises that are parts of diverse industries across all the three sectors of the economy viz., primary, secondary and tertiary. Although each sector has its specific set of constraints, inability to access financial services is characteristic of all enterprises across these sectors.

According to the Economic Census 1998's All India Report 2001, only 4.7 per cent of the total 30.4 million enterprises in the country got financial assistance from institutional financiers[18]. Similar findings were presented in the Nayak Committee Report (1992), which stated that in 1992, the village and tiny industry received only 2.7 percent of its output as working capital assistance. It is not a surprise, therefore, that over 80 per cent of the enterprises in the unorganised sector are self financed[19].

A World Bank Report on SME financing and development states that among several factors accessing adequate and timely finance on competitive terms are the key constraints to the growth of SMEs[20].

In a recent paper on bank financing in India, it has been argued that there is clear evidence that profitable lending opportunities to the poor remain unexploited in the current environment by the banks. Indian Banks do not easily lend to the unorganised sector in spite of a strong demonstrated demand[21].

One of the main reasons why banks have not been keen to address this unmet demand has been the lack of clarity and complete understanding of how entrepreneurs in the unorganised sector create wealth[22]. No organised knowledge is available about the way the entrepreneurs identify opportunities, the problems they typically face, their survival rate and possible social and economic infrastructure that can remove such impediments. Also there is a lack of understanding on how enterprises are started and the issues they face in the initial stages of growth. Limited availability of data about the sector constrains the financing sector from understanding the risk and opportunities available.

Therefore, multiple concerted efforts are necessary to ensure increased flow of investments in this sector.

4 Promoting Investments in the Unorganised Sector

Most of the enterprises in the unorganised sector are highly undercapitalised. Enterprises are started with funds scraped together from personal savings, loans from friends, personal borrowings, mortgages etc[23] . There has been a strong reluctance on the part of capital markets to provide this capital[24]. The retail investor has demonstrated a strong preference to hold non-financial assets[25] and other "low risk" assets such as savings deposits[26], insurance policies and guaranteed return equity funds.

As stated in the earlier section, the nature of business in the unorganised sector[27] poses several challenges for attracting equity investments. The small size of these enterprises makes it economically unviable for investors to gather specific information about each enterprise. It is also not feasible for such investors to take active role in the day to day management of the entities. Moreover, the form of registration, which for most of these enterprises is either proprietorship or partnership, is not conducive equity investments. The problem is further compounded by the fact that the existing equity investors use the same criteria for assessing the venture irrespective of whether it is a tiny, small or a large enterprise. This methodology of risk assessment makes the unorganised sector seem riskier.

4.1 Strategy for Addressing Constraints of Capital for the Unorganised Sector

Addressing the constraints of capital for the unorganised sector will require a two pronged strategy. The strategies need to be geared towards:-

- Reducing the overall need for capital in the sector and
- The need to simultaneously work towards increasing the supply of capital for the unorganised sector.

4.1.1 Strategies to Reduce the Overall Requirement of Capital

The cash flows of tiny and micro enterprises are marked by very high levels of unpredictability. Owing to the size of operations and the nature of the business, it is not always possible for the entity to reduce or effectively manage such uncertainties through its operations, therefore, requiring higher amounts of capital.

Reduction in need for equity will, therefore, require understanding systemic risks and making available such risk reducing instruments. The livelihood and enterprise risks occur across the whole range of rural production activities and they impact the rural population by increasing volatility of the output.

Studies have emphasised that a) weather related (which has a multiplier effect on the economy) and, b) health related risks are the main sources of risk to rural poor[28]. The risk of asset

loss, which has an impact on local micro enterprises, can have devastating consequences for people dependant upon it. Other reasons of risk include wage days which are lost mostly due to adverse weather conditions and consequent lower requirement of labour for agricultural operations and death of livestock that is weather induced or caused by some other factors like disease, impacts the lives of poor people significantly.

Livelihood or enterprise risks are different from household risks in the sense that while the former makes the income uncertain the latter brings upon unforeseen expenses upon the household and sometimes even the loss of breadwinner leading to a long term loss in income. Household risks could be classified in the category of health disorder, death and accidents which have grave consequences for the households in terms of increased expenditure on healthcare; death of earning member of the household; and increased expenditure and loss of earning member of the household due to permanent disability.

High exposure to systemic risks (weather related and health related epidemics) could make financial institutions overly conservative and weary of lending to rural population. But stronger risk management products coupled with credit can actually reduce the risk and help to build the confidence of the lending agencies.

It is possible, in part, to reduce the capital requirements through innovative financial solutions to address some of these risks. Availability of insurance products addressing systemic risks[29] , derivatives against price risks and availability of warehouse financing can help reduce requirements of capital. Similarly, extending financial services to the entire supply chain[30] reduces the need for capital as the future cash flows of the entity can be predicted and can be used as a security for extending financial services.

4.1.2 Increasing the Availability of Capital

Addressing specific contextual issues could increase flow of capital to the sector. As discussed earlier, one of the serious impediments to the growth of the unorganised sector lies in its inability to attract equity investments. Free flow of capital encourages genuine entrepreneurship to seek productive and innovative avenues. Besides, the availability of other forms of capital such as subordinated debts, mezzanine finance, leveraged buyouts, acquisition financing and distressed debt are equally critical.

4.2 Addressing Constraints of Capital for the Unorganised Sector

Reduction in the need for capital as well as increasing its availability is broadly constrained due to two reasons a) Information Asymmetry and b) Difficulty of Access. Each of these reasons and the possible ways of addressing these issues are discussed in the following sections.

4.2.1 Issues of Information Asymmetry

Issues of information asymmetry lead to a high perception of risk by the investor/ financier, of adverse selection and moral hazard. The unorganised sector is characterised by the absence of complete financial records. The absence of registration under any specific regulation also contributes to the difficulty in verifying the risk associated with the provision of financial assistance/ capital to such enterprises. This is further compounded by the inability of most enterprises to offer any security in the form of collaterals, mortgages or guarantees for raising loans.

Better information on tiny and micro enterprises' performance and their financial health should eventually improve their commercial risk profile. As a result, tiny and micro enterprises' might eventually require less equity and start getting more risk capital and other longer-term finance and investment[31] .

Issues related to information asymmetry can be addressed through the following methods:

Group Lending Models

Lending to the unorganised sector is often not collateralised and, therefore, the lending by financial institutions actually constitutes equity. However, the returns from this high risk debt are limited for the lender, at the same time the promoter manages to raise 'capital' at extremely low rates. To address this anomaly, group lending methods are commonly used. Such methods have been successfully able to address the issues of information asymmetry and have therefore, helped in making available financial resources to the unorganised sector. The two common group lending models that have demonstrated the capability of scaling are a) the Self Help Group model (SHG) supported by NABARD[32] and b) the Joint Liability Group (JLG) model of Grameen Bank[33].

In such models, the issues related to information asymmetry are addressed through the knowledge of the group members about each other, moreover since the group members are jointly liable for all loans, it ensures that only the "good" borrowers band together to form an SHG or JLG which comes forward to take a loan[34].

However, according to authors Philip Bond and Ashok Rai (2004), JLG models reduce the flow of capital and debt to entrepreneurs[35]. They argue that in the absence of information about individual borrowers, most financial institutions will only make symmetric group loans, limited by the repayment capacity of the weakest group member.

There is a need to move towards extending credit and equity to individuals. However, there is insufficient understanding of the drivers of default and credit risk at the level of the individual[36] in these models and there remains a need to invest in solutions that are able to build individual credit history. Investment in the creation of credit information bureaus could address this issue.

Credit Bureau

A credit bureau allowing sharing of credit information related to individuals between various lenders in any systematic manner could result in credit histories being used to make lending decisions. Such a bureau will require the existence of a unique national identifier[37]. Credit information tracking and sharing will enable lenders to provide incentives to members with good credit history and provides a strong deterrent to wilful default. This will also facilitate transition to individual lending programmes from group lending over time. NABARD may play an important role in catalysing this initiative. Other developing economies are also investing in such institutions. The National Loans Register in South Africa is one such example. The bureau is a unique collaboration between the public and the private sector[38]. It provides negative feedback on default behaviour of clients. The Philippine National Bank, Bangko Sentral ng Pilipinas (BSP) is in its final stages of setting up a similar credit bureau for financial institutions catering to the needs of the unorganised sector[39]. The Singaporean Government has also set up specific credit bureaus for the SME sector[40].

Supply Chain Financing

The sector is marked by lack of transparent credit information, limited sectoral data with high impairment propensity. Focussing on supply chain financing for certain industries could be a scaleable model for delivering finance to this sector. Through this model investment in reducing information asymmetry can be limited to understanding few highly rated companies in a business to which the enterprise is a regular supplier or is a dealer of such a rated company. The enterprise can seek financing against the receivables from such a company or leverage that relationship even if on its own it does not have very strong financials.

Specialised Product or Industry Specific Banks

One way of addressing the 'lack of market information' issue is by creation of specialised Industry banks and financial institutions. Such banks can build specific skills in the particular sectors financed by them, also owing to their specialisation, these banks will be aware of the impact of macro and micro economic indicators on such industries. Sectoral knowledge also implies that the financial institutions understand the entire value chain and are able to identify bankable industry clusters.

Innovative Customised Financial Services

Some innovative approaches to address information asymmetry issues at a large scale for tiny enterprises and SMEs have been employed by Korean Banks like Woori and Kookmin. Kookmin Bank classifies un-audited companies which get a 'clean' opinion from accounting firms designated by it as a "Kookmin Green Company". The Bank pays up to 70% of the auditing fees of such

enterprises. A Kookmin Green Company applying for loans is provided with a wide range of services such as preferential lending rates, commission waivers as well as credit extensions[41].

4.2.2 Difficulty of Access

Besides, issues related to information asymmetry, access to finance for the unorganised sector is constrained by difficulty in accessing such financial services due to absence of banking channels. The transaction costs of servicing the unorganised sector are extremely high due to the low ticket size and high costs of processing, service & delivery.

In order to achieve ubiquity that is meaningful, models of outreach must have the ability to leverage local information while being cost-effective. Any strategy for universal access to financial services will have to address two key challenges[42], ubiquity[43] and the provision of a comprehensive range of financial services in the context of high transaction costs[44].

The two broad strategies that seem to be effective in this regard are:

Delivering Financial Services through Local Financial Institutions

Local Financial Institutions (LFIs) have emerged as a viable option to deliver financial services to the unorganised sector. LFIs are private, professionally run, community based entities engaged in the delivery of financial services. These entities could be set up either as a for-profit or a not-for-profit entity.

Such LFIs, being a community based institution, are aware of the intricate social structures in the area they operate and are also able to closely monitor the financial inflows and outflows of the enterprise. The biggest strengths of this form of financial organisations are its ability to remove information asymmetries and servicing the financial needs at a fraction of the costs of the formal financial institutions[45].

These LFIs work in close association with the formal financial institutions and, therefore, help in leveraging the relative strengths of banks (access to large capital and diversified risks) as well as the LFI (low transaction cost and local information).

Community Development Financial Institutions (CDFIs) broadly referred to as LFIs have been servicing the financial needs of the unorganised sector in USA[46]. These CDFIs in addition to extending financial services to the poor entrepreneurs also help them develop financially sound business models[47]. These Local Financial Institutions are better suited to asses risk, service it in a commercially viable manner and provide customised products.

Presently, India has only 30 – 40 mature LFIs with a combined outreach of approximately three million households. There is a visible need to strengthen the existing LFIs and promote new LFIs to service the large unorganised sector. The following needs to be done in this regard:

Promoting venture capital investments for promotion of LFIs: There is a need to promote investment in such LFIs. One possible way is to make it attractive for venture capitalists to make investments to help set up such LFIs. This could be facilitated by creation of possible exit options for the venture capitalist. One possibility is the creation of a fund that provides the venture capitalist an option to exit at a predetermined price based on the rating of the LFI, through a leveraged buyout, by extending a long term debt to the entrepreneur for buying out the stake of the venture capitalist. This can be further facilitated if the LFIs are able to service all financial needs of the unorganised sector, raise capital from venture funds and other international investors, generate and distribute profits (dividends) and get listed on stock exchanges for accessing equity from general public and institutional investors.

Creation of training support for scaling up such LFIs: The growth in number and scale of LFIs can be facilitated by the existence of trained staff in adequate numbers for different roles in an LFI. Most LFIs are in the emerging phase and need continuous capacity building and mentoring support. LFIs typically recruit locally and provide on-the-job training. With rapid growth the need for a management cadre for scaled LFIs is increasing. There needs to be a systematic training strategy for the sector. Large LFIs will also need to build internal capabilities in risk management, asset-liability management and other financial aspects of the micro finance business[48] .

There is also a possibility of opening franchisees of large LFIs. In this situation the franchisor LFI could provide support in the form of a business plan, training and mentoring support[49].

Strengthen ties with existing financial institutions: LFIs don't have a strong capital base, and by virtue of being a local financial institution, their risk is highly concentrated. However, these organisations bring with them local knowledge and lower costs of servicing the unorganised sector. There is a need to facilitate collaboration between the financial institutions and the LFIs to leverage on the relative strengths of each of these entities.

Facilitating access to capital markets for raising on-lending funds: In the long run, it will be possible for LFIs to raise funds at rates lower than bank credit by accessing the capital markets. This could be done by a specialised entity providing such financial and advisory services[50].

Shift from targeted lending approaches: Instead of directing subsidised credit, price caps on loans etc. effort should be made towards strengthening the LFIs and the banks should be encouraged to partner with LFIs to lend to the unorganised sector.

Investment in Alternative Banking Channels and Institutions

Simultaneous existence of other banking channels (low cost village level channels), such as banking correspondents and internet kiosks providing financial services can further increase the reach of the formal financial structures. These direct service channels could complement services provided by the LFIs.

Banking Correspondents (BCs): Banking correspondents can enable banks to extend its financial services to the unorganised sector without the need to set up branches, thereby reducing the costs of delivery and expanding access to financial services. BCs have worked very well in the Brazil and have played an important role in providing financial services to low income households in less developed municipalities.

A change in the banking regulation in Brazil (1999), allowed banks to appoint BCs to provide financial services to the underserved sections. Since 2001, points of sales have grown by more than 200 per cent. Presently, there are 17,000 bank branches and almost 27,000 providers of banking correspondent services in Brazil [51].

Use of Internet Kiosks to offer Financial Services: A village level internet kiosk can be an effective channel to deliver a suite of financial services to the unorganised sector at the village level. A diverse range of products such as Life & General Insurance (weather, health, livestock, personal accident), Investment Services (Stocks, Bonds, Mutual Funds), gold purchase, credit products including micro-loans, agricultural loans, consumption loans and transaction & bill payment services and derivatives for small farmers (coffee options, soybean futures, etc.) can be currently delivered through the kiosks. Given the low initial investment[52] required in the channel, the kiosks are expected to break even within the first year of operation[53].

An infrastructure of village-level kiosks is being promoted across the country by internet service providers, public-private partnerships and agribusiness corporates[54]. By far the most successful of these initiatives has been the one launched by ITC in terms of number of kiosks on the ground[55].

Current RBI regulations forbid the disbursal of cash at non-bank / non-ATM locations. While this regulation may have been put in place with a view to prevent money laundering, it in effect hinders the efficient flow of money from cash surplus locations. Existence of cash surplus points such as petrol pumps and Octroi/Toll nakas which are wide spread and located in the close vicinity of rural and low value segments could provide a suitable cash dispensing alternative. These points currently struggle with the issue of handling, managing and transporting large quantities of cash to banks usually situated at urban locations. Enabling cash disbursal from these points would reduce cash usage, therefore, be a positive scenario for all involved.

Strengthening alternate banking channels requires investment in facilitative infrastructure and giving effect to legislations to provide hybrid technology enabled access points through banking correspondents.

Some of the possible ways of increasing the availability of risk capital are discussed below:

4.3 Other Ways of Increasing Access to Financial Services

Availability of financial services, including equity can be increased further by the following:

4.3.1 Creation of an Entrepreneurship Support Fund

Although, the measures reducing information asymmetry and enabling ubiquitous access will increase the availability of capital, the existence of a National Entrepreneurship Support Fund for enterprises in the unorganised sector could be catalytic in increasing flow of funds to this sector. Such approaches have been tried earlier but have met limited success. However, by a change in the design and role of such a fund, it is possible to meet the desired objectives.

The equity investment should be made by the financial institutions (LFI), with the proposed fund being used to provide a First Loss Default Guarantee to the LFI. This would facilitate the creation of markets, particularly if they combine resolution of information asymmetries with the function of providing risk-capital[56].

It may not be economically feasible to invest in an extremely rigorous due diligence process before making investments in the unorganised sector based on an in-depth understanding of the business model, promoter, cash flows and exit options. It may, therefore, be necessary that investment decisions be based mainly on the risk return profile of the enterprises assessed by the LFI on account of its reduced information asymmetries.

While a part of the equity requirement can potentially be addressed by Foreign Direct Investment (FDI), the Government may have to emerge as the provider of the bulk of such risk capital with banks and capital markets addressing the need for debt finance. In the past the Government has tried to combine the role of provider of this risk capital and debt funds within integrated development banks but for a variety of reasons, this approach has not met with much success[57].

4.3.2 Provision of Other Forms of Capital

The unorganised sector does not have access to other forms of capital such as subordinated debts, mezzanine finance, leveraged buyouts, acquisition financing and distressed debt etc. Such forms of capital become relevant in different growth phases of the enterprise.

Securitization of loans to Small and Medium-Sized Enterprises (SMEs)**:** The capital market has traditionally been viewed as the exclusive marketplace for large corporations to raise funds through the issuance of stocks and bonds. With the growing sophistication of structured finance transactions, loan securitization now makes it possible for small and medium-sized enterprises (SMEs) to access the capital market too. This should be available to tiny and micro enterprises also.

The SME loan securitization pilot programme provides an alternative financing option for enterprises that generally do not qualify for existing loan schemes. Loans granted to a diverse range of SMEs could be pooled together and turned into tradable bonds that offer competitive yields to investors. With a broader lending criterion, the programme will reach out to a wider base of SMEs, potentially including those with no established track record.

The Feedback Group recognized the usefulness of this programme, and hoped the Government could lend further support to introduce the programme to a wider base of SMEs[58].

4.3.3 Knowledge about the Business

Banks lack the market knowledge and information about specialised sectors that form the unorganised sector[59] . The branch led model may not be the most efficient approach in responding to the needs of a sector engaged in extremely diverse activities. In a typical branch banking model, banks and financial institutions do not always understand the nature of the business undertaken by entrepreneurs, and are, therefore, unable to assess the risk in extending financial services to such enterprises. Moreover, the current financial system is not geared to supporting new enterprises.

There is a need for a systemic effort for developing training packages for the staff of the financing institutions for better assessment of the risks of such enterprises[60]. Making available appropriate financial services is a function of specialised knowledge about the sector and requires the banking sector to expand its technical skills. Please refer to Annexure 3 for a detailed case study on Wells Fargo which has developed such skills.

4.3.4 Well-Defined Metrics

It has been suggested that the public sector character of several of the large participants in the financial system has led to very passive responses to the needs of finance for the under-served sectors and to the overall management of the institutions themselves. However, it is not obvious that privately owned banks within India either before or after nationalisation have sought to aggressively build new models to profitably serve the credit-constrained segments. While, within the corporate world in India and within Banks outside India metrics such as shareholder value-add, detailed segment level performance reporting and balance score cards have played a key role in aligning the incentives of managements, within India these issues have not been given much attention. While longer run solutions may involve privatisation of banks and other financial institutions, the answer to better overall performance of the financial system may lie more within a better design of metrics of performance[61] rather than in change of ownership – at least in the medium term[62].

4.3.5 Provision of a Range of Financial Services

Access to well-designed products that cater to various needs (growth as well as risk management) is critical for the overall development of the sector[63]. However, most of the work

that has happened in India has been geared towards increasing access to small loan amounts that may be used either for consumption or for enterprise purposes (typically livestock). While this is a critical need, there are gaps in access and availability of other financial services including insurance (life and non-life), savings, investment, remittance and derivatives.

One of the main factors constraining the availability of a range of financial services has been the total absence of information on the unorganised sector. Although the existence of LFIs ensures that the risk associated with servicing the unorganised sector can be reduced, such local knowledge does not always inform product development.

5 Facilitative Environment

As discussed earlier, basic facilitative infrastructure like educational institutions, health facilities, road connectivity, electricity, telecommunication etc. have the nature of a public good and boost the local economy in the long run. Investments in facilitative infrastructure are required in three main areas:-

a. Basic infrastructure such as roads, irrigation facilities, electricity, telephone, internet connectivity and warehousing facilities etc.

b. Soft infrastructure such as education, health, information, finance, vocational training facilities, etc.

c. Supportive policy and regulatory framework

Investment in facilitative infrastructure will enable financial service providers to offer financial services with a superior design and convenience to the client. Such investments, mainly in the nature of public goods, might be too huge to be made by any one private provider. However, wherever possible these investments should be made through private financing and management.

Necessity of a basic infrastructure is in fact critical to the growth of the economy. According to Gregory Clark and Susan Wolcott[64] India, because of its diversity, does not need to have productivity gains in all sectors or all regions to achieve national growth. As long as some industries and some localities can achieve productive growth, gains can be transmitted to the economy as a whole through the migration of capital and labour to successful locality. Through international trade the economy could even specialise in production in specific sectors[65].

It suggests that there has been a growing regional disparity in per capita incomes within India since 1961. Data supports the fact that states with high incomes in 1998 were recipients of migrants, while those with low incomes were net losers of people. But migration rates are modest compared to population change occurring due to natural increase in population[66]. The responsiveness of migration to economic opportunity transferred to India would imply that a state like Maharashtra would experience net migration equivalent to five times the actual rate of the

1990s. Within United States and Europe movement of people from low-income regions to high income regions has been an important force in overall economic growth rates.

The paper suggests that in the light of international past experience (Within United States and Europe movement of people from low-income regions to high income regions has been an important force in overall economic growth rates.), if in each year of 90s, 1 per cent of the population of the lowest income states would have migrated to the highest income states the growth rate of income per capita in India would have increased by 0.3 percent per year.

The paper makes a strong case for policies supportive of labour migration. Basic rural infrastructure like better road connectivity to habitations and telecommunication contribute positively to supporting labour migration.

5.1 Basic Infrastructure

There is an urgent need to augment the basic infrastructure in the country. Provision of last mile connectivity up to the village level in terms of roads, power, and tele-communication networks could be enabling mechanisms for facilitating the growth of the unorganised sector.

However, one of the main constraints has been the absence of financial resources for the creation of such infrastructure. Public private partnerships could be a possible solution for the creation of such infrastructure where the private sector is responsible for the creation and management of such infrastructure. The private contractors are allowed to levy user charges to pay for the creation of such infrastructure. The Economic Survey (2005) already hints such public private partnerships for the creation of this infrastructure through an approach of providing subsidies to private operators to boost the returns possible by levying user charges from otherwise unprofitable activities in funding public infrastructure[67] . This could be beneficial as it will reduce immediate need for public finances for setting up such infrastructure. The public sector could make investments in neglected areas and other areas of strategic interests.

5.1.1 Provision of Urban Amenities in Rural Areas

The President of India, Dr. A.P.J. Abdul Kalam, recently identified 'Provision of Urban Amenities in Rural Areas (PURA)' a Central Government scheme as key for the development of rural areas. This scheme could be a movement in this direction and if scaled beyond the present 30,000 envisaged villages could address these specific infrastructure limitations[68]. PURA aims to give a boost to the rural economy and prosperity by addressing the following four critical issues:

Physical Connectivity: by providing good roads, transport services and reliable access to power;

Electronic Connectivity: by providing reliable communication networks, including telephony (mobile and fixed) and internet capabilities;

Knowledge Connectivity: by establishing more professional institutions and vocational training centres, schools with high quality infrastructure, teachers who are devoted to teaching, production centres for rural artisans, primary health centres, recreation centres, etc; and

Market Connectivity: that will help realise best value for the products produced and services rendered by rural people, and constantly expand and enrich employment opportunities for them.

The model envisages transforming rural India into a holistic habitat that would improve the quality of life and also help in decongestion of urban areas[69]. Some of the specific areas that need immediate investments are:

Rural Electrification

Around 63 percent of the rural households in the country remain un-electrified. The estimated cost of connecting the remote villages alone by power is placed at around Rs. 37,000 million[70].

An alternative could be micro household level renewable power units financed by the user. Commercially viable solar units aimed at meeting such energy requirements of customers in remote habitations are already available[71]. It is possible to explore a leasing option for such assets for the poor and lower income groups. The leasing model has been extensively used for providing selling household solar Photo Voltaic (PV) systems in Kenya[72]. The high cost of solar PV systems is spread over a period of years with the solar PV system leased to the customer (the lessee) against lease payments. Once the cost of the solar PV system along with the interest is recovered through such lease payments, the ownership of the solar PV system is transferred to the lessee.

A similar model of increasing access to rural electrification through user payment model with a local financial Institution as an intermediary has been demonstrated by the 'Gensis Empresarial' based in Guatemala[73].

Water: Potable and for Irrigation

India Water Vision, 2025 estimates the gross water demand will double in 25 years from now requiring corresponding investments to the tune of Rs. 2,000 million per year. A large part of this demand is expected to come from agriculture, which accounts for 85 per cent of the country's fresh water consumption. Additionally, with only 40 percent of the cropped area irrigated, investments to the tune of Rs.1,200 million would be required in next 5 years for making irrigation facilities available in a substantial part of nation's dry lands.

Operations and maintenance of existing infrastructure, being a public good has been very difficult, especially with the government thrust firmly on increased numbers, often neglecting the performance of the assets that have already been created. Some solutions lie in better management

of water resources, such as in Andhra Pradesh where major efficiency gains very achieved by transferring responsibility for the operation and maintenance (O&M) of irrigation schemes to the Water User Associations (WUAs)[74] . The reform metamorphosed the role of irrigation agency[75] from service provider to facilitator and has led to increased revenues, an increase in irrigated area, and enhanced involvement of farmers in the operation of irrigation[76].

Another model leading to better management has been the implementation of tradable water rights, as in Chile[77]. In this model, water users are provided with tradable property rights with economic value capable of even being offered as loan collateral. Owing to demand for water from the cities, the value of the water rights held by farmers is higher than its value in the agriculture use prompting farmers to adopt efficient irrigation systems to reduce their water consumption enabling them to sell the rights of saved water to cities at higher prices[78].

Besides, there is a need to make Investments for better and efficient water management through development of water harvesting structures and watersheds, check dams, drip irrigation systems, sprinklers, mulching etc. Private participation in the irrigation sector could be promoted in line with the concept followed by National Highways Authority of India (NHAI)[79].

Telecommunication Facilities

Provision of telecommunication facilities to all habitations in the country enabling reliable voice and data transfer for applications such as telemedicine and banking along with other internet based applications need to be made. Investment is necessary in mobile telephony as well to enable use of hand held devices[80] . Other technological solutions such as one piloted by HP in Kuppam using low cost broadband wireless internet connectivity can also be explored. N-Logue has also been working towards the provision of reliable last mile access for internet and telephony.

Road Network

Under the Pradhan Mantri Gram Sadak Yojana Rs. 26,480 million have been sanctioned to build roads connecting rural habitations through all weather roads[81]. Presently, more than 200,000 villages are unconnected by roads. The construction of such infrastructure also has other developmental impact as well, besides facilitating mobility and direct benefits to trade, it is estimated that for every Rs. one million invested in rural roads, approximately 165 people move out of poverty[82].

Warehouses, Cold storages and Cold Chain facilities

There is a need to augment the warehouse, cold storage and cold chain facilities in the county. This when linked with commodity exchanges could provide effective hedging instruments for price fluctuations and also act as a security for raising loans for farmers and entrepreneurs' dependant on agricultural produce.

Warehouse Financing could be used as an effective means for the provision of financial services to the unorganised sector. Thomas (2003) makes a case for the evolution of Dematerialised Warehouse Receipts so that they may be traded in both spot and futures markets using the capabilities of the existing exchanges. Warehouse receipts could serve as collateral against which banks would be able to provide finance without the need for farmer/ entrepreneur to provide additional information about the enterprise (therefore eliminating problems of information asymmetry). It would also considerably reduce the need for equity. The only risk capital that would need to be provided would be the price-fluctuation margin[83], which could also be suitable hedged through price derivatives.

Rural Hypermarkets

Rural hypermarkets can be extremely beneficial to small enterprises/ households because of two main reasons viz., increasing the real income of households or lowering cost of inputs for enterprises resulting from aggregation of demand of a large number of buyers; and by making available better quality products. Availability of consumer credit while developing a thin-asset business model by partnering with informal sector will boost the growth of the channel. A chain of such hypermarkets can also provide critical support for the growth of rural markets resulting from direct purchases of farm and non farm outputs and sale across the hypermarket chain. Some such innovations which could be scaled with modifications are the supermarket chains like Apna Bazar, Hariyali Kisan Kendra and Choupal Sagar[84]. Subheeksha an upcoming hypermarket chain has already shown interest in setting up rural operations. Kisan Seva Kendras (an initiative of Indian Oil) can also be an important potential channel.

5.1.2 Specific Investments for Provision of Financial Services

Besides PURA, the following specific investments will help in designing and delivering a comprehensive suit of financial products:

Computerised weather stations at the village level providing real-time weather data: A large number of people engaged in the informal sector are directly or indirectly impacted by the agricultural productivity. One of the main drivers of risk in the agricultural sector continues to be weather related. Although, crop insurance schemes have been tried to address this risk in the past, they have been fraught with several implementation and moral hazard[85] issues. Over the last few years index based weather insurance customised to various crops has been successfully implemented in various states. A few states such as Himachal Pradesh, Rajasthan and Andhra Pradesh have already moved to such index based insurance schemes[86]. However, currently such policies have mainly been offered to cover risks related to the timing and adequacy of rainfall.

The main benefit of this index based rainfall insurance has been reduced transaction costs, ease and transparency in assessment of claims, faster pay-outs and absence of moral hazard. However, there are three main problems;

i. The weather stations are currently located at the block level, which means that village level rainfall data is not captured by the existing systems of the Indian Meteorological Department (IMD). This can potentially be disadvantageous to certain farmers especially if rainfall in their village is less than that recorded at the block level weather stations[87].

ii. The data is not available real time. Indexed based weather insurance policies can actually allow for payments to be made on a daily basis (depending on the criticality of weather phenomenon on that particular day). Such daily payments can help farmers to take corrective measures for protecting their crops.

iii. Weather insurance can be extended to other weather phenomenon as well: Agricultural risks can be caused by other phenomenon as well. Hail storm (ready wheat/ rice crop, apples), excessive frost, extreme temperatures (especially for high value crops such as strawberries, etc), high speed winds (mangoes), humidity levels, etc. can all cause excessive damage to crops. Extreme weather conditions also impacts the output of livestock, e.g. in extremely high temperatures, milk production of buffaloes goes down, shelf life of milk is reduced making transportation difficult, increases disease incidence in poultry birds. However, appropriate weather insurance products can be designed and offered for these risks if relevant data is available.

Weather futures (temperature-related weather derivatives), have immense potential and hold special significance in the Indian agriculture context dependant on the vagaries of monsoon. They could even be seen as alternative to crop insurance and even MSP by way of option trading by farmers wherein government could think in terms of paying the options premium. According to UNCTAD's global expert on commodity futures Lamon Rutten, weather futures are a good example of product innovation. "Weather futures are important and cheaper than crop insurance which is important to make the agriculture -sector cost-effective under the WTO regime". Weather futures were first traded on the Chicago Mercantile Exchange (CME) in the year 1999 and since then they have picked up significant volumes. It has also started trading in the Euro next-London International Financial Futures Exchange (LIFFE). NCDEX intends to launch this facility in the country soon[88].

Investment in village level computerised weather stations that are able to provide this data on a real time basis will help in designing such insurance products and will directly impact an extremely large proportion of population forming a part of the unorganised sector. NCDEX through National Collateral Management Services limited (NCMSL) is already contemplating to set up such weather stations in a few parts of the country. However, there is a need to make such weather stations across the country.

Investment in Card Infrastructure: Cash handling costs form the bulk of the costs of servicing the highly dispersed unorganised sector. Until recently, real-time authorisation required an immediate, real-time voice or data connection with the buyer's bank. However, technologies such as smart card systems can track available funds without real time backend authorisation support. With smart cards and the appropriate terminals, a merchant can authorise transactions even in rural areas where telecommunications are unreliable or unavailable. Increasing the usage of cards also reduces costs associated with cash handling. The Government may see value in investing in the creation of a card infrastructure in rural India.

The existence of such card infrastructure can help instant transfer of value to the farmer in the form of credits for insurance claims, receiving remittances, credits under government schemes, salary payments to government employees, etc.

5.2 Soft Infrastructure

At extremely low levels of income, efficient investments in primary health and elementary education can provide a strong impetus to the growth of the skilled work force in the country by improved cognition and physical ability. Although gains have been made in the recent years in terms of increasing literacy rates, there is a need to make a concerted effort towards the provision of good quality elementary education[89] (not just limited to functional literacy).

At such low levels of per capita income the marginal product of investments in basic health and elementary education could dominate other investments made by the governments and there may not really be a trade-off in making such investments. At higher levels of income there may be tradeoffs but the efficiency of growth impulses in terms of poverty reduction could be a function of how well and completely the first step (of making investments in basic health and elementary education) has been carried out. This may explain the differences in performance on this count between India and China[90].

Towards this end, long term investments in each of these areas will have to be made to strengthen the state provision with the goals to build capacities of all individuals rather than target based quantitative indicators. According to India Vision 2020[91]

> "*Successful education policy forms the bedrock of all fields of national development—political, economic, technical, scientific, social and environmental. Education is the foundation for a vibrant democracy, growth of productivity, income and employment opportunities…*
>
> *… Literacy is an indispensable minimum condition for development, but it is far from sufficient. In this increasingly complex and technologically sophisticated world, 10 years of school education must also be considered an essential prerequisite for citizens to adapt and succeed economically*."

5.2.1 Business Development Services

Investments need to be made in business development services for existing and potential entrepreneurs. The objective of such programmes is to provide specific business support rather than skills for the production of certain goods and services. Simultaneously, there is also a need to strengthen institutes that can train people in a large number of market demanded skills. Currently, only five per cent of the country's labour force in the age group 20-24 years has undergone formal vocational training, compared to levels ranging from 28 per cent in Mexico to 96 per cent in South Korea[92]. However, the current infrastructure in the country can only train 14 per cent of the total additions to the workforce each year[93].

However, vocational training alone may not be a complete solution. The Livelihood Advancement Business Schools (LABS) model of Dr. Reddy's Foundation for Human and Social Development (DRFHSD) is an interesting innovation in this sphere. It trains young adults from economically weaker backgrounds to acquire entry level workplace competencies[94]. More than 16,000 youth in the age group of 18-25 have been trained and placed with well known firms in the last 5 years[95]. The programme is now operational in Hyderabad, Chennai, Mumbai and New Delhi apart from 4 districts in Andhra Pradesh[96]. LABS is now exploring a collaboration with nakuri.com, one of India's largest online placement agencies[97], for identifying the skill sets in demand as well as for placing students.

Lack of good extension services for agriculture and animal husbandry could lead to low productivity levels. Access to such services continues to be critical area of challenge. Emergence of contract farming, private service provides like MSSL, Rallis, Parry acting on behalf of the buyers have addressed this problem in a limited scale but situation continues to be grim in most parts of the country. Hence such efforts would require scaling up in an accelerated manner.

Another potential programme being explored by ICICI Bank is a possible collaboration of LABS programme with nakuri.com.

5.3 Supportive Policy and Regulatory Framework

There is a need to create a supportive policy and regulatory framework to unlock the true potential of the unorganised sector. Some of the current policies include directed credit from banks and credit at concessional rates for the sector through priority sector lending norms to certain kind of business. While free flow of capital creates a more vigorous and dynamic culture of entrepreneurship, the outcome of measures such as directed lending in drawing new entrepreneurs is debatable. Such an approach may force the mainstream players to look at the sector as a compulsion and not invest in developing skills to identify opportunities to build a market here. Such a forcible approach may "kill" the market and not stall innovations.

It can be argued that rather than creating market distortions through such policies, the relative benefits of government making investments in public goods which are a part of the facilitative infrastructure may lead to higher growth rates of the unorganised sector[98]. (Refer to Annexure 2.) A case in point is the crop insurance product where the subsidised Government programme has resulted in very limited participation from the private sector.

Rajan and Zingales state that "In a sample of eighty countries over the period 1960-89, different measures of beginning-of-period financial development are associated with higher subsequent rates of growth in the country's gross domestic product, its capital stock and its productivity over the subsequent decade. Countries where much of the credit is allocated by the central banks are typically considered to have underdeveloped financial systems[99] ".

There is, therefore, also a need to provide regulatory support for hybrid models for the delivery of financial services to the unorganised sector. Creative responses to the challenge of access to financial services will require experimentation with several delivery formats. Regulators including the RBI, SEBI and IRDA must encourage innovative pilots in order to better address the challenges. Learning from these pilots may be actively disseminated.

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Glossary

BC	Banking Correspondents
CDFI	Community Development Financial Institution
DWCRA	Development of Women and Children in Rural Areas
JLG	Joint Liability Groups
ICLS	International Conference of Labour Statisticians
IRDP	Integrated Rural Development Programme
ITI	Indian Technical Institutes
LFI	Local Financial Institution
MBDA	Minority Business Development Agency
M. ha.	Million Hectares
NABARD	National Bank for Agriculture and Rural Development
NAS	National Accounts Statistics
NBFI	Non Bank Financial Institutions
NDP	National Domestic Product
NHAI	National Highways Authority of India
NSSO	National Sample Survey Organisation
OECD	Organisation of Economic Cooperation and Development
PACS	Primary Agriculture Credit Societies
PV	Photo Voltaic
RBI	Reserve Bank of India
RRB	Regional Rural Banks
SIDBI	Small Industries Development Bank of India
SHG	Self Help Group
SME	Small and Medium Enterprises
SSI	Small Scale Industries
TVE	Town and Village Enterprises (China)
TEB	Town Enterprise Board (China)
WLL	Wireless in Local Loop

Annexure 1: Share of unorganised segment in Net Domestic Product by economic activity

Industry	1993-94	1997-98	1998-99	1999-00	2000-01	2001-02
Agriculture, forestry & fishing	96.5	96.6	96.8	96.9	96.5	96.7
Mining & quarrying	7.3	7.4	7.4	8.4	9.1	9.7
Manufacturing	36.6	37.8	38.9	39.2	37.7	37.1
Electricity, gas & water supply	7.2	5.8	5.1	6.2	6.3	7.6
Construction	51.1	57.0	56.9	58.2	59.1	60.9
Trade, hotels & restaurant	88.8	83.4	81.9	80.4	79.5	76.0
Transport, storage & communication	42.7	48.8	50.7	54.3	57.1	57.8
Financing, insurance, real estate & business services	50.7	42.4	42.2	40.2	42.5	41.9
community, social & personal services	19.0	18.0	17.1	16.4	16.8	16.9
Net Domestic Product at factor cost	63.1	60.8	60.3	59.2	58.6	58.5

Source: Statement 76.3 (National Accounts Statistics 2004): Share of unorganised segment in net domestic product by economic activity

Annexure 2: The Chinese Experience of Town and Village Enterprises

The Chinese experience of Town and Village Enterprises (TVEs) in developing rural business hubs consisting of agro based and non farm enterprises with backward and forward linkages, technical support and continuous hand holding has been highly successful in positively influencing the average per capita income. This model helped fillip industrial growth in rural areas of China. The TVEs essentially played the twin roles of (a) ensuring robust growth in China and (b) efficient transmission of growth impulses into poverty reduction.

The Township Enterprise Board (TEB) is responsible for town and village enterprises to produce agricultural inputs, farm machinery, agro-products and other low value-added goods. These institutions were initially run by farmer collectives employing surplus rural agricultural labour. Due to its low cost of production and increased economic efficiency, a large number of urban industries shifted production to such TVEs. Increased rural income due to TVEs gave a boost to the demand for consumer goods and housing, creating markets for products suitable to be produced by small firms. These demand and supply factors propelled rural industrialisation through TVEs.

The model is based on the premise that there are high growth residuals in productivity improvements related to reallocation of resources from low to high productivity sectors (from agriculture to manufacturing and services).

Chinese Government has developed special funds for aiding the use of better technology in rural areas through technical training for practical use.

The state also encourages and supports households to migrate out of areas of extreme difficult living conditions. To solve the problem of income and employment opportunities for labour the Chinese Government encourages and organises the transfer of labour from areas favourable for such transfers.

Annexure 3: Banking with the small and medium enterprises: Wells Fargo's model

Wells Fargo Business Direct is the 5th largest bank in United States of America. Wells Fargo & Company is a diversified financial services company with $397 billion in assets, providing banking, insurance, investments, mortgage and consumer finance through more than 5,900 stores and the internet (wellsfargo.com) across North America and other international locations.

Wells Fargo brought in strategic changes from conventional lending to move into small business lending. Prior to 1990, Wells Fargo was not a significant small business lender. In late 1989, its Business Lending Division was created to lend to firms with less than $10 million in sales. Reports and studies in 1994 showed that standard lending processes (distribution, underwriting, servicing) were uneconomic for the smallest loans. So in 1994, 'Business Direct' was formed to focus on streamlined lending primarily to firms with less than $2 million in sales. The new approach adopted new services and promoted score card based decisions[100].

In the new approach, the lending operation to the small business brought about modular changes in marketing, underwriting, credit scoring models and portfolio management[101] of the businesses. It encouraged the borrowers for accessing credit who were sorted out by carefully designed processes[102]. Wells Fargo drew a culture of constant testing, measuring and learning for creating effective small business marketing. Product innovation, effective communication and risk taking are the key attributes which it researched and developed over the years promoting the small business lending model[103].

The implications of Wells Fargo's edge in the small business could be seen from its status. The bank went from $500 million in small-business loans in the late 1980s to $5.4 billion in 2004. In the process, it went from being a small player in California to the highest-volume lender in the US in the small-business loan segment, with 300,000 loans outstanding. The loans have been so profitable that they helped first-half earnings at the Business Banking Group jump 45% from a year earlier to $128 million which itself accounted for a quarter of Wells Fargo's profits.

Footnotes

1 According to Planning Commission, 26 per cent of the population lives below the poverty line (Planning Commission, Annual Report 2003-04)

2 Planning Commission (2002), Report of the Committee on India Vision 2020

3 Defined In the Fifteenth International Conference of Labour Statisticians (15th ICLS), held in January 1993

4 Annual Report (2003-04), Ministry of Labour, Government of India

5 Ibid.

6 National Accounts Statistics "Share of unorganized segment in net domestic product by economic activity" Statement 76.3, (2004)

7 Refer to Annexure 1 for details

8 Economic Survey (2003-04), Ministry of Finance, Government of India

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10 Between the years 1993-94 and 2000-2001 the organised sector's contribution to the GDP has gone up marginally from 36.9% to 40.5% and the total employment has declined from 27.38 million to 27.21 million. Economic Survey, (2003-04), Ministry of Finance, Government of India

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18 Banks and financial institutions directly financed only 2.8 per cent of the enterprises and 1.9 per cent received funding under government poverty alleviation programmes such as the Integrated Rural Development Program (IRDP), Development of Women and Children in Rural Areas (DWCRA) or other State schemes.

19 Nayak Committee Report, (Reserve Bank of India (1992)
http://www.laghu-udyog.com/thrustareas/credit.htm

20 World Bank Report on SME (2004)

21 Banerjee, Abhijit, Shawn Cole and Esther Duflo (2003)

22 The problems faced by enterprises in their daily operations are not clearly known. Entrepreneurs assume a great deal of risk. They identify a profit opportunity, organise capital, labour and equipment to exploit this opportunity and continuously innovate to address internal and external challenges.

23 Bhide V. Amar (2000)

24 Data presented by Prithvi Haldea at a conference on "Adapting Indian Financial Sector to a globalising World held at Goa (October 31- November 2, 2002) suggested in the previous twelve years while Rs.1,120 billion of projects were financed through public issues in the first six years, in the next six years only Rs.190 billion was raised.

25 India is the largest consumer of gold in terms of demand in key world markets, followed by China and Japan: World Gold Council Report 2002

26 In the past savings accounts have offered as little as 10 percentage points below the 10 year Government of India Security yield but that has not diminished the Indian investors ardour for the savings account. Even banks that have, on occasion had negative capital adequacy, have seen on those very same occasions, a very significant growth in their savings account balances.

27 a) The extremely small size of enterprises, b) absence of formal and complete set of records, and c) non availability of market data on such small heterogeneous enterprises makes assessment of profitability difficult.

28 A Livelihoods Participatory Rural Assessment (PRA) was undertaken in four districts (Adilabad, Anantapur, Srikakulum and Prakasam) during January-February, 2002 by Society for Elimination of Rural Poverty (SERP). Also stated by Ananth, Bindu and Soju Annie George (2003)

29 An extremely large proportion of enterprises in the unorganised sector are directly or indirectly dependent on agriculture, which is highly dependent on rainfall. The existence of insurance products such as weather insurance, therefore, reduces the risk substantially.

30 This is discussed in details in the subsequent sections.

31 Draft Report of the Commission on Enterprise, Business Facilitation and Development on its Sixth Session, 18-21 February 2002, Trade and Development Board, United Nations Conference on Trade and Development. http://www.unctad.org/en/docs/c3l19a2_en.pdf

32 http://www.nabard.org/roles/mcid/shgbanklink.htm

33 www.grameen-info.org/mcredit/cmodel.html

34 Murdoch and Rutherford (2003) however argue that the reason why the SHG model has not grown in popularity within Grameen and BRI has been because the poor prefer individual service and that should mass-outreach financial services retailers of the Grameen or the BRI kind emerge in India the SHG movement would find it difficult to compete with them.

35 In their paper, titled, "*Co-signed or Group Loans*", the authors argue that "In order to reduce default, financial institutions make a symmetric group loan, where the bank is forced to level down the loan size to a point at which even the member who faces the least significant social sanction still repays".

36 Ananth Bindu and Soju Annie George (2003)

37 In order to develop individual databases and credit histories, it is vital to have a way to uniquely identify individuals and enterprises. Unique identifiers have great relevance for products such as individual loans and health insurance. The issuance of the unique identifier (which could combine bio-metric data for authentication) is best done by the Government or agencies such as the Employees Provident Fund Organisation (EPFO) so that the unique ID can be used for multiple purposes.

The unique identifier and a centralised database are essential tools which could be used for developing specific credit scoring models, thereby reducing risk of dealing with this segment as also help in the faster roll out and deeper penetration of financial services for the unorganised sector.

38 Micro Finance Regulatory Council of South Africa was set up on June 1, 1999 and was identified as the official and single regulator of all money lending transactions falling within the scope of the Usury Act Exemption Notice http://www.mfrc.co.za/detail.php?s=340

39 Lirio, Ricardo P. Managing Director SEII, Supervision and Examination Sector, Bangko Sentral ng Pilipinas in the *National Conference on "Regulation of Microfinance in India"* New Delhi, India 19 – 20 January, Organised by Sa-Dhan, 2005

40 Newly set-up SME credit bureau provides transparent credit information and risk-profiling for SMEs, making it easier for lenders to assess firms, easing access to loans. The SME Credit Bureau and SME credit rating system may have helped SMEs gain access to more financing options. http://app.feedback.gov.sg/asp/ocp/ocp04.asp?id=2183

41 Kookmin Bank is Korea's biggest retail banker, and stands out in the SME loan market as well. Kookmin Bank, Woori Bank and state-run Industrial Bank of Korea were found to dominate the SME loan market. The three lenders extended a total of 14.77 trillion won to SMEs in the year to August (2004), taking up for about 54 percent of the total loans extended by the lenders to SMEs during the cited period.http://eng.interbill.co.kr/board/board.html?Db=best&mode=view&nid=16&page=3&. http://inf.kbstar.com/quics?page=A006721&cc=a016445:a016451

42 Refer to Ananth, Bindu, Bastavee Barooah and Rupalee Ruchismita (2004) for details

43 Although Ubiquity as an idea has been pursued in India, it has remained at the level of ensuring physical proximity to banking channels and has not been extended to other important dimensions of access such as reliability, continuity, convenience and flexibility which are critical from a client's perspective as stated by Murdoch, Jonathan and Stuart Rutherford (2003). Refer to Ananth, Bindu, Bastavee Barooah and Rupalee Ruchismita (2004) for a more detailed discussion.

44 The experience of extending financial services through the infrastructure outlined above suggests the following – costs of delivery have been high under traditional models (The total accumulated losses for RRBs till November 2002 is approximately Rs. 10347.5 million (USD 206.95 million) (for 29 loss making RRBs in 14 states), local information is not sufficiently leveraged (reflected in poor repayment rates and poorly designed products), there is an almost exclusive focus on credit and neglect in aligning staff incentives

to maximise outreach. Moreover, a banks' process of risk assessment is traditionally geared towards larger enterprises.

It may, therefore, not be commercially viable for banks to provide financial services on a large scale through a branch based model. From an entrepreneur's perspective the classical branch led model of providing finance may not be tuned to respond to his unique needs. Nevertheless, since a large number of such enterprises are geographically dispersed and located in rural and peri-urban areas, there is a need to make investments in some form of channels delivering financial services to them.

45 For detailed discussions please look at Ananth, Bindu, Bastavee Barooah and Rupalee Ruchismita (2005)

46 This Community Development Financial Institutions Fund's mission is "To promote access to capital and local economic growth by directly investing in and supporting Community Development Financial Institutions (CDFIs) and expanding financial service organisations' lending, investment and services within underserved markets. However, governance issues are still a concern. The Fund is a wholly owned government corporation within the United States Department of the Treasury."

47 The CDFIs got a boost as an alternative to the formal banking system in the year 1994.

– A survey conducted, in the year 2001, on 106 CDFIs, who received a total of USD 114 million from the CDFI Fund during the period 1996-98, showed that the CDFIs disbursed a total of USD 3500 million in community development loans and equity investments in a period of 5 years. This amounts to USD 31 in financing for every dollar received from the CDFI Fund.

48 The Centre for Micro Finance Research, based at the Institute of Financial Management and Research (IFMR), Chennai along with aiming at catalysing and supporting empirical research evaluating the impact of access to financial services. The Centre plans to provide top management training programmes as well as specific risk management and ALM training support.

49 CGAP is working towards the creation of such a franchisee model.

50 Grameen Capital India (GCI) is being registered as an NBFC to provide such services. GCI will provide credit enhancements to the LFI portfolios and will help in syndicating these portfolios to banks and other financial institutions. Over time, GCI will also convert these portfolios into primary market debt papers.

51 Gomes, Amaro Luiz de Oliveira, Banco Central do Brasil in the *National Conference on "Regulation of Microfinance in India"* New Delhi, India 19 – 20 January, organised by Sa-Dhan, 2005

52 A typical internet kiosk costs around Rs. 60,000 (non V-sat terminal to connect to the internet)

53 Operating in a catchment area of about 5,000 people

54 Several participants have been engaged in this task. ITC, n-Logue, Drishtee and Development Alternatives (Tara Haat) have built more than 6,000 internet kiosks using technologies such as Wireless in Local Loop (WILL) and VSAT Terminals.

55 ITC's International Business Division has conceptualised the e-Choupal as a chain of Internet kiosks to facilitate procurement of specific commodities. These kiosks are connected through VSATs and are managed

by the farmers, selected from within the community and trained, known as 'Sanchalaks'. Each kiosk is a part of a hub and spoke model with the ITC procurement centre as the hub and the e-Choupal as the spoke.

The investment in each kiosk is around Rs. 0.25 million (USD 5000). At the kiosks, the 'Sanchalaks' help the farmers access the different agricultural crop-specific websites that ITC has created in the relevant local language. The farmers can learn on-line the best farm practices for their crop, the prevailing prices and price trends for the crop in the Indian and world markets, and the local weather forecast. Moreover, if the farmer decides to sell his goods in the ITC procurement centre, the kiosk operator issues her/him a referral slip, which the farmer uses to sell her/his goods in the centre. It currently has 4700 installations covering 28,000 villages in 6 states (www.itcportal.com)

56 Shirole (2003), Rao (2003) and Malhotra and Nigam (2003) for a detailed discussion on role of such risk capital in the financing of SMEs and infrastructure

57 Other countries such as South Korea, China and Japan have been willing to allow these entities to build up a large quantum of Non-Performing Assets (NPAs) and have allowed them to write it off repeatedly but within India this approach has not found much favour.

58 http://app.feedback.gov.sg/asp/ocp/ocp04.asp?id=2183

59 Project Information Document (PID), SME Financing and Development. Report No.: AB756, World Bank, 9 March 2004.

60 "International financial institutions were encouraged to undertake comprehensive and consistent capacity building efforts to train commercial bankers in developing countries to deal with SMEs', Draft Report of the Commission on Enterprise, Business Facilitation and Development on its Sixth Session, 18-21 February 2002, Trade and Development Board, United Nations Conference on Trade and Development. http://www.unctad.org/en/docs/c3l19a2_en.pdf

61 Pitman (2003) discusses the use of Shareholder Value Add (SVA) as a metric for driving the performance of Banks. During his tenure at the helm of affairs (from 1983 to 2001), the market capitalisation of the British bank Lloyds TSB increased 175 fold from about Rs.1500 crore to over Rs.260,000 crore.

62 Refer to Mor and Sharma (2002) for a more detailed discussion on this issue as well as on the whole question of competencies of Boards and Managements (both of public sector and private sector financial services institutions) to function effectively in the current deregulated environment. They argue that once suitable metrics of performance are established, development of the required competencies would not pose a significant challenge.

63 For a detailed discussion refer to Ananth, Bindu, Bastavee Barooah and Rupalee Ruchismita (2004)

64 Clark, Gregory Clark and Susan Wolcott "One Polity, Many countries" Economic Growth in India, 1873-2000, chapter 3, In search of Prosperity, edited by Dani Rodrik, 2004

65 This happened in North Britain with increased productivity growth in textiles. Ibid.

66 Maharashtra, now the richest state had a net gain of only 0.44 percent of the population every year. Similarly out migration from poor Uttar Pradesh was estimated at only 0.07 percent per year, compared to a natural rate of population increase of 2.8 % per cent per annum. Ibid.

67 This model has been pursued for private rail franchising in the United Kingdom which led to efficiencies in offering services to consumers with minimum and fixed drain on public resources. Dyson, Michael, Michael. A. and Neil Kenward (2000)

68 http://indiabudget.nic.in/ub2004-05(I)/bag/bag5.htm

69 http://www.indiainfoline.com/nevi/apjk.html

70 As referred in the "Enhancing Investment Credit in Agriculture" paper by Panthary, Rajiv, (2005)

71 One such example is Shell Solar. Shell Solar is providing solar electricity and equipment directly to remote households on commercial terms in 6 developing counties: South Africa, China, India, Philippines, Morocco, and Sri Lanka. The household solar unit, lights, up to 5 lights. The product is commercially sold through dealers and installers as well as distributors. 'Shell Solar: Reliable Power for Today and Tomorrow', www.shell.com (2004)

72 Cockburn, Mark, Michael Dyson, Michael. A. and Neil Kenward (1999) as sighted by Panthary, Rajiv (2005)

73 Ibid.

74 This was facilitated by the Andhra Pradesh Farmers Management of Irrigation Systems (APFMIS) Act of 1997

75 Reform has also made the irrigation agency accountable to the farmer organisations, and resulted in the tripling of water charges and linking the money collected to the costs of operating and maintaining irrigation systems

76 A similar programme has been initiated in Indonesia in collaboration with the World Bank and the Government of the Netherlands. The Government of Indonesia (GOI) has instituted an irrigation improvement fund (KIIF) that is allocated among irrigation systems managed by federated Water User Associations (WUAs). A minimum standard of maintenance and quality provisions are stipulated as a part of this award.

77 Water Supply Sector report Part 2 , Also refer Holden, P and Thobani,: Tradable Water Rights: A World bank Policy Research Working Paper as sighted by Panthary, Rajeev (2005)

78 This has resulted in other benefits such as efficient utilization of water, ecological gains from reduction in salinity due to excessive use of water, etc.

79 NHAI has been extensively promoting public private partnerships. A large number of new projects have been sanctioned as Build-Operate-Transfer projects.

80 Singh, Harsha Vardhana (2005)

81 http://indiabudget.nic.in/ub2004-05(I)/bag/bag5.htm

82 Kumar, Ashok, Zhi Liu, Piers Vickers (2002)

83 With the availability of hedging instruments such as futures contracts (assuming that banks were permitted to use these instruments) even the need for price fluctuation margin may fall.

84 The 'Choupal Sagar' is a rural hypermarket which provides multiple services under one roof. It creates a platform for farmers to sell their produce. Farmers can also buy quality products for their farm and household consumption from 'Choupal Sagar'. This rural mall also provides farmers additional services of soil testing, banking, insurance, medical facilities and restaurant. ITC plans to open 50 such hypermarkets over the next two years. (http://www.itcportal.com/sustainablity_report/page_57.htm)

85 Some of the main issues relate to high costs of assessment of damage, delay in claim settlement, problems in understanding claim calculation by the farmers, etc.

86 Such insurance products assign weightages to quantity and timing of rainfall, negative weightages can be assigned for wrong timing of rainfall such as rainfall just before the harvest

87 In hilly regions, certain areas could lie in rain shadow areas

88 Panthary, Rajiv (2005)

89 In India, this translates into 8 years of formal education (7 years in case of certain states)

90 As summarised by Mor, Nachiket, Executive Director, ICICI Bank, based on discussions from Indian Monetary Fund Seminar on "*Growth and Poverty Reduction-Lessons from Africa, China and India*" November 4-5, 2004, Nairobi, Kenya.

91 Report by the Committee on India Vision 2020, Planning Commission, Government of India (2002).

92 Ibid.

93 India has over 4,200 Industrial Training Institutes (ITI) imparting education and training in 43 engineering and 24 non-engineering trades. Of these, 1,654 ITIs are run by the Government, while 2,620 are private. The total seating capacity in these ITIs is 0.62 million.

94 A similar role has been performed by the Minority Business Development Agency (MBDA) in the U.S (http://www.mbda.gov).

95 LABS identifies several competencies that are in demand. Some of these include drivers, retail stores helpers, hospital helpers, trained people for the hospitality industry, mobile phone repairs, etc.

96 The model is based on involvement of the business sector to identify the business needs, identifying curriculum requirements, potential faculty and industry mentors and finding possible placement opportunities. The LABS programme are demand driven and training as yet has been provided for: Office Assistant, House-Keeping, Garment manufacturing, Driving, Child Care, Auto Mechanic, Hospitality, A/C repairing, Hardware, Home nursing, Photo/Video and IT Enabled.

Source: Upward Bound: Social Mobility through business to Youth Networking, 'Why Livelihoods? Why Labs', Livelihood Advancement Business School, 2004

97 http://naukri.com/

98 Chinese Experience with Town and Village Enterprises (TVEs)

99 Rajan, Raghuram G. and Luigi Zingales, (2003)

100 The Wells Fargo Scoring and underwriting System includes collection of data (like years in business, years as a bank customer, credit history of the business owners, average deposit balance, financial assets and liabilities of the owners), analysis, evaluation and modification of the system by segment-level analysis on total profitability, implementation strategies and develops profitable models.

101 Portfolio of the company is analysed by the sector of the industry, geography, origination channel and partner, risk segment, time loan originated, loan size, rate and usage behaviour, etc.

102 The selection for direct loan decision process involves targeting long established small business with good trade credit whose applications are processed with screening the data and testing them by putting them in the statistical score cards which also determines the setting price and credit amount.

103 There are four types of business credit-scoring systems or models to choose, or to combine, depending on the need of the business. They are: 1. a generic model that predicts the likelihood of a company paying in a severely delinquent manner based upon a sample of businesses from across all industry segments, utilizing a wide range of commercial information.2. An industry-specific model that predicts the probability of delinquent payment based upon a sample of firms within a given industry.3. A model that predicts the likelihood of a small business' payment performance based on the owner's payment behaviour and 4. A scoring model developed from a sample of businesses that most resemble the bank's actual borrowers.