Inclusive Financial Systems

Some Design Principles and a Case Study

Besides facilitating overall economic growth, finance can help individuals smooth their income, insure themselves against risks and broaden investment opportunities. Empirical evidence shows that inclusive financial systems significantly raise growth, alleviate poverty and expand economic opportunity. This paper lays out several principles that should be kept in mind when designing such systems, supported by a case study of ICICI Bank.

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Financial inclusion, at a minimum, may be interpreted to mean the ability of every individual to access basic financial services which include savings, loans and insurance in a manner that is reasonably convenient and flexible in terms of access and design and reliable in the sense that the savings are safe and that insurance claims will be paid with certainty. In our view the provision of these services requires adherence to certain core design principles irrespective of whether the provider is a cooperative bank, regional rural bank, scheduled commercial bank, non-banking finance company (NBFC) or a not-for-profit civil society organisation. We have outlined these principles below.

I Design Principles for Inclusive Financial Systems

Financial Services Providers' Perspective

Providers of financial services must be able to fully recover all the costs that they incur in the provision of these services. A model that relies on cross-subsidisation is inherently unstable because as soon as the source of the profit that is supposed to cross-subsidise disappears, so does the ability to cross-subsidise and therefore, offer this service.

Risks in a lending or insurance business should be warehoused by institutions most capable of managing these. Specifically, in the case of institutions that seek to offer retail deposit taking and insurance services, they must have an adequate amount of financial capital to protect the financiers (depositors and insurance policyholders) of the risks that offering this service implies.[1] The reference here is to cooperative banks, regional rural banks, scheduled commercial banks, deposit taking non-banking finance companies and not-for-profit civil society organisations that are engaged in the business of deposit mobilisation – including self-help groups (SHGs) where group-leaders are permitted to collect savings and operate group savings accounts on behalf of the self-help group members thus acting as mini deposit-taking institutions.[2] The belief is that to be a reliable provider of insurance and deposit taking services, the institution must be a formally regulated entity, have a minimum amount of capital that is specified by the regulator for any entity that seeks to offer these services and an adequate amount of capital for the risks it assumes so as to protect its depositors and insurance policyholders.

The distribution/origination function may be viewed as separable from the function of providing risk capital and owning the financial asset/claim (whether it is a loan, savings or insurance product). This is related to the previous point. Organisations most capable of managing risk through diversification and other strategies that imply a certain level of scale might not have expertise in origination of assets that require local information. Similarly, large financial institutions and banks often have cost and control structures that make the handling of small savings accounts and loans unduly expensive and inflexible. In these scenarios, there is a good case for pursuing hybrid models where the outreach of local institutions can be combined with the ability of larger and regulated organisations to manage risks. The recently developed business correspondent model[3] brings this insight to bear in offering savings services to rural India. ICICI Bank's partnership model in microfinance (discussed later in the note) is also based on this. This may well be extended to improving access to insurance and other financial services in under-served markets, without necessarily infusing additional risk capital at all levels of the financial intermediation chain and entailing inefficient usage of an extremely scarce resource, capital.

In the case of a provider of loans, the entity must have sufficient capacity (either driven by an operating model, specialised knowledge or proximity to the customer)to adequately assess credit risk and subsequently collect money from the borrower. While very institution must have an adequate scale, it must also be configured in such a manner so as to be managed well and have the ability to retain and build on its ability to assess local risks and opportunities.

Client Perspective

While convenience of access may be defined in various ways, providers must ensure that the point at which the financial service is accessed must be no more than an hour's walk from the place of residence of the client and must have hours of operation that allow this access to happen in a manner that is convenient to the client and does not result in a loss of wage owing to travel to and from the access point.[4] This point of transaction must be such that it does not exclude people from a literacy status, gender or other socio-economic considerations.

Comprehensiveness of access to financial services is key from a client perspective. In other words, the client must be able to choose from a range of services that includes basic banking, Advt Page

credit, insurance (including life, accident, health, weather) given his/her particular requirement. A focus on credit alone might not fully address the household's risk management and consumption requirements.

In the landscape of providing access to financial services to poor households, two distinct but complementary models have emerged. One in which the managerial aspects related to such access is the responsibility of a specialised service provider, say a NBFC or a cooperative bank, and another in which this responsibility is assumed by the users/community themselves, as in the SHG models where groups take responsibility for accounting and book-keeping. Each model of financial services delivery has its own unique strengths; however, clients must have a choice between the two. Policy-makers must not assume that managerial responsibilities are easy to assume and discharge or that low-income households are eager to do so in every instance. This is particularly the case for households with competing demands for time as is the case with urban low-income households. Specialised service providers provide this managerial ability in return for a fee. Clients must be free to choose between paying that fee to an external provider or internalising these managerial costs themselves through self-organisation into groups of various kinds. In either case, the important point is that these costs exist. The fact that communities internalise them does not mean that they go unreckoned. In addition, there is also a concern about viewing community groups as permanent entities. Even if we concede that a group can mange a savings or credit operation in perpetuity, this approach is not flexible to accommodate the evolving financial service needs of the underlying members – be it larger loan sizes, individual liability loans or new products such as insurance and derivatives. Once again the point being made here is that the choice of format to access financial services must be left to the customer at all points in time and there should be no attempt in the design to hard-code a particular format in which delivery is possible.

Specifically in the case of credit, individuals unable to offer collateral must be able to systematically build and "port" their credit history across financial service providers. Helping the poor develop credit histories and centralising credit histories make credit markets less segmented and therefore, borrowers have access to cheapest sources of credit.[5]

Regulator Perspective

The preceding discussion seeks to make the point that the final configuration of how access to finance is created is dynamic and must be informed by previous experiences in this regard. The outcomes that regulators should care about are (a) whether access to financial services is universal, (b) whether such access is of a quality that is acceptable (here, quality is used to cover aspects such as the lender-borrower relationship and features of financial services offered) and (c) whether providers are sustainable and meet certain governance norms. Regulation must not favour one or the other model for reasons beyond the above, i e, regulators must be outcome-driven and model-neutral. Historically, certain institutional designs have been supported with a view to increasing financial inclusion. For example, cooperative banks and regional rural banks were created with this mandate. The primacy of this mandate has often meant that other metrics such as capital adequacy have not been used to evaluate these institutions and these entities have been recapitalised on occasions. Despite these substantive concessions, they have not delivered on the objective of financial inclusion. This experience shows us that financial inclusion cannot be achieved merely by diluting design principles. On the contrary, that may impede the emergence of other models with the potential to address the challenge of financial inclusion.

The regulator has been concerned that lowering the entry level capital requirement in order to obtain banking and NBFC licences might lead to proliferation of entities. The concern is with reference to the regulatory capacity being a limiting factor – if "too many" underlying regulated institutions are created, then the supervision responsibilities on the regulator may become unsustainable.[6] Implicitly, the minimum capital norm is also meant to be a screening device for quality of financial service providers. One pragmatic alternative that reconciles this trade-off between financial access and supervision load is to consider models such as the partnership model (for credit) and business correspondent (for savings) that rely on already regulated entities extending their outreach through third parties. Where entities desire to warehouse risk on their own balance sheet, they would have to be in conformity to the minimum capital norms specified by the central bank.[7]

II
What Have We Learnt about 'What Does Not Work'?

Attempts to impose interest rate caps have resulted in either distortion of pricing by providers or withdrawal of lenders thereby hurting rather than aiding improving access to finance.[8]

Deposit-Taking by Poorly Capitalised and Narrowly Diversified Entities

Given the experiences of a variety of service providers on the ground, there would be real concern if, particularly for the poor, poorly capitalised entities are permitted to warehouse risk on their balance sheet. The points of failure could be multiple:

(1) Use of savings for on-lending into the same geography exposes client savings to systemic risk in the region. This approach does not leverage benefits of national diversification to provide security and liquidity to client savings. This concern is applicable to a wide class of service providers: (a) non-bank finance companies; (b) cooperative banks; (c) regional rural banks; and (d) SHGs that collect savings and use them for on-lending directly or as collateral in some form. For example, people in a region might be saving in order to build protection against rainfall failures. In a model in which deposits from these individuals are re-deployed as loans in the same geography, rainfall failure might imply loan riskiness and therefore, inability of savers to use deposits when they need it the most.

(2) As a consequence of the above, narrowly operating entities typically have to offer higher rates of interest to attract depositors. This in turn forces them to charge higher rates on loans. This gives rise to the concern that the loan portfolio over time will suffer from the problem of adverse selection – those who are willing to borrow at higher rates may be "riskier" thereby affecting the security of depositors in the same entity.

(3) An entity that accepts deposits in addition to a lending function must be able to manage the inherent asset-liability management issues and liquidity risks. This entails the ability to invest in automation and information systems that can support these functions, which is typically not the case with small entities.

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(4) Additionally, lack of access to instruments such as credit derivatives impairs the ability of these entities to manage credit risk through strategies other than diversification in origination. This in turn is challenging for entities that by design operate in narrow geographies.

Governments investing in creating systemic infrastructure are seen to facilitate other providers to work in these markets. This systemic infrastructure could take the form of national identification numbers, credit registries, payment systems, electronic commodity and auction markets and weather measurement stations that are in the nature of public goods and stimulate market activity. This is superior to more "interventionist approaches" such as the government being a provider of subsidised financial services.[9]

III
ICICI Bank Case Study

While these design principles may be consistent with many on-ground configurations pursued by other institutions, ICICI Bank has chosen the following:

(1) ICICI Bank and its group companies are to be the providers of deposit taking and insurance services and therefore they warehouse all the attendant risks. Since as on June 30, 2006 its assets are $ 60 billion, its networth exceeds $ 5 billion and its rating is AAA, it is in a good position to absorb these risks. As on date, ICICI Bank has built a portfolio exceeding Rs 16,000 crore in rural finance of which Rs 2,500 crore is to low-income families and has a customer base exceeding 2.5 million clients.

(2) To develop a relationship with a network of local institutions (both urban and rural), which could be cooperative banks, producer cooperatives, NBFCs and not-for-profit civil society organisations to actually distribute these services. A combination of these partner institutions, rural hub branches at a cluster level and agents (such as tractor dealers) appointed by the bank represent the core of its "no white spaces" strategy that aims to cover 200 districts by 2007. Under this strategy, the bank plans to have at least one touch point (collectively referred to as ICICI Bank 'grameen kendras' which may belong to ICICI Bank or its partners) every three to five kilometres in rural and semi-urban areas [Iyer 2006]. If the model succeeds this implies that the number of ICICI Bank grameen kendras capable of offering a reasonably complete suite of financial services would exceed 50,000 (or 1 for every 10 to 12 villages) by March 2007 and the customer base could exceed 25 million by 2010 [Anand 2006].

(3) To use the "partnership model" for the lending business in order to build incentive compatibility with the local institution that is delivering this specific financial service. This design draws on the separation of functions discussion in the preceding section. The partnership model leverages the local information and cost structure of a local financial institution in order to unlock the financing ability latent in the commercial banking sector. The model has been designed with the feature of the local institution sharing the risk with the bank so that there is careful origination and supervision on an ongoing basis.[10]

(4) For deposit taking work with a variety of local institutions to provide these services under the business correspondent model.[11] Business correspondents are agents identified by the bank to provide basic banking services such as opening bank accounts, collecting savings and deposits and offering insurance products in rural areas. ICICI Bank takes full responsibility for its correspondent's business conduct. The bank has already launched this service in Orissa and Andhra Pradesh.[12]

(5) Similarly in insurance, ICICI Bank and its group companies ICICI Prudential Life Insurance Company and ICICI Lombard General Insurance Company work with local institutions for design and delivery of insurance products – under the bancassurance model these policies will be sold at the ICICI Bank grameen kendras. Given the peculiar challenges of health insurance delivery, it has worked with hospital networks and third-party administrators to coordinate quality of healthcare as well.

(6) In order to facilitate better price discovery and price risk management for farmers, ICICI Bank co-promoted the National Commodity and Derivates Exchange (NCDEX) jointly with National Bank for Agriculture and Rural Development (NABARD), the National Stock Exchange (NSE) and Life Insurance Corporation (LIC). NCDEX along with its affiliate National Commodities Management Services Limited (NCMSL) is attempting to improve access to price derivatives for farmers, facilitate commodity-based finance through banks, provide weather stations and improve the warehousing infrastructure.[13]

(7) For its work in product development, ICICI Bank has combined its expertise in financial engineering with the insights generated by its partners and allied research institutions. To date, ICICI Bank and its group companies have designed and are taking to scale products including the following: (a) index-based rainfall insurance; (b) catastrophic health insurance; (c) working capital facilities for agriculture traders; (d) working capital facilities for crafts people and artisans; (e) take-out finance for start-up local financial institutions; (f) warehouse receipt based financing; (g) credit to low-income households through the partnership model; and (h) savings to low income households through banking correspondent model.

(8) It is ICICI Bank's belief that in order to improve efficiencies in financial intermediation, especially in the context of small unsecured loans, the role of technology is crucial. ICICI Bank's initiatives in technology may be broadly thought of in two categories: (1) Front-end technology investments – this includes issuance of smart cards with unique identifiers to its clients that help the client track financial services usage data on a real-time basis as well as sharing of credit information across ICICI Bank's network. (2) Back-end technology investments – this relates to investment in creating better core banking systems among its partner institutions. This enables more efficient data capture and sharing and reduces margin of error on transactions. ICICI Bank has collaborated with FINO, a company that seeks to provide front-end (smart card, point-of-sale terminals), back-end (banking software, performance management and reporting, MIS) and information services (credit bureau) to community-based financial institutions[14] and is now looking to partner with NABARD, State Bank of India and the Credit Information Bureau of India Limited to try and see if FINO could, as in the case of NCDEX, become a provider of these technology services on a system-wide basis particularly to cooperative banks and NBFCs engaged in the business of lending to and collecting savings from small borrowers. The participation of the RBI and NABARD in some of these initiatives that have a systemic benefit would be an accelerator of access to finance.

(9) ICICI Bank is conscious that working in rural India and with poor households is fairly uncharted territory. It has tried to base its growth strategies on systematic results of what works at the

household and local economy levels. In order to catalyse high-quality work in this area, it works closely with research centres that systematically research issues related to access to finance.[15] These centres are housed within the Institute for Financial Management and Research and they seek to provide thought leadership to all institutions working in this field.

IV
Conclusions

This paper aims to express a point of view on the financial system design principles essential to achieve the goal of financial inclusion. A shared vision of what these financial system design principles are, can guide thinking on what the key initiatives (in order of priority) are for achieving inclusion. While the principles outlined in this note including capital adequacy, cost recovery and institutional pre-requisites of entities warehousing risk may not be complete or accurate, it is certainly our belief that these or variants of these principles must first be agreed upon before any attempt is made to implement a particular design or reform. Many of the achievements of institutions in rural and micro-finance are in the nature of "second best" owing to the fact that there are deeper structural constraints that have not been recognised or past failures that have not been learnt from. Current prescriptions for reform that are being implemented or debated do not recognise this and instead, address symptomatic issues. For example, the inability to track credit information or effectively recover collateral poses challenges to every lender in the financial system, forces distortion in product design and may even prevent entry of lenders. The note discusses the salient design aspects from the perspective of the provider, client and regulator. It also discusses some lessons from past experience such as allowing deposit-taking by poorly capitalised entities, all with a focus on design considerations. While designing a financial system to maximise access to the poor, rather than dilute basic design principles that are key to sustainability, these should be adhered to even more rigorously. The ICICI Bank case study is discussed as a specific configuration consistent with these principles and designed for maximising financial inclusion. EPW

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Notes

[The views expressed in this note are entirely those of the authors and do not in any way reflect the views of the institutions with which they are associated.]

1 This capital adequacy framework, now guided by the internal ratings approach of Basle II, must apply in a stringent, institutional neutral manner particularly for those institutions that choose to warehouse these risks on their balance sheet and finance themselves by accessing retail deposits or offering insurance services.

2 Certain self-help promoting organisations are interpreting savings in an SHG as member equity. However, this immediately endows it a character different from the safety and liquidity associated with savings. See for instance the INAFI report (2006) that says, "The savings of the poor within their group build their stake and ownership which means savings is not a product but has a strong character of equity and effectively used for leveraging further resource mobilisation and also as a hedge against risk".

3 See RBI circular RBI/2005-06/331 DBOD.No.BL.BC.72/22.01.009/2005-2006 and the Report of the Internal Group to Examine Issues Relating to Rural Credit and Microfinance, July 2005, www.rbi.org.in

4 Morduch and Rutherford (2003) defines the important dimensions of access as being (a) reliability – whether finance is available when needed or desired, (b) convenience – how easy it is to access finance, (c) continuity – ability to access finance repeatedly, and (d) flexibility – whether the product is tailored to the needs of the household or enterprise.

5 See Banerjee (2001). Similarly, Rajan and Zingales (2003) also emphasise the role of initiatives such as credit bureaus expanding access to finance, especially for those who cannot afford to provide collateral.

6 How many regulated institutions is "too many" is an issue to be debated and understood.

7 What this minimum level of capital must be would be derived from the desired scale of investment in systems and processes as well as the minimum level of asset diversification that needs to be built in order for the deposits to have an investment grade rating and to deal with liquidity shocks that may occur from time to time. Answers to both the above can be found through debate and research. In the case of banks, Rs 25 crore might be an appropriate minimum capital requirement.

8 See Helms and Reille (2004) and Porteous (2006). The latter discusses the experiences of Uganda, Bangladesh and Bolivia with respect to competition and interest rates.

9 See Demirguc-Kunt (2006) for a discussion on the role of the government in financial sector development.

10 See Ananth (2005), Harper (2006) and Report of the Internal Group to Examine Issues Relating to Rural Credit and Microfinance (2005) for a detailed discussion on ICICI Bank's partnership model.

11 RBI circular RBI/2005-06/331 DBOD.No.BL.BC.72/22.01.009/2005-2006.

12 See 'ICICI Bank to Hire More Banking Correspondents', *The Hindu Business Line*, August, 2, 2006.

13 ICICI Bank is also working closely with SAFAL in Bangalore to attempt a similar transformation in the processes for fruits and vegetables.

14 See 'ICICI Bank Launches New Initiative in Microfinance', *The Hindu Business Line*, July 14, 2006.

15 This includes the centre for microfinance, centre for development finance, centre for insurance and risk management and the centre for small enterprise finance. More details on them may be obtainable from the IFMR web-site: www.ifmr.ac.in.

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