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Regulatory Aspects of Universalising Financial Services Access

by

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Regulatory Aspects of Universalising Financial Services Access

1. Introduction

1. Economic theory has long argued that one of the most powerful ways to release the "poverty trap" in which the poor find themselves is to make available to them as near a set of complete financial markets as is feasible. This allows them to protect themselves from adverse shocks and to make investments in high return activities in a manner that is not limited by their current low income. These could include investments through borrowed money in high return service enterprises such as dairies, tea-shops, eateries and grocery stores or investments through retained earnings in improved education and health care.

2. Market failures in credit and insurance markets arise from limited information and limited enforceability. This problem is compounded while dealing with the poor owing to their inability to provide collateral. Peer lending models that use local information and the threat of credit denial as leading strategies have gained popularity in the nineties and subsequently. This paper, while taking stock of the state of financial services access in India, will focus on the regulatory environment and policy initiatives that are critical to achieve universalisation.

3. Other than the Government of India[1] and highly rated large companies[2] (AA and above credit rating) and more recently, middle to upper income urban households[3], most other segments are very poorly served. The underserved segments include:

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1 Driven in part by the strong savings rate, a strong preference for bank deposits by savers and a very high proportion of these deposits being held by banks as investments in Government of India securities. Against a regulatory requirement of 25% of net demand and time liabilities the average for the banking system as a whole is about 40%.

2 For moderate amounts of finance. For quantums larger than $1 billion, given the depth of the Indian financial markets, resource mobilization becomes a challenging exercise. Derivative markets are also very shallow and management of even moderate amounts of interest rate, currency, credit and commodity risks becomes a challenge. Also see Mor and Sehrawat (2003) for a detailed discussion on infrastructure finance.

3 While the proportion of retail finance overall remains low at only 3% of GDP relative to other South East Asian countries, for example, Korea where it is 55% of GDP; there has been a vast improvement in the availability of consumer finance over the last decade, particularly in the last five years with the entry of ICICI Bank as a large originator and securitiser of these loans. The Indian mortgage market grew from around $ 3,000 million in 1997 to $ 12,000 million at the end of 2002, or at a compound annual growth rate (CAGR) of 32 per cent. Credit card outstandings have increased from $100 million in 1999 to about $600 million in 2003. (Bandyopadhyay,T., 2003). It would now be quite accurate to claim that the urban upper to middle class customer does not any longer face a constrained credit market and has access to channels and instruments which allow easy access to most financial markets.

1. **State Governments:** they are facing increasingly tight budget constraints as avenues for increased collection of taxes are becoming harder to find. They are responding by cutting out essential basic services and development expenditure. While this improves the rationale for them to act as facilitators rather than financiers there is still a need for them to access finance to support critical expenditures on healthcare and education. While new instruments such as cash flow securitisation do offer them some avenues for additional borrowings a lot of work is needed to develop alternative means of finance for state governments.

2. **Public Sector Units (PSUs):** while several central PSUs have been able to obtain a AAA rating (ONGC, IOC, GAIL, BHEL, NTPC, to name a few) and have, therefore, been able to access the financial markets with ease, several government entities such as state road transport undertakings and state electricity boards have not had an equal measure of success. As in the case of State Governments, there is an urgent need to improve access to finance for these entities.

3. **Urban Local Bodies:** they are largely in a similar position as the state governments.

4. **Mid to low quality large companies:** these companies are faced with severe competitive pressures from domestic companies that happen to be larger and better capitalised as well as from international competitors. The differences in access and financing cost translate to as much as 4 to 5% in some cases making their competitive position even weaker. Even here there is a need to improve access to finance.

5. **SMEs, Rural Individuals and enterprises and Urban low income and poor households:**

   This paper will focus principally on access to finance for the rural and urban poor.

2. The state of access to financial services for the poor in India

4. The state and implications of diminished access to financial services is often difficult to discern and cannot be derived from stated demand and supply gaps alone. In many instances, behaviour of the poor is influenced in anticipation of limited access. For instance, Morduch (1995) finds in his study that for less well-off households in the ICRISAT villages, production choices will be made with an eye to reducing the likelihood that the shocks will happen in the first place. Similarly, over-diversification of economic activity as observed by Hess, Richter and Stoppa (2001) is another manifestation of reduced access to insurance-like services which over time, prevents the household from deriving advantages of specialisation and scale. There is a framework (See Banerjee and Newman, 1998) that tries to explain low rates of migration in India from less productive rural occupations to high productive urban occupations in terms of constrained credit access at urban locations. Therefore, the pernicious effects of constrained access may in several cases, be seen indirectly in sub-optimal production and consumption choices among the poor, not in demand data.

5. However, even going by overall data, the achievements are negligible. The banked population in India as defined by population above the age of 15 with a bank account is merely 20%[4]. Even here, there are disparities between rural and urban populations vis-à-vis access to bank accounts. Against an estimated demand for credit for poor households in India ranging from $3 to $9 billion annually the formal sector is barely able to provide $200 to $300 million. There is a high degree of reliance on informal providers for savings facilities and insurance arrangements that prevail in rural areas especially among the poor tend to be informal and mutual in nature, not offering sufficient protection against systemic shocks.

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4 The same figure is 98% in the case of Germany. (Visa, 2004)

3. Access to financial services and dimensions of access

6. It is useful to describe various dimensions of financial services access and understand what universalisation means given this context.

7. Several authors have discussed attributes of access that are important for the poor. For example, Morduch and Rutherford (2003) summarise it thus; "Poor people want what many of the less poor already enjoy: reliable, convenient, and flexible ways to store and retrieve cash and to turn their capacity to save into spending power, in the short, medium and long term. And they want it on a continuing, not a one-off, basis."

8. Access has to be distinguished from mere physical proximity to source of the service. Due to various historical factors including nationalisation of banks, India has a large network of formal financial institutions that includes rural branches of Commercial banks, Regional Rural Banks, Cooperatives and Non-Bank Financial Institutions and Local Area Banks[5]. However, that by itself has not always ensured sustained or universal access[6]. Incentives of staff working within these organisational formats is a challenge to be addressed.

9. Mor and Ananth (forthcoming) observe that availability often refers to a problem of access unrelated to the price. It refers to restrictions on availability irrespective of the rates that users are willing to pay[7]. This could also be a result of organization and service characteristics. For instance, in India, a commonly cited problem is that timings of bank branches are not suitable to the rural context and this in turn, limits access. There is also a more subtle concern that while there are specialised institutions catering to the needs of some segments (for example, micro finance institutions for the poor and urban co-operative banks for small businesses), there are no mechanisms to smoothly graduate these segments from one level of funding to another and often there are large gaps in credit availability at the intermediate levels.

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5 Formal financial services are available to low-income families through the 33,000 rural and 14,000 suburban branches of the major banks and RRBs and by 94,000 cooperative outlets – either bank branches or village level societies. Refer Sinha (2003). This needs to be viewed against the fact that India has more than 550,000 villages. There are issues both with the extent of outreach as well as the quality of access that the existing network affords to the rural poor. Access to a bank branch, which may in addition observe a more traditional 9 to 5 schedule, may involve significant costs both explicit as well as implicit (lost income for the time spent commuting to the bank). From the providers perspective however, providing a larger network of branches is also difficult since high transaction intensities, combined with low per-transaction value, render bank-branches serving very small communities, unviable. A similar situation prevails even for the most basic of insurance products – life insurance. Total insurance premium paid annually in India is only 2.7% of GDP when compared to 14.2% for UK (Source: Swiss Re, Economic Research & Consulting, sigma No. 6/2002). However, due to the existence of a wide network of insurance agents (use of such agents is not permitted in banking, particularly where savings are concerned) the availability may be far easier here relative to banking.

6 There is some empirical evidence to show that the presence of a branch has some implications on access. Pande and Burgess (2003) use state-level data to show that rural branch expansion in India was associated with significant reductions in rural poverty. In addition, household data demonstrate that, during the years of the social banking program, bank borrowing among rural manual labor households was higher in states which saw more rapid rural branch expansion. They also show that the program increased access of lower caste and tribal households to bank loans.

7 Several anecdotes point to existence of credit rationing among the rural and urban poor in India where rationing is defined (Stiglitz and Weiss ,1981)as a state where there are identifiable groups of individuals in the population, who with a given supply of credit are unable to obtain loans at any interest rate

10. Another key aspect is the range of financial services access. Although much of the attention of policy makers and donors is on credit, other financial services including savings, investment, remittance, insurance (life, health, accident, weather) and derivatives are equally important in the overall discussion. In several cases, especially among the very poor, it might be the case that services like insurance are more relevant than credit. Even as regards credit, while MFIs have made available small loans (USD 10 – 300) for consumption and working capital, access to enterprise finance or housing finance for the poor that entail larger per capita amounts of credit continue to be gaps that are not adequately addressed. Therefore, universalisation also entails designing services in each of these categories and making them available at scale.

11. Continuity in access to financial services has been an important challenge in the Indian context. Partly, the failure to pursue commercial models capable of scale explain why there have been more 'schemes' for financial services than permanent institutional designs that respond to the needs of the poor. If one were to examine the leading rural credit programme in India, the Self-help Group Bank Linkage programme, the emphasis is on obtaining one loan for the group from a commercial bank branch and this is indeed the metric that is tracked for programme success. It fails to analyse the mechanisms in which the individual/group may access credit and savings services on an ongoing basis. Price ceilings may themselves act to limit availability of financial services on a sustained basis. For example in the case of farmer-loans in India below Rs.200,000, where interest rates are capped, even those providers that would be willing to make these loans (but only at higher rates that reflect underlying transaction costs and risks) may refrain from doing so. A similar effect is observed when subsidized products (for example life insurance products for the poor, crop insurance policies, and auto insurance policies) are introduced in the market through a limited number of government owned entities or through the imposition of artificial price caps. The subsidized rate also effectively acts as a price cap leading to diminished supply (by few players) of these products and in addition acts as a strong deterrent for new players to enter and market forces to have free play.

12. Among certain segments, large farmers for instance, a history of loan forgiveness programmes has resulted in the creation of a credit culture that does not provide a strong deterrent to default. The absence of shared credit histories further erodes the credibility of the credit denial threat.

13. It follows that a discussion on universalisation needs to encompass issues of institutional structure and incentives, product and contract design and regulatory/policy environment. This paper will highlight certain key regulatory aspects.

4. Regulatory Approach to Universalisation in India

14. With the advent of financial sector reforms, there has been an entry of new participants in the banking, insurance and mutual funds industries. While this has corresponded with an increase in credit availability for certain segments in urban areas[8] and impacted financial markets (for instance, derivatives market) positively, there has been no real impact of reforms on the rural and poor segments. Both public and private sector banks fall short of meeting priority sector requirements. The Reserve Bank of India's report on Advances to Agriculture and Weaker Sections (2004) reveals that only four out of thirty private sector banks and seven of twenty-seven public sector banks met the target for lending to 'weaker sections'[9]. Innovations in product design have also been few and far in between.

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8 Refer growth in mortgage market referred to earlier

9 www.rbi.org.in

15. The regulatory approach to the access issue has been what is popularly known as 'directed credit'. Through a series of measures including 'priority sector norms' for credit and insurance and special schemes for identified sections of the population, the regulator has sought to address diminished presence of formal providers in rural and under-served markets.

16. The main regulatory policy in this regard is the priority sector obligation, which requires all commercial banks in India to advance 40% of their Net Bank Credit in a given year to certain defined sectors, including agriculture, small enterprise, micro-credit, rural infrastructure and others[10]. The same approach is true in the insurance industry as well, which mandates insuring a specified number of lives (in the case of life insurance) and a proportion of premia from among the rural and socially vulnerable population[11].

17. Another aspect of banking regulation in rural India has been the 'service area approach' which carves out geographical areas which are to be served by designated bank branches only. Bank branches are assigned targets based on district-level credit plans. While the intent may have been to ensure universal coverage, this approach thwarts competition among banks. Regardless of ownership (whether private or public), competition between players may result in better choices for certain segments. The service area norm also reveals a bias for a branch-based approach[12]. It is entirely possible that with advances in technology-based hybrid models, the need for bank branches at a village level is obviated.

18. While approaches such as 'service area' inhibit competition between banks, there has been limited scope for non-traditional competitors to emerge. For example, Money Market Mutual Funds (MMMF) in India are not permitted to offer checking facilities to account holders unless it is by way of redemption by the investor. If this were not the case, MMMFs could substitute savings bank accounts[13].

19. Re-finance has been yet another policy instrument aimed at increasing access to credit for certain segments, prominently self-help groups and cooperatives. Over a longer term, this discourages banks from making pricing decisions based on risk estimation and undermines the scope for innovation by providing a direct subsidy.

20. The absence of segment-wise reporting for banks does not reveal the true profitability of the performance of rural branch operations. There are aspects of cross-subsidisation by other functions of the banks, trading for instance. This again, creates a credit culture which tolerates unviability.

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10 See RBI Master Circular dated August 1, 2001 for a detailed description of the priority sector norms. www.rbi.org.in

11 For the rural sector, in respect of a life insurer the obligation starts at 5% of total policies in the first financial year and goes upto 15% of total policies in the fifth year. In respect of a general insurer, the obligations begin at 2% of gross premium income in the first year and 5% from the third year onwards.

12 New private sector banks are required to open a minimum of 25% of their total branches in Rural/Semi Urban areas as a condition of the licence issued to them under Section 22 of the Banking Regulations Act, 1949.

13 Money Market Mutual Fund should be in the nature of a drawing account, distinct from any other account, with clear limits for drawals, the number of cheques that can be drawn, etc, as prescribed by MMMF/MF. It should not however be used as a regular bank account and cheques drawn on this account should only be in favour of the investor himself (as part of redemption) and not in favour of third parties. No deposits can be made in the account. Each drawal made by the investor under the facility should be consistent with the terms prescribed by the MMMF/MF and treated as redemption of the holdings in the MMMF/MF to that extent. www.rbi.org.in, DBOD.FSC.No. 56/24.01.001/2003-04

21. There is also a view that regulation implicitly requires all banks to be 'direct originators' irrespective of their comparative advantage. By facilitating a secondary market to emerge for new asset classes such as micro finance, there may be a move towards specialisation among banks where those with relative strengths in origination supply assets to other banks in the system[14].

22. Deposit mobilisation remains a very highly regulated activity in India. Entities other than banks and approved Non-bank Finance companies cannot collect deposits. This is a concern often voiced by micro finance organisations who view savings as a critical need for the poor to smooth consumption. In the current scenario, providing access to savings facilities for the poor appears like a difficult task. Bank branches will find it a huge challenge to provide access to small savings accounts with high transaction intensity in a viable manner, given that returns on deposits have to be uniform across all accounts. Transaction costs for the clients are also likely to be high because of the rigidities implicit in transacting with a formal provider[15]. In this scenario, MFIs are demanding the right to offer savings facilities on their own. While this seems to be a response to an observed market failure, it is fraught with risks. Due to their inability to achieve asset diversification and low capital base, MFIs are less suited to be providers of savings facilities.

23. Some countries (South Africa, Brazil) have responded to this challenge by treating cash handling as a function distinct from being the provider of savings accounts to clients. This has led to adoption of agenting norms where third-party entities accept and dispense cash. The bank continues to be responsible for safety, liquidity and privity of contract issues. This is an interesting approach to increasing access to savings facilities which has not been tried in India.

24. It may be argued that the current regulatory approach has not contributed to making rapid growth in outreach. It may be the case that greater domestic de-regulation which incentivises existing players to expand access through market-based mechanisms holds more potential rather than entry of further players or even privatisation[16].

25. In the next section, the paper advocates a role for the regulator that is much more focussed on creating facilitative financial infrastructure and to a lesser degree, reliance on instruments of subsidy (either directly for products or indirectly through re-finance to lenders).

5. Elements of an Enabling Environment for Universalisation

26. Emergence of a large number of local financial institutions: India is a very large and diverse country and as pointed out earlier[17], with only about 33,000 branches there is in any case a serious gap. Local Financial Institutions (LFI) not only provide availability and much more appropriate designs for their financial services, these institutions also help to overcome the issue of information asymmetry through appropriate methodologies, whether group or individual, to create a low-cost local

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14 A positive development in this regard has been recognising pass through certificates that have underlying agricultural assets as qualifying for priority sector status.

15 Refer earlier discussion on branch timings and employee incentives

16 This comment is specific to the scenario of access to finance for the poor. On the contrary, for infrastructure finance, liberalization might have near-term benefits in terms of making available the volume of funds and expertise necessary in that sector.

17 See footnote no: 6

distribution capability that can be leveraged for multiple financial services delivery[18]. They may take a variety of autonomous organisational formats and be for-profit and not-for-profit. However, their principal contribution is in evolving models of outreach that are scaleable and sustainable. The fact that the local financial institution has a limited geographical outreach capability (unlike commercial banks) provides an incentive for it to address the financial service needs of its constituency in a comprehensive manner. The staff base of these organizations, being recruited locally, is able to overcome some of the 'cultural' issues observed among managers of commercial bank branches[19]. Supporting the emergence of these institutions then becomes an important strategy for universalisation. While models for scale-up are largely commercial in nature, there is space for Government and donor participation for supporting training initiatives and meeting the start-up expenses of these institutions.

27. In addition to increasing the number of local financial institutions, a set of initiatives in improving the financial infrastructure in India are critical. Some of these have been identified below:

28. Unique identifier: Having a unique identifier is the basis on which initiatives such as credit history tracking and targeting for services such as health insurance can be implemented. The unique identifier is best generated by the Government so that it can be used for other services as well. It is the first step towards creating a centralized credit database.

29. Credit bureau: Credit information tracking and sharing enables lenders to provide incentives to those with good credit history and provides a strong deterrent to wilful default. This will also facilitate transition to individual lending programmes over time. See Banerjee (2001) for instance where he says that helping the poor develop credit histories and centralizing credit histories make credit markets less segmented and therefore, borrowers have access to cheapest sources of credit. Similarly, Rajan and Zingales (2003) also emphasise the role of initiatives like credit bureaus expanding access to finance, especially for those who cannot afford to provide collateral. In its 2002 report on strengthening financial systems infrastructure, the World Bank stated that more than half of the institutions participating in a credit bureau reported decreases of 25% or more in defaults, in costs, and in processing time for lending decisions[20].

30. Rural infrastructure: Investment in certain kinds of rural infrastructure will enable providers to offer financial services with a superior design and convenience to the client. While such investment might be too much to undertake for any one provider, such infrastructure will assume the character of public goods. Relevant examples include computerised weather stations providing real-time weather data and internet connectivity at the village level enabling ATMs and other payment devices. In some cases, this infrastructure will spur more sophisticated product design. For example, real-time availability of village-level rainfall data makes it possible to offer index-based rainfall insurance contracts.

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18 For instance, the Community Development Financial Institutions (CDFI) in the USA represent a class of local financial institutions. CDFIs do not supplant conventional financial institutions. Since CDFIs and banks share a market-based approach to serving communities, CDFIs often work in partnership with banks to develop innovative ways to deliver loans, investments, and financial services to distressed communities. Oftentimes, they jointly fund community projects, with the CDFI assuming the more risky subordinated debt. Mainstream financial institutions also invest their own capital directly in CDFIs, receiving Community Reinvestment Act (CRA) credit.

ICICI Bank's own vision for universalisation is the existence of 200 such LFIs serving a million clients each and providing a range of financial services to them. ICICI Bank will seek to work with these LFIs by providing scaled amounts of debt and mezzanine finance, technology, training and a comprehensive product suite.

Banerjee, Duflo and Cole (2003) make a similar recommendation for the creation of finance companies linked to bigger corporates which would have detailed information and lend to firms in a particular industry as a way to overcome 'under-lending' in some segments.

19 See Thorat et al (2003) for a detailed discussion on this issue

20 State Bank of India (SBI), Housing Development and Finance Corporation (HDFC) and Dun and Bradstreet Information Services India Private Ltd. (D&B) and, TransUnion International Inc. (TransUnion) have joined hands to establish a Credit Information Bureau of (India) Limited (CIBIL). However, it appears to be principally designed to serve urban middle to upper income markets and not rural markets.

31. Presence of payment infrastructure, either through internet or through cards can ease financial transactions in rural areas. Wireless technologies can expand the range of electronic payment systems and provide the critical 'last mile' access. Certain environments can be connected via wireless POS products and reduce cash handling needs. Cash handling contributes significantly to the total transaction costs[21].

32. Regulator support for hybrid models: Creative responses to the challenge of access to financial services will require experimentation with several delivery formats[22]. Regulators (including the RBI, Securities and Exchange Board of India and Insurance Regulatory and Development Authority of India) must encourage providers to carry out pilots in order to better address the challenges. Learnings from these pilots may be actively disseminated. As discussed earlier, one specific policy aspect that poses a constraint in the Indian context is that handling of cash related to a bank account can be done only the employees of a bank. This is in contrast to other countries where acceptance and withdrawal of cash is permitted at third-party locations including grocery stores.

33. Discontinuation of direct subsidies and recognition of issues around risk and capital : Subsidising financial services directly (either through interest rate caps or premia caps) blunt incentives of providers to innovate in product design. A case in point is the crop insurance product where the subsidised Government programme has resulted in very limited participation from the private sector. Subsidy may be best channelled towards public goods as outlined before. Regulation must encourage banks and financial institutions to recognize the risk inherent in various kinds of lending and deal with it through market-based mechanisms such as derivatives in the case of commodity risk[23].

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21 The total costs of a cash payment system are not always readily apparent. Merchants have labour costs, for counting, bagging and transporting cash to the bank, and for reconciling accounts. Errors and pilferage by employees raise these costs further. At the central bank level, cash is cheap to print, but expensive to manage. Cash is expensive to transport, insure, and distribute. Large volumes of cash enable shadow economies to thrive, depriving the government of tax revenues. And cash economies can support criminal activities such as counterfeiting, as well as encourage a culture of bribes and special favours. Some observers estimate that the total cost to an economy of maintaining a cash-based payment system can be as much as 5% of GDP (Visa, 2004)

22 ICICI Bank is experimenting with the use of village-level transaction points that are typically internet kiosks for the delivery of a range of financial services. The emergence of connectivity and transaction devices increases the scope for agent-based models. For example, internet connectivity enables third-party agents to offer 'transaction fulfilment' at a non-bank/provider location. For instance, a person desirous of purchasing an insurance policy can avail it from an authorised agent of the insurance company in a village. The process now looks as follows: client chooses the relevant policy and makes payment to agent; agent accepts cash and remits the money through the payment gateway from his/her account. The agent also updates the database of the provider (in this case the insurance company) on a real-time basis. The provider issues the policy online; the agent prints it out and hands it over to the customer. In this manner, the entire transaction loop is closed at the agent location itself without a time lag and without the client having to ever travel or interact with the provider directly. The distinction between the process outlined above and a traditional agent model is the fact that internet connectivity is leveraged to reduce potential for fraud (agent has to update provider databases online and make payments immediately. Lags in this process increase agent risk) as well as reduce transaction costs (agent is responsible for entire transaction, not parts of it). Similarly devices such as Automated Teller Machines (ATMs) enable the provider to disburse and collect cash at a non-provider location while minimising the risk of fraud. The ATM has the ability to authenticate the customer and update the transaction on a real time basis.

23 Regulation in India prohibits banks from hedging commodities. This forces lenders to largely ignore the commodity as collateral both pre and post-harvest, significantly increasing the cost of finance and excluding several potential borrowers whose primary collateral base may only be a commodity.

Conclusion

34. Building greater access to financial services for the poor in addition to being an important objective in its own right, may also have the potential to provide growth impulses for the economy by signalling resource allocation. Universalisation of access to financial services calls for a regulatory and policy environment that permits experimentation. It requires a transition from an interventionist approach characterised by price subsidies and licensing to a facilitative one where investments are made in creating systemic ability to respond to the needs of under-served segments. A key feature of building access, evident from the Indian experience, is the role for local financial institutions serving in concentrated geographical areas addressing financial services needs of clients in a comprehensive manner. Systemic ability will be enhanced through efforts aimed at creating a national unique identifier, credit information sharing and improvement in critical rural infrastructure.

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