MEASURES TO INCREASE FINANCIAL INCLUSION

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1.0 Background

Financial Inclusion (FI) aims to address financial exclusion - which is the lack of access, faced by the most needy members of our community, to appropriate low-cost, fair and safe financial services from mainstream providers. It is a well known and researched fact that conventional banking has not reached the grassroots in most South Asian developing countries. This is due to a variety of causal factors or barriers such as culture, education (especially financial literacy), gender, income and assets, physical accessibility, lack of status (on the part of most members of the deep rural hinterlands proof of identity), unavailability of technology, and high cost of creating such accessibility. In an era where conventional banking and mode of its delivery are being re-examined FI with respect to conventional banking has to be analysed in the context of the above causal factors and the dynamics of such causal factors, in the changing financial services landscape. Bankers are faced with severe competition to their hitherto jealously guarded businesses such as deposit taking and credit with a diverse set of financial institutions offering the same. Therefore FI makes excellent common sense for bankers and banks to pursue as a survival strategy. Bankers and planners should not lose sight of the fact IF would result in increased market size.

A thought provoking parallel is the mobile communication industry. This industry has not created a digital divide but on the contrary Digital Inclusion (DI). With more and more banks FI has decreased.

1.1 Current scenario on "Financial Inclusion" in Sri Lanka

In most developing countries financial services are available only to a minority. Most often, the underserved population consists of people from the poorer sections of society who have no bank accounts, no access to credit from a formal financial institution or insurance. Based on the Central Bank of Sri Lanka (CBSL) Annual Report of 2004 an approximate 66% of the population is above the age of 18 years. Taking into account all the delivery channels of the banking system excluding finance companies and other financial institutions the penetration of delivery channels across the population, which is eligible to have a bank account stands at a low 0.1%. In the absence of well developed financial systems such people use other informal systems to save monies, obtain credit and insurance and transmit funds between countries and fall prey to unscrupulous middlemen. Although a few local banks, to their credit have valiantly attempted to bridge the gap through mobile banking, such moves have not been fully sustainable in the absence of sophisticated financial systems at the centre. In reality there is widespread FI in Sri Lanka and other developing countries.

Banks by their traditional business models are highly leveraged institutions, which have been afforded to them as a privilege by the Central Banks of the countries in which they operate. This brings in its wake a host of fiduciary obligations on the banks as acceptors of monies of the public in carrying out their business. FI has to be viewed in the context of fiduciary responsibility by all banks. The present fiduciary responsibilities are mainly for safeguarding existing depositors and to mitigate systemic risk which is also highlighted in the CBSL Annual report of 2006.(Chapter 8 Financial Sector Developments and System Stability, Page 119).

The Licensed Commercial Banks (LCBs) have expanded delivery channels in recent times. At present 23 LCBs operate through a network of 1530 branches, 1986 other service outlets, 1127 automated teller machines (ATMs) and 8753 electronic fund transfer facilities at point of sale (EFTPOS). These measures, although heartening, have not significantly increased FI.

Where most sizeable banks cannot access, diverse financial entities such as micro finance institutions have met with success. The Draft Micro Finance Institutions Act (MFI Act) aims to regulate the Cooperative Rural Banks, Thrift and Credit Cooperative Societies, Samurdhi Banking Societies, Sarvodaya Development Finance Centers and several Non-governmental organizations which are involved in deposit taking and micro financing. Non-governmental organizations cannot however accept deposits without the approval of CBSL. The Draft MFI Act seeks to give recognition to all such organizations and license them to accept deposits and provide financial accommodation.

2.0 Generic Causal Factors and Remedial Measures

2.1 Banking Practices

Common, existing banking practices themselves exclude large sections of the population such as the pensioners, self-employed and those who are in the unorganized sector. Such practices are maintenance of minimum balances, various charges, need for personal introductions and rigid documentation. Although the initial objective would have been safety of the depositor's money it is unintentionally creating Financial Exclusion.

Remedial Measures

- Introduce a special category of accounts where minimum balance and withdrawal charges are waived off. The cost could be mitigated, by offering a marginally lower interest rate on such deposits. A steady build up of deposits would soon enable to reach a critical mass, which will offset the costs incurred.

- Documentation should be kept simple and to a minimum with brochures indicating the features of the products in a very basic user friendly manner.

2.2 Financial Literacy

FI cannot take place without Financial Literacy. Financial literacy is the ability to make an informed judgement and effective decisions about the use and management of money. It's an essential skill for functioning in modern society and is becoming increasingly important to the long-term wellbeing of individuals and the community. Banks as well as regulators have failed in this regard.

Remedial Measures

- Holding informal workshops in underserved areas by a person who is acceptable to the community and who speak the same language.
- Officers to help persons with information upon their visits to a bank so that everything is understood. Currently such services are offered only to privilege customers. It is a simple matter of using the same concept to serve another sector of the population.

2.3 Payment Systems

"Payment systems are the backbone of the financial infrastructure of the nation, enhance globalization and act as tools of economic empowerment by Financial Inclusion. There is a need to create payment systems that are efficient, reliable, affordable and of global standard."
Shri M.V.Nair Chairman and Managing Director Union Bank of India

It is a moot point whether the economic empowerment had really occurred and resulted in FI through payment systems as so laudably proclaimed by Mr Nair. Practicing bankers have lamentably little or no involvement with building payment systems at a conceptual level. Their involvement has been at the implementation level where the priority has been that of aligning practices and internal systems with the payment systems. In fact information technology experts have been the sole decision makers at a conceptual level in most financial organisations.

The increased use of payment systems in the retail segment can be achieved by widening their reach and developing practical commercial applications that would directly benefit the users. To widen the reach and awareness, integration of the semi-urban and rural areas into the electronic clearing system is required. Participating institutions like banks have a significant role to play in achieving the objectives.

Simply put the concept of any payment system should replicate with improvements where necessary the intricacies of the settlement and clearing systems of banks. The Central Bank of

Sri Lanka should be saluted for their ground breaking efforts in introducing the Sri Lanka Interbank Payment System (SLIPS), Real Time Gross Settlement System (RTGS) and the Scripless Securities and Settlement System (SSSS) in the years 1994, 2001, and 2003 in this regard. Sri Lanka was leading among the South Asian region countries in this sphere. However these developments have not been able to increase **FI significantly in Sri Lanka.**

In the context of FI it is vital to note that RTGS is for high value transactions and SLIPS is for lower value without the advantage of real time basis transfer. It is imperative then a subsidiary system be implemented to accommodate the low value transactions with the same benefits as far as possible. SLIPS although is intended to cater to the lower value transactions have not exploited its possibilities as a strategy

Remedial Measures

- Developing any system demands a large capital commitment, which could be avoided by banks pooling their resources so that the costs are spread.
- A payment system with a common switch, similar to RTGS, which facilitates real time transfers for small amounts. Ideally this system should have a ceiling amount for transfer in order that high value transactions do not clog the transaction volume.

2.4 Para-banking

Most developing countries have systems to access micro credit and informal saving schemes, which may be costly in the long run. Planners to increase FI cannot ignore the impact of the traditional social order such as moneylenders. In Sri Lanka one very popular form of saving in village and semi urban societies is the Seettu. A group of people is formed and one person (the leader) collects an equal sum of money from everybody in the group. The total amount of the Seettu is specified at the outset and the number of payments each person has to contribute at regular intervals (usually monthly). Therefore the total duration of the Seettu is also known at the outset. The first such collection is credited to the leader. The subsequent collections are distributed in total to each member of the rest of the group so that with the passage of time every member gets the same amount of money. The order in which members receive their contributions is determined by drawing lots where every member is present. Here too number 1 is for the leader and only the rest of the numbers are drawn. The leader's responsibility is to collect all the monies every month and make the payments without fail. Basically the scheme operates on trust. It is also a forced saving as the leader will invariably come to collect the monies that are due to the group from every member during each payment period. The leader and the other members, who receive the lump sum in the initial months, benefit by accessing monies first and enjoying time value of money at no cost.

The method has acquired sophistication and evolved into an auction method through the needs of the members of such Seettu schemes. In principle as explained in the above paragraph the members who draw the latter numbers in the group, through no fault of theirs are disadvantaged by receiving their funds later. In order to circumvent this the leader would facilitate the earlier number holders to offer their tickets on an auction basis to the latter holders who would pay a higher price (receive less) and obtain the earlier tickets. In banking parlance this is discounting which is a normal transaction. It is indeed interesting to observe the manner in which para banking has instilled the principles and practices of banking in an informal way.

Remedial Measures

- Customise banking solutions to work round the existing para banking practices. For example the bank officer could assume the role of the leader and market a group of depositors to deposit fixed amounts on a periodical basis. At the outset a lump sum is paid to the depositor who has been selected by the bank. The balance depositors would be paid at the end of the subsequent periods. There will be an agreement reached into between the bank and the members which will specify the terms of payment and collection in simple easy to understand language. The advantage to the bank is that money flows into the bank and the depositor is **included** (FI has occurred). The depositor has an assurance that his money is absolutely safe which he earlier received by trusting an individual. An attractive rate of interest could be paid and distributed in proportion to the periods the members kept the monies with the group.
- Appoint such leaders as deposit collectors to the bank. Distrust and apparent fear of banks could be mitigated, by channeling the business through such agents at the outset.
- Auction based method could also be offered included in the same contract by discounting the Seettu deposits.

2.5 Accessibility

One of the major causal factors for FI is the lack of accessibility. Delivery of cash and other mode of payments could be addressed to a great degree since the onus is on the banks. Collection although certain persons could be appointed from the regions is not a total solution.

Remedial Measures

- Utilise existing networks spread throughout the country to mobilise and deliver deposits and loans and collect funds such as the postal network, telecommunication network which includes the ever growing mobile communication networks, schools and private chains of stores. In appointing persons to collect funds for the bank a model on the lines of insurance agents and brokers or bank employees could be adopted.

Example

The banks could use an existing widespread network, which has public acceptability and credibility. The agents who will collect the funds and disburse the funds would either be employees belonging to the network, bank employees who are manning desks at such network offices or third parties who would serve for a commission. In the last option the collection and disbursement would have to be through the network to the banks to ensure accountability.

- Mobile banking
  Although hugely popular the potential has not been fully utilized to capture all bankable persons. The mobile banking option should be taken to the far flung villages coupled with other promotions such as mobile communication, consumer durables etcetera to make a total proposition and enable FI.

3.0 Benefits of FI

FI is an important policy goal both from the perspective of realisation of growth opportunities as well as improved risk management for poor households. FI means 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. Recognising the importance of FI several policy interventions have been undertaken to address this in the Sri Lankan context. The most important of these include the encouragement of expansion of state-owned banks into rural areas and the creation of specialised rural finance institutions such as the Regional Rural Banks (RRB) and cooperative banks. Despite these well-intentioned efforts, the state of access to finance leaves much to be desired. Design aspects of the financial system architecture are crucial to universalising access. One key requirement is an environment that promotes the emergence of sustainable financial service providers to work in under-served markets.

a) Micro and small enterprises can help them to better integrate into the economy of their countries.
b) Access to financial services also, actively contributes to their human and economic development, to the economic growth of the countries where they live, and to the social safety net that can help protect them against economic shocks.
c) Firms from developed market economy countries are dominant in virtually all main traded service sectors. Their competitive strength is based upon the underlying comparative advantage inherent in developed economies as well as specific factors at the micro-economic level. Out of nine key factors Financial Capacity could be related to FI. In this context access to banking services, credit and insurance are highlighted as important for being competitive.

4.0 The way forward

The way forward lie in the policies at the centre to incentivise those banks who attempt to cater to all sections of the community on an equitable basis including those who are under-privileged. The traditional view in credit, especially in these markets, has been that the originator of loans is also required to manage the implied credit risk of these activities. A separation of the origination and risk warehousing functions, making a case for numerous thinly capitalised local entities that specialise in understanding customer needs and running cost-effective operations which in turn are backed by financial institutions / banks with the ability to diversify risks and raise capital is one measure our neighbour had already looked at. This separation will permit the optimum use of scarce capital in the system without compromising on the scale of outreach. This insight is equally pertinent when thinking about making access to savings universal. This necessitates the legal permission by the regulator to enable partnerships between banks and non-bank entities. The optimum scale of originating entities is an important aspect of design; it must be large enough to afford investments in robust operating systems but contained enough to reap the benefits of local knowledge. Also, in order to encourage entrepreneurial providers to emerge in these markets, they must be able to fully meet the cost of providing services on an ongoing basis. Regulation that takes the form of price caps, for instance, is antithetical to this notion. There are also important regulatory considerations in financial inclusion. We need regulation that is outcome-driven and model neutral. In other words, rather than encourage specific configurations such as, say, cooperative banks, regulation should be focused on encouraging diversity of approaches to deepening access. The outcomes that regulators should care about are, whether access to financial services is universal, whether such access is of a quality that is acceptable (quality is used here to cover aspects such as lender-borrower relationship and features of financial services offered) and whether providers are sustainable and meet certain governance norms. Regulation must not favour, either by way of diluted capital adequacy norms or direct subsidies, one or the other model for reasons beyond these. Finally, the role of the government in financial inclusion is much debated. The biggest contributions lie in creating systemic infrastructure that takes the form of unique identification numbers, payment systems, credit bureau and electronic auction markets that stimulate market activity as a whole as opposed to more interventionist approaches that promote specific institutional types.

4.1 Government incentives

For banks, which formulate strategies to increase FI in the country tax and other such incentives could be given. Already there is a tax benefit allowed for banks, which provide credit to enterprises outside the Western Province. Of major importance would be to channel funds sourced outside the Western Province to be utilized in the areas outside the main province.

4.2 Prudential incentives

Relaxation or reduction in statutory requirements on deposits taken by areas outside Western Province which could effectively increase interest rates on such deposits as well as reduce lending rates.

Continuous monitoring on the part of CBSL to assess the scope, nature and cost of services provided by banks to all sections of the community

In this instance it is important that like in India, in Sri Lanka too transparency be ensured on maintaining minimum balances and charges levied on transactions. Banks should be encouraged to practice differential pricing on categorized sectors such as income earners below a certain threshold level, direct certain state business volumes to banks which provide credit to identified sectors such as farming.

As mentioned banks have to meet several fiduciary obligations in regard to being highly leveraged through public deposits for the greater good of the depositors and systemic resilience. However there needs to be a constant aligning to see if the meeting of such fiduciary responsibilities itself creates FI. It is strongly felt that well established, profitable and soundly managed banks with diverse ownership should be rewarded by less rigorous fiduciary responsibilities.

Although Moral Suasion is an option it is not advised due to the fact that banks should be encouraged to look at FI as a survival strategy rather than in a patronizing way.

4.3 Align banking practices to increase FI

Simple, affordable and accessible products and services

Banks have ventured with gusto into wealth management, private banking so on and so forth. However in this endeavour simplicity, which will no doubt help to create increased FI has been neglected. Banks should be proactive and offer rate comparisons on simply written and designed brochures even though the regulator may not mandate it. The probabilities of increasing FI are high as well as incentivising the targeted segments to choose the mainstream financial sector as opposed to others. What may go to your competitor could very well come to you tomorrow.

4.4 Payment Systems

While electronic online payment systems are indeed a sine qua none for the urban and suburban dweller it is not so for the community outside the metropolis. Smart cards and hand held devices, which will provide access to payment systems at reasonable cost should be explored more. In this the bankers could take a leaf out of the telecommunications industry where the prepaid cards although not cheap have provided access. SMS banking is one innovative mode of banking which could be utilized to strengthen FI through building on its inherent capabilities. The statistics of mobile phone ownership and banks accounts have revealed interesting trends in countries like India where the former exceeds the latter. While one could regret so, its potential should not be ignored as an access tool. Mobile phone usage is another factor that transcends social and economic barriers.

There is an urgent need to ramp up technology based delivery channels particularly in the rural areas. The challenge would be to identify a delivery channel that is not only cost effective but user friendly given the literacy levels of potential users in the rural areas and migrant labour. The introduction of low cost biometric ATMs would go a long way to bridge this gap. Ensuring that the benefits of technology, reaches the unreached is another challenge. It is essential that we think in terms of introduction of a Biometric National Identity Card, which will be utilized for all the needs of the individual and not just the financial needs. If the technology revolution is to fully impact the rural areas, concentration on providing soft infrastructure is a must.

The Blue Book so titled due to United Nations Department of Economic and Social Affairs (UNDESA) and the United Nations Capital Development Fund (UNCDF) being the authors have compiled the results of an intensive study on **"Building Inclusive Financial Sectors for Development"**. This contains information, which pertains to tools the policy makers of developing countries could make use of to increase FI in their countries.

5.0 Developments in FI

Gulbarga has just become the first district in Karnataka and the second in India to be declared 100% financially inclusive by the Reserve Bank of India at a formal function last week (the first being Palakkad in Kerala). With a literacy rate of just 36%, and nine out of 10 Talukas having been classified by the Nanjundappa Committee as most backward, Gulbarga presented an unparalleled challenge for those involved. When the task was taken up in July 2006, the requirement was to open a stupendous 1.85 lakhs of accounts for urban families and 3.97 lakhs of accounts for rural households. It required not only passion for the job, but also very close collaboration between government officials, banks, the RRB functioning in the area and associated NGOs, in identifying the wherewithal and capacity for completion of the job. It was a job well done and is now a good case study for banks and developmental economists faced with the challenges and opportunities of financial inclusion. But what has been done is only the first step. The second, third and the nth relate to inclusive growth and integration with an economy growing at a phenomenal rate of 9%. Mindsets of both the bankers and the banked must be changed. Affordable financial services must include, not only need-based credit, but also insurance services, payment and remittance facilities, and, in due course, financial advise.

Mindset aspects include promoting trust and financial discipline in the rural populace and a revised sense of opportunities amongst bankers. So far, rural operations of commercial banks have not been as commercially lucrative as operations in the more developed urban and metro centres. Their performance in terms of asset quality and composition has not been much better than that of the Regional Rural Banks and Rural Cooperative Banks, all of which had the rural growth mandate, but floundered because of weak technology, low capital bases, inadequate human resources, lack of professional skills and exclusion from reforms.

For commercial banks, hitherto, finance to the rural sector has been of small value and largely by way of dispensing government sponsored schemes, which have had abysmally low recovery percentages. The growth of NGOs, has brought about a radical change in views. Recovery rates of over 90% have made such finance a very acceptable and sought after proposition. Added to this, the new-found interest of corporates in rural India present enticing possibilities, particularly in investment credit. While access to credit is important and vital, other issues of viability, servicing and pricing need to be addressed so as to encourage and expand the outreach that the new model has brought in. In a situation where credit is asset based, i.e., ownership of assets commanding accessibility to credit, equitable distribution of credit is a major challenge. One other major constraint in taking financial services to the unbanked is the transaction costs which are much higher on account of the small ticket size, geographical spread, lack of quality manpower and intense supervision required. While technology can be a mitigator to some extent, I believe cost-effective inclusive growth can be realistically achieved only if we include the existing operators who are in the field, such as the NGOs, local business facilitators and possibly even the money lenders, who have firsthand knowledge of the credit risks and consumption needs of persons, speak the local language and are available dawn to dusk. On the path to inclusive growth, the government can definitely contribute by way of enabling policy and legislative support.

6.0 Conclusion

Banks and the regulators need to build a taskforce which will address issues such as optimisation of payment systems to enhance FI and reduce costs through consolidation measures such as strategic alliances, innovative delivery channels, creation of niche marketing efforts. Initially banks could formulate **Corporate Social Responsibility (CSR)** projects around FI as it is a project which banks could readily give their expertise to. Banks and Central Bank needs to analyse the structure of how payment systems in Sri Lanka have aided Financial Exclusion and develop mechanisms and parallel systems for low value transactions to promote Financial Inclusion. The needs of the community, barriers to FI need to be the focal point in the development of any payment system.

Sources

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