

Financial Inclusion - Micro Finance a Sustainable Model

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“India’s poor are more prompt in repaying loans and deserve access to more financial services. The poor in India, he said, were ethical and not bad borrowers, and asked banks and financial institutions to make extra efforts to lend more to those in the bottom of the pyramid” (P.Chidambaram, 2012)

“Microfinance is an economic development tool whose objective is to assist the poor to work their way out of poverty. It covers a range of services which include, in addition to the provision of credit, many other services such as savings, insurance, money transfers, counseling, etc” (Y.H.Malegam, 2011)

“UN Secretary General Kofi Annan mentioned - sustainable access to microfinance helps alleviate poverty by generating income, creating jobs, allowing children to go to school, enabling families to obtain health care, and empowering people to make the choices that best serve their needs” (Anand Sinha, Strengthening Governance in Microfinance Institutions - Some Random Thoughts, 2012)

ABSTRACT:

Reserve Bank of India(RBI) has defined Financial Inclusion as the “process of ensuring access to appropriate financial products and services needed by all sections of the society in general and vulnerable groups such as weaker sections and low

*income groups in particular, at an affordable cost in a fair and transparent manner by **regulated, mainstream institutional players.**” Financial Inclusion has been in the top of the agenda of the Central Government and RBI. Financial inclusion is a flagship programme of the Reserve Bank. Its objective is to bring people, hitherto excluded, under the ambit of formal financial institutions. The article examines whether it would be feasible for banks to achieve the objective of financial inclusion. The low penetration level of bank branches in rural India, the high cost of operations/transactions of rural bank, product design and suitability etc are the challenges for the task. Among the alternative models Non-Banking Finance Company-Micro Finance Institutions seem to suit the most suitable. Financial inclusion will lead to economic development and NBFC-MFIs can play an important role in developmental agenda of the central government and RBI.*

KEY WORDS:

Financial Inclusion, micro finance, self-help group, Non-Banking Finance Company-Micro Finance Institutions, down trodden, banking products.

Introduction:

Financial Inclusion:

“Financial inclusion may be defined as the process of ensuring access to financial services and timely and adequate credit where needed by vulnerable groups such as weaker sections and low income groups at an affordable cost” (Dr.C.Rangarajan, 2008)

“Financial Inclusion, broadly defined, refers to universal access to a wide range of financial services at a reasonable cost. These include not only banking products but also other financial services such as insurance and equity products” (Rajan R. G., 2009)

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“Financial Inclusion has been in the top of the agenda of the Central Government and RBI. Financial inclusion is a flagship programme of the Reserve Bank. Its objective is to bring people, hitherto excluded, under the ambit of formal financial institutions”. (RBI, Page 75 RBI Annual Report, 2012-13)

Micro Finance: “Micro finance, involving extension of small loans and other financial services to low income groups, is a very important economic conduit designed to facilitate financial inclusion and assist the poor to work their way out of poverty.

It has the potential to fill the critical gap left by formal financial institutions in providing financial services to low income groups. *Mainstream institutions shied away from providing financial services to the poor considering them unviable owing to high costs involved in reaching out to the unbanked/under banked areas where there is not enough scale of operations due to low numbers and low value of transactions.* Other reasons cited for such exclusion are, perceived high risk and inability of poor borrowers to provide physical collateral for raising loans” (Anand Sinha, Strengthening Governance in Microfinance Institutions - Some Random Thoughts, 2012)

Micro finance is looked upon as means of credit-based poverty alleviation and financial inclusion. The basic principles of micro finance credit delivery are small amounts of loan, lack of physical collateral and emphasis on social collateral/peer monitoring.

“There are several delivery models in micro finance. The model of micro finance developed by the Bangladesh Grameen Bank wherein women borrowers were organised into Self-Help Groups (SHGs), which would borrow from the lending institution. Such groups are normally created by women from similar socio-economic background. As the entire group was involved in seeking the loan its repayment was ensured by peer monitoring.

“In India, there are two models of micro finance delivery :a) the SHG-bank linkage programme (SBLP) model and b) the Micro Finance Institutions (MFI) model. Under the SBLP, the following three different models have emerged:

- Model I: SHGs promoted, guided and financed by banks.

- Model II: SHGs promoted by NGOs/ Government agencies and financed by banks.
- Model III: SHGs promoted by NGOs and financed by banks using NGOs/formal agencies as financial intermediaries.

Model II has emerged as the most popular model under the SBLP programme. Commercial banks, co-operative banks and the regional rural banks have been actively participating in the SBLP.

Micro Finance Institution Approach(MFI)

The MFI model has also gained momentum in the recent past. The MFI model in India is characterised by a diversity of institutional and legal forms. MFIs in India exist in a variety of forms like trusts registered under the Indian Trust Act, 1882/Public Trust Act, 1920; societies registered under the Societies Registration Act, 1860; Co-operatives registered under the Mutually Aided Cooperative Societies Acts of the States; and non-banking financial companies (NBFC)-MFIs, which are registered under Section 25 of the Companies Act, 1956 or **NBFCs registered with the Reserve Bank.**

Bank Partnership Model

Banks can use MFIs as their agent for handling credit, monitoring, supervision and recovery. In this model, the bank is the lender and the MFI acts as an agent for handling items of work relating to credit monitoring, supervision and recovery, while the borrower is the individual. The MFI acts as an agent – it takes care of all relationships with the client, from first contact through final repayment.

Another variation of this model is where the MFI, an NBFC, holds the individual loans on its books for a while, before securitising them and selling them to the bank. Such refinancing through securitisation enables the MFIs a greater funding access.” (RBI, Report on Trend and Progress in Banking , 2007-08)

Though it is true that model II has emerged as the most popular model around 2007-08 as observed in Trend and Progress Report it has certain limitations particularly with regard to regulatory oversight. The Bank Partnership model is yet to evolve due to several reasons.

Non-Banking Finance Companies – Micro Finance Institutions (NBFC-MFIs): When pros and cons of this model are listed it seems that the pros outweigh the cons and the model if nurtured properly could become **the most important vehicle for financial inclusion. It could also be the delivery model to the under-privileged both in rural and urban areas. It could be the most effective tool for alleviation of poverty.** It could be the vehicle for economic development.

A comparison of the bank-led model and NBFC-MFI led model for financial inclusion and delivery model for access to finance to those at bottom of the pyramid would be relevant. This would enable in arriving at the logical conclusion.

Bank Led Model: Banks include commercial banks, which in turn could be a public sector or private sector bank. Banks model has two variants – ‘brick and mortar’ or electronic (e-banking).

With low level of literacy and a sub-optimal level of financial literacy in the rural areas the e-model of banking would be shunned by the rural folk.

The model adopted by the banks in India is 'brick and mortar' presence. "In aggregate, there are 105,753 branches across all scheduled commercial banks in India of these. Of these, about 39,336 branches are in rural India" (Mor, 2014)

"Banks are important financial intermediary, but our problem is that banks access is not there, today out of 600,000 villages only 40,000 villages have bank branch;.... banks penetration is very important" (Dr.K C Chakrabarty, 2013)

Banks with their nominal presence in rural areas would not able to contribute much towards the financial inclusion agenda. The various other factors as to why the bank led model may not be effective in achieving financial inclusion are listed below.

Bank Accounts: Many a time it is quite a challenge to open a bank account. According to media reports, D.Subbarao (former RBI Governor) faced problems opening a bank account in Hyderabad, where he has settled down post-retirement, as he could not provide proof of residence. "We have to look at what regulations make sense and what regulations don't make sense. If a senior (ex-)RBI official cannot open a bank account, there is something wrong in the system. We have to figure out a better way" (Economic Times, 2014)

Further, with centralization of account opening by banks it takes about a week to open an account. Closing of banks accounts which too has been centralized takes even more time.

Banks lending approach: Though commercial banks need to deploy the resources in the most profitable sector (since they are **commercial** banks) they need to use the scarce financial resources in socially

desirable and economically viable activities. If banks' objective is only commercial then the resources would be deployed in the most profitable avenues. As 'risk and reward' go together, higher the risk higher the reward. If banks were to deploy the financial resources as per the 'profitability' norm alone then there would be convergence of resources only to a few sector/sections/regions of the economy, obviously the 'most profitable'. This is exogenous to the 'social control' over banks which lead to nationalization of banks in the 70s. Banks as financial intermediaries have a role to play in the economic development of a country and also balance regional development. The regulator has mandated banks to ensure that atleast 40 per cent of the total advances be allocated to priority sector/need sector lest banks in their quest for better returns could forget the objective of bank nationalization.

Informal channels: Why do the under privileged poor resort to informal channels for savings and borrowings? This would require a deeper understanding about the psychology and their behavior which is quite different. Informal institutions provide flexibility and convenience as their income flow is small and uneven. They can easily follow the uncomplicated informal savings products. In addition, these products are suggested by their peers, neighbours, village elders and others based on personal relationship. The informal referrals carry a better impact than the formal savings products of banks.

Further, the banks' asset and liability products are not designed to cater to the needs of the bottom of the pyramid.

Banking asset products: Due to uneven, unsteady and fluctuating cash flows the lower strata of the society can only repay their micro credit daily or other in-frequent intervals of such small sums. Banks will be

unwilling to offer such products for the reason that the cost of servicing these loans/transaction costs are quite high. In addition, the lower strata require finance to meet medical emergencies, litigation, death, religious ceremonies etc. They would not be able to offer collaterals for risk mitigation. Hence the risk premium charged by banks would be quite high.

The popular jewel loans in urban areas will not take off in some parts rural areas. "For instance, in Uttarakhand, jewellery loans are not in demand, unlike Tamil Nadu. In Uttarakhand, jewellery is seen as a symbol of pride, not to be pawned" (Rajshekhar, The Local Touch: Financial inclusion in Pudhhuaru, Thanjavur, 2010). Further, banks would be unwilling to offer jewel loans below a floor of say Rs.2500/- while the requirement of these folks would be Rs.500/-.

Many of the small borrowers are from the informal sector who trade perishables and thus have daily working capital cycles (like flower, fruit and vegetable vendors). Would banks be in a position to finance daily-working capital cycle requirement of say Rs.200/- to Rs.550/-?

Banks would be reluctant to lend to these segments as it is risky, involves high transaction costs and hence find it unfeasible to design such products.

Banking liability products: A vast country like ours has different states/regions and the requirements of people are different. The need of an urbanite is different from a rural folk. The needs of poor are entirely different from the middle class and still different from the upper echelons of the society. It is for banks to understand the difference and offer products that are most suitable to their clients. Nearly 70% of the country's population lives in rural areas and

most of them are from the lower strata of the society. The rural incomes of these people are quite different. Their cash flows are uneven, unsteady and could be lumpy. It could be daily, weekly or fortnightly. Many a time it is lumpy around the harvest season. There could be no income but only expenses say around the sowing season. To compound their woes they do not have the discipline to save due to lack of self-control and temptation spending. Many a time the poor borrow money in a lumpsum and invest it in savings. Because of the exigent nature of their expenses like accidents and health care the poor would be unable to save large amounts over a period of time. The interest they pay on these borrowed amounts is borne by them as a tax on their inability to save.

"The poor often turned to risky savings products and services offered by unregulated informal financial intuitions, in absence of safe formal ones offered by banks. Such informal institutions are frequently managed by local service providers, who collect savings from members on a daily or weekly basis, in return for a fee. Unlike banks, which do not provide flexible solutions for small and irregular savings by the poor, these institutions allow clients to save from Rs 5/- to Rs. 150/- per day" (Das, 2010).

Can banks offer liability product which could be suitable to these people? For instance, whether a bank would be willing to accept a daily recurring deposit of say Rs.5/- to Rs.50/- a day?

Hence the downtrodden depend on unregulated chit funds and other informal sources for depositing their hard savings. Many a time they are lured by con operators offering high rate of interest and the consequences are obvious.

Cost of Operations: While banks would not be in position to offer such products, NBFC-MFIs with their low operating costs and flexible approach would be in a position to offer the same. “The cost of setting up a Pudhuaru branch -- interiors, counters, biometric devices, safe, connectivity, burglar alarm, 2 PCs and inverter, among other things -- is about Rs.3.50 lakh. The running cost of the branch – rent, salaries and utilities – is about Rs.35,000/- a month. A head office for a 250-branch setup costs about Rs.50-75 lakh, which adds another Rs.10,000/- to the operating cost of every branch. In other words, the operating cost of a branch is about Rs.45,000/- a month, or Rs.5.4 lakh a year” (M.Rajshekhar, 2010).

Banks ‘brick and mortar’ model may not be able to shrink the cost operations to match a NBFC-MFI.

Capital Requirements and Basel III norms: “It is estimated that banks would require additional capital of higher capital requirement under Basel-III and this would increase the pressure on Indian banks to raise capital. Banks may need Rs.2.6 lakh crore of additional capital by 2018 as they strive to meet Basel-III requirements. “Banks face a constant need to replenish capital at regular intervals to support their high growth. Starting April 1, 2013, Indian banks will begin to implement the new Basel-III capital requirement, which will increase their capital requirement in phases” (Bureau, 2013)

NBFC-MFIs are not mandated to migrate to Basel norms and hence their capital requirement could be minimal.

Bank business timings: Banks stick to strict time discipline ‘banking hours’ and operate between 10 am a 3 pm. An agriculturist timings are quite different. Mostly they work without a clock or a

calendar from sunrise to sunset with intermittent relaxations. He has to be in his farm during the business hours of the bank and due to the low penetration of banks in rural areas the branch would be accessible only after travelling for a couple of hours. With poor motorable roads travelling even a few kilometers in rural areas is tedious and adds to the transaction cost of the client.

Incidentally, RBI’s guideline on customer service has left to the banks discretion to fix their operations timings. Banks have, however, not found it suitable to cater to their rural clients’ business timings.

NBFC-MFIs score over the banks in this regard with their flexi timings.

Bulky Documentation: In addition, they are also put off by the enormous paper work to be undertaken in a bank and the time consumed. With the low level of literacy the bulky documentation is a nightmare for them.

Bank Physical Structure: Self-efficacy is the measure of the belief in one’s own ability to complete tasks and reach goals. It affects every area of human endeavour. It strongly influences human behavior and the choices a person is most likely to make. The under-privileged self-efficacy is quite low. There could be several reasons for this including literacy levels and exposure. The physical structure of a bank (bank building) itself is quite intimidating to these people. The paraphernalia and the professional looks of the banker do not create confidence in him and many a time scares him away.

Here the NBFC-MFIs with their low cost structure and informal approach would be able to draw interest from the people at the bottom of the pyramid.

Local feel and local touch: “There is a growing consensus around the world that

small business/farmer credit is best delivered by local small private or voluntary Institutions. Experiences in US, Europe, the Philippines, and other countries in the creation of small and local financial institutions are a case in point. These institutions should be 'local' because someone who is part of the locality has much better information on who is creditworthy than someone who is either posted temporarily from a city, or someone who takes the bus everyday from the nearest town" (Rajan D. R., A Hundred Small Steps, Report of the Committee on Financial Sector Reforms, 2009) .

Instead, in a micro finance institution the localite is recruited who would have a local feel and local touch and also able to understand local farmer and business needs better.

In local institutions "the centre of decision making is close to the loan officer—he can get approval directly from the manager without the documentation, delays, and loss of information that would be incurred if he had to get approval from head office" (Rajan D. R., Report of the Committee on Financial Sector Reforms, 2009).

"...local, small, private or voluntary institutions have the low cost structure and low staffing costs (because their local hires will be paid at local wage rates instead of at city rates) that allow small loans to be profitable" (R.Rajan, 2009).

Further, a local person would be able to understand the local needs and offer products that are local in nature. For a large bank localisation is hard.

Suitability of Products: As the clients of banks in rural areas literacy levels are low

and financial literacy is sub-optimal "it is not enough to just create a menu of products," says Ananth. "We need a system where we can look at the client's situation and then decide what is the right product for her." Adds Dr.Mor "Financial services should be delivered the way medicine is. Like doctors, financial services providers should be suitably trained to offer careful guidance to their clients and be held accountable." (Rajshekhar, The Local Touch: Financial inclusion in Pudhuaaru, Thanjavur, 2010)

While banks may find it challenging to advise the rural clients on the suitability of products, NBFC-MFI can do the same as they are localized and understand their clients better.

Acquiring the right people: "While my friends in the banking industry are busy developing "on-line" application forms and "on-line" tests, we need to probably question if we are even targeting the right kind of talent pool. I would like to have a study on how many people in remote villages, at the taluka/tehsil level, appear for the recruitment tests that are conducted. Because, these might be the people who could be best suited to drive our financial inclusion agenda." (Dr.K.C.Chakrabarty, 2012).

"Institute of Banking Personnel Selection (IBPS) must not only endeavour to select the best people but the most appropriate people for a job. Out of my own experience as a bank chairman, I can tell you that I found very few people willing to undergo rural postings. As the Indian banking system embarks on the massive goal of financial inclusion, IBPS would have to ensure that candidates having compassion for poor and underprivileged, willing to work in rural areas, etc. are selected for the banking industry". (Silver Jubilee function of

Institute of Banking Personnel Selection (IBPS) (Dr K C Chakrabarty, 2010)”

A NBFC-MFI which recruits people locally and their posting is also local would be in a better position to serve the people. These have empathy towards poorest of the poor and would be best suited for the job and participate in the financial inclusion drive of the regulator.

Conclusion: Banking Regulation Act, 1949 defines banking as ‘banking means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft, order or otherwise’. But banking is not just accepting deposits and sanction loans and advances. It is creation of livelihood. It needs to have a human touch. Though banks adhere to definition of banking scrupulously the spirit seems to have been lost. Financial inclusion and economic development are closely related and banks need to look beyond the banking definition.

As banks are found wanting in the financial inclusion drive it seems NBFC-MFIs are most suited to take up the challenge. Banks have challenges in ramping up their rural presence and have other handicap like localization of products, high transaction cost etc etc. NBFC-MFIs can score over banks in providing access to finance. Low cost model, localized decision making, flexible products, low transaction cost, informal approach enable them to penetrate deep into rural areas. Till the banks have a presence in all villages in India and revisit their strategy, NBFC-MFIs will have to take guard. NBFC-MFI is a sustainable model and a sine-qua-non to achieve the objective of Financial Inclusion.

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