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Financial Inclusion: Synchronizing the Existing Financial Institutional Framework

Malobika Bose
Assistant Professor,
Amity University Uttar Pradesh, Lucknow, Uttar Pradesh, India

Abstract

Financial inclusion has garnered a lot of interest in the recent past as digital payment systems have become more and more necessary for day-to-day transactions. The important question that arises out of this phenomenon is whether India as a country is ready to take up the challenge when the majority of the citizens still do not have access to basic financial services offered by the government such as banking and post office saving schemes due to lack of financial literacy. In such a situation, the microfinance institutions come into the picture and without their proper regulation most of the times the general public is at the receiving end of their fraudulent practices. It is, therefore, time to integrate and regulate the financial services offered to the needy and bring all the citizens of the country into the fold of financial inclusion by making financial services accessible, risk-free, and properly monitored. The present article aims at proposing a model for integrating the available financial institutions into enabling access to financial services for the backward and rural areas of the country and work in a public-private partnership model.

Keywords: *Financial inclusion, Microfinance institutions, Monitoring, Digital payment systems, Financial literacy, Transactions*

****Author for Correspondence*** E-mail: malobika.bose@gmail.com

INTRODUCTION: THE RELEVANCE OF BANKING IN INDIA

In the earlier days, banks used to cater to the needs of mostly the people belonging to higher economic strata of the society. The poor could not even dream of being associated with a bank. Very few people who were economically well-off had the need to maintain a bank account to keep their surplus wealth with a bank. Only wealthy people were considered for lending by the banks as it were only they who could offer the desired securities to cover the loans.

In our country, most of the banks were owned by big business houses that bothered less about the possible banking needs of the common man. On the contrary, they used to mobilize financial resources and invest the funds in their own or other big business houses.

It was in the year 1967 that it was felt necessary by the government of India to extend the facilities of banking sector to the general masses of the society, especially the rural masses who were not even familiar with the word ‘Bank’. It was a serious attempt to inculcate banking habits among the common man.

Another objective was to free the banks from the clutches of the business houses owning the banks, and ensure utilization of public money available with these banks, for integrated development of the country and its people.

In order to ensure that the common man becomes conversant with banking, it was decided by the government to take the bank to the doorsteps of the people. It was indeed a very enterprising and challenging step envisaged by the government.

It was, however, thought by the government that owing to the vested interest of the owners of the banks, the objectives of social obligation of the banks might not come through. To ensure that the government’s objectives were fulfilled, the historic step of acquiring the banks and bringing them under full control of the government was taken by nationalizing top 14 banks on 19th July 1969. and later six more in 1980.

Consequently, the Lead Bank Scheme was formulated through which all the districts in the country were distributed among the nationalized banks. Each bank was directed to prepare a comprehensive credit plan for each and every district allotted to it for a period of five years called the District Credit Plans initially, and revising these plans every year to Annual Credit Plans depending upon the cumulative achievement till the immediate past year.

Various loan schemes were formulated by the central and state governments for both urban and rural economically weak population and were incorporated in the Credit Plans by the banks taking into consideration the physical and financial targets fixed by the government for each loan scheme every year. The banks are responsible for achieving the targets in each of the districts allotted to them. The integrated credit plan is prepared keeping in view the credit input in each sector of activity mainly, agriculture, industries and services, as directed by the central/state governments from time to time.

In the era of urbanization, one must not undermine the potential of the rural sector and the quantum of business that can be generated through it. According to a World Bank research, approximately 2.5 billion people**1** globally (of working age group) do not have access to any formal type of financial services that are commonly accessible to the wealthy and rich (2015). This figure mainly represents the rural areas and indicates that financial inclusion of such areas can boost the economic growth. The Centre for Financial Inclusion defines financial inclusion as, "*a state in which everyone who can use them has access to a full suite of quality financial services, provided at affordable prices, in a convenient manner, with respect and dignity. Financial services are delivered by a range of providers, in a stable, competitive market to financially capable clients"* (Mission and Vision)***2.*** The question that now arises is how can financial inclusion of the rural areas help to spur economic growth of a country? To answer the question we need to understand how the financial system works in rural areas in absence of a formal, regulated financial mechanism. People buy livestock and land for savings and investment purposes and go to the local money lender in case they need credit and end up paying too much interest in return to pay off their debts and thus the poor become poorer. An increasing number of researches indicate that economies in which financial intermediation run deep, grow at a faster pace than others. The access to appropriate financial services helps remove financial inequality and encourage entrepreneurship among people. The financial services are not only restricted to the banking system but also include insurance, microcredit industry, government and non-government aids including both financial and technical help, government subsidies, etc. With the help of financial and technical support encouraging entrepreneurship, more and more people are willing to take risks and initiate new business ventures. This paper endeavors to explore social banking and microfinance as a tool for financial inclusion of the rural sector in India and try to determine that which is better at handling the challenges of financial inclusion in India.

We shall first explore Social Banking, which is a vertical approach of the Government of India and RBI in providing financial inclusion to the rural, specially the unbanked areas and then further move on to explore microfinance which is more or less based on a public private partnership model providing a horizontal dimension to the process of financial inclusion.

SOCIAL BANKING: THE VERTICAL APPROACH

The Genesis

The pre-independence era was characterized by the existence of private banks as joint stock companies. In the absence of proper regulatory framework many of them failed. In 1935 when the Reserve Bank of India came into existence there were limitations in the process of regulation and supervision as per the provisions of the Reserve Bank of India Act, 1934 and Companies Act 1913 (The Reserve

Bank of India, 2008)**3.**The regulated banking system was still not accessible to all, as a result of which the semi-urban and rural folks were the perpetual victims of exploitative nature of the local moneylenders. In such a scenario, cooperative credit brought some hope but was successful in only a few regions **4**(The Reserve Bank of India, 2008) due to absence of infrastructure and technical know-how. At this time when illiteracy was a major issue, the absence of financial literacy was a forgone conclusion. With no proper markets in place, the channels of information could not be regularized and supervised resulting in asymmetric distribution of information. In absence of institutionalized credit, absence of adequate assets and no banking habit in rural areas it was difficult to promote entrepreneurial credit. This scenario began to change with the implementation of social control in 1967 and thereafter nationalization of fourteen banks in the year 1969. This was a sincere attempt to promote banking habit in the rural areas as prior to this the presence of banks and financial institutions were skewed in favor of the urban areas. The Lead Bank Scheme (The Reserve Bank of India, 2008) **5**paved the way for the rapid expansion of the banking system and penetration of banks in the rural areas. Though the credit lending by the unorganized financial sector fell sharply, it also created issues for the banks. The banks could not generate profit as they compulsorily had to disburse advances as per the government schemes that often created NPAs (Non-Performing Assets), as a result of poor governance, lack of political will and operational inflexibility and the financial sector became the 'Achilles heel of the economy', (1993) as stated in the report by Rangarajan Committee constituted in, 1988. In light of the Rangarajan report remedial actions were taken in the 1990s and structural reforms were introduced in 1991. The focus shifted from the micro to macro goals (the larger picture) with liberalization, deregulation and adoption of international benchmarks customized as per the requirements of the economy that spurred reforms in the financial system. The stricter prudential NPA norms for big industrial house as well as a poor farmer who is not aware of the financial discipline to be maintained has gradually dampened the spirits of the lending banks in extending loans to the weaker section of the society.

THE NEED FOR SOCIAL CONTROL OF BANKS

The major concerns regarding the banking system in India at the time of independence and 20 years hence were:

a) The 'nexus' between banks and industry resulting in the apprehension that the industrial houses may eventually takeover all of banking assets, and
b) Continuous neglect of the agricultural sector (Balachandran, 1998)**6**

To address these apprehensions, the concept of social banking was introduced through the Banking Laws (Amendment) Act 1968, which came into force on February 1, 1969. Some of the focal points of the Act were (The Reserve Bank of India, 2008)**7**:

1. The board of directors of the bank must contain 'not less than 51%' of total members having practical knowledge or being specialists from the field of 'accountancy, agriculture and rural economy, banking cooperation, economics, finance, law and small scale industry' (Reserve Bank Of india, 2008)**8**
2. Every bank would have a whole-time chairman who was not an industrialist, but a professional banker with knowledge and practical experience of banking, or financial economic or business administration with his term not exceeding more than 5 years.
3. The RBI had the power to appoint, remove or terminate the services of not only the chairman but any executive director, chief executive officer or any employee of the bank if circumstances so demanded, keeping in view the interests of the bank, its depositors, banking policy and public interest.

Social control of banks helped reach banking services further into the rural areas, easy and wide spread of bank credit, prevented misuse of credit, control and direct flow of the credit in the desired prioritized sectors and improve the effectiveness and efficiency of credit disbursements. For better functioning of the above mechanism, the National Credit Council was set up in February 1968 to help the RBI and government in prioritizing and deciding upon allocation of credit funds to various sectors. The aim was to uproot unsavory money lending practices and lenders who charged exorbitant interest rates and replace them with commercial banking sector and cooperative banks and other financial institutions. Despite the implementation of social control on banks, a large segment of the population was still outside the reach of 'organized lending system'. To counter this problem the RBI came up with the Lead Bank Scheme. This scheme aimed at providing hassle free credit to the economically weaker sections and reduced the burden of all nationalized bank to expand rapidly in the rural areas. As per the scheme a 'Lead Bank' was designated for a district which would be responsible for surveying and understanding the credit needs of the district allotted to it and then help syndicate credit along with the help of other nationalized banks present in the district for disbursement of advances for developmental projects. While assigning the lead bank, RBI kept in mind the regional orientation of the bank and the resource base of the bank. This scheme yielded encouraging results as there was a growth of 129% in expansion of branch networks to unbanked areas [9]. Coincidently, during the period of nationalization of banks, the Green Revolution was also initiated and the combined effects of both the schemes led to mobilization of credit towards rural areas generating higher incomes. With the agricultural schemes flourishing, the focus of credit could now be diverted towards uplifting and encouraging cottage industries and handicraft industries. Thus, the social banking initiative by RBI and Government of India proved to be a vertical approach to penetrate the unbanked areas of the economy and provide it with a much needed impetus for growth in form of institutionalized credit.

Over time the rural banking expansion has had to face a lot of challenges in terms of expansion and customization of products according to the regional needs. The aim of RBI to cover all unbanked villages with a population of more than 2000 is a Herculean task and the expenditure incurred itself is huge. This adds to the financial burden of the economy and hits the bottom line of the banks' balance sheets. Thus it is a forgone conclusion that along with the vertical channels of financial inclusion promoted by RBI and Government of India, some horizontal channels of financial inclusion are also needed to be introduced into the system so that the financial burden on the nationalized banks can be alleviated and customized regional products can be introduced in the rural areas. Thus regional rural banks, cooperative societies, NGOs, and other private financial and microfinance institutions need to come together to expedite the process of financial inclusion in the rural areas.

Further initiatives taken by the government as a part of social banking are as under:

Financial Inclusion

a) Identification of persons not having any bank account.
b) Opening of an individual bank account of every such person with age of 12 years and above through the business correspondent mode with the nearest bank branch for enabling doorstep banking.
c) Linking all social security scheme payouts such as MNREGA, old age, widow pension, scholarships, etc., extending facility of direct transfer of funds to their individual bank accounts.
d) Extending both inward and outward fund transfer facility.
e) Providing at least one micro-insurance product to each account holder.
f) Routing all banking transactions through this account only.
g) Providing a microcredit product by way of an overdraft facility for emergent needs of the account holders.

National Pension Scheme

Providing the facility of National Pension Scheme to the persons occupied in unorganized sectors.

MICROFINANCE INSTITUTIONS: THE HORIZONTAL APPROACH

In the words of Kofi Annan, former Secretary General of the United Nations, "Microfinance recognizes that poor people are remarkable reservoirs of energy and knowledge. And while the lack of financial services is not just a sign of poverty, today it is looked at as an untapped opportunity to create markets, bring people in from the margins and give them the tools to help themselves." Microfinance, as the name suggests is availability of financial services at a regional and local level. Microfinance includes a number of services such as microcredit, insurance, savings account facilities (no-frill accounts), self-help groups, cooperative societies and many other such institutions. These services are essentially provided to the economically weak who do not have sufficient collateral to raise loans from formal financial institutions. India being primarily an agriculture based economy employs almost 60% of its population in agriculture sector. This creates a situation of perpetual unemployment for a large section of the population engaged in agriculture based on Keynes theory of marginal utility. Microfinance can be used to counter such instability and inequality in employment by funding small scale enterprises to generate employment and income in the rural sector and reducing dependency on mere agriculture. The point to be noted here is that the government is already focused on funding the agriculture sector of the rural areas introducing schemes like Kisan Credit Cards, Kisan Call Centers; Credit Relief schemes, etc. Therefore microfinance institutions promote small business startups to bring in self-sufficiency among the rural households and in the process alleviate poverty. The revolution of microfinance gathered momentum in the 1970s and can be traced to the successful venture of Dr. Mohammed Yunus, who revolutionized microfinance with the phenomenon commonly known as Grameen Bank for which he won accolades worldwide. This was an attempt to self-finance small ventures and promote cottage industries with the help of crowd funding and formation of cooperative societies which generated funding without the help of any formal financial institution. This structure also had the advantage of collective equity in risk and hence the burden of risk would be shared by all members instead of just one person. This also induced a collective responsibility among the members to work hard in creating a successful venture as each one had a vested interest in it. Though the movement initially focused on the village women folk to help them generate household income, it soon gathered momentum and snowballed into the idea of creation of microfinance institutions. Microfinance institutions help to counter problems generally faced by the economically weak when they approach formal financial institutions such as banks. The problems range from inadequate collateral or guarantors, high transaction cost of credit processing, lack of financial infrastructure in remote areas to fear of creation NPA's by banks etc. With the knowledge of the fact that almost 70% of India's population lives in rural areas and agricultural land holding growing smaller day by day, it provides a huge untapped market of financial service consumers and mobilization of funds into the rural areas can generate a quantum leap in small scale industries and enterprises. The impact of microfinance is three fold; at the personal level (self-sufficiency of individual), at community level (social and economic upliftment of the community as a whole) and finally the regional level (prosperity and poverty alleviation of the region). To understand how microfinance institutions work at the horizontal level, we first need to understand the various credit lending models in microfinance.

CREDIT LENDING MODELS IN MICROFINANCE (Srinivas, 2015)10

Since microfinance institutions work at the local grass root level, we first need to understand how the institution works, where does the funding come from and how does it reach the end customer. Further we also need to explore the functioning of various models of MFIs. The following flowchart (Figure 1) shall give a general idea as to how funds flow in an MFI.

THE ASSOCIATIONS MODEL

In this model, the community forms an association through which funds are mobilized by pooling in of the money by the community members. The MFI is not only restricted to manage savings but undertakes other microfinance activities as well. The basis of association can vary from religion to culture, politics, and community, etc.

THE BANK GUARANTEES MODEL

This model obtains loans through commercial banks by arranging a guarantee/guarantor externally that is donor enterprises or internally with the help of the savings of the members.

The loan can be given directly to an individual in need of it or be given to the self-formed group. Several national and international agencies (such as World Bank and other Government Bodies) act as donor enterprises which provide access to guarantee funds so that MFIs can pledge them to commercial banks and access credit through them.

THE COOPERATIVES MODEL

Cooperatives are autonomous and voluntary organizations where people come together with a common economic and social goal through joint ownership and democratic governance of the organization. The financing activities are sometimes exclusive to members only.

THE CREDIT UNIONS MODEL11

It is a democratic, non-profit financial self-help cooperative. They are designed to provide credit to members of the cooperative at reasonable interest rates and the funding is done by pooling in the resources (creating a pool of savings with each member contributing a predetermined amount) by the members of the group. The basis of formation of the group is a common bond which may be working for the same employer, going to the same Church, belonging to a labor union, social fraternity etc.

THE GRAMEEN MODEL

This model is based on the Grameen Bank model given by Dr. Mohammed Yunus. As per this model, a bank model is established, and Field Managers are appointed to survey and establish the needs of credit in the region. They establish contact with the locals and explain them the lending system of banking model and how it can help them access credit. They then form five-member groups of perspective borrowers and select two most viable members to advance loans, viable meaning the ones who have the highest possibility to return the advances made to them. After observing them for a period of fifty weeks, if and only if the two members continue to regularly repay the loan are the other members given credit. This form of credit lending enforces a peer pressure on the members of the group to maintain clean records and hence collective responsibility serves as collateral for loan.

THE GROUP MODEL

The basic philosophy of this model is 'together everyone achieves more' (TEAM effort). It helps to overcome individual weaknesses and collectivism forms the collateral for individual endeavor. The aim is to collectively help each other when a member or the community is in need.

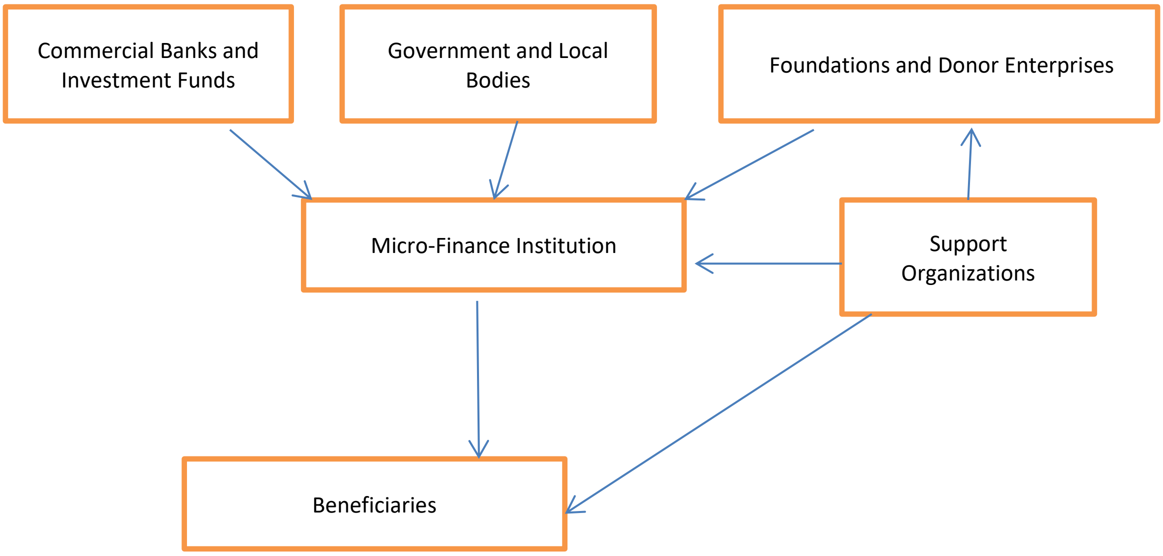

Fig. 1: *Flow Chart Depicting Direction of Fund Flow from Various Participating Institutions.*

THE INTERMEDIARIES MODEL

This model is dependent on an intermediary which is sometimes acts as a support organization whose job is to generate credit awareness among the potential borrowers and educate them about the eligibility criteria for availing credit. By doing so the intermediary helps to create credit worthiness among the borrowers and make them eligible for loans. The functions provided by these intermediaries may cover funding, creating credit awareness, liaising with funding agencies and helping people in getting credit. The roles of such intermediaries are now increasingly performed by NGOs. NGOs not only help in providing microfinance to the rural areas but also help in providing technical know-how entrepreneurial ventures and help them to access larger markets.

THE ROTATING SAVINGS AND CREDIT ASSOCIATIONS MODEL

The functioning of this model is similar to that of a chit fund where the members of a group pool in equal and regular contributions cyclically into a common fund and a selected member is given the lump sum amount in each cycle. The selection of the member may be done on need or lottery basis.

A review of the above models clearly shows that all the financial activities of the MFIs are concentrated at the local level and these intermediaries are thus in a better position to customize financial products according to the needs of the local people. Despite this MFIs are affected by various issues which work as retarders in their work. For example, MFIs are highly leveraged and depend heavily on banks and other funding agencies which cause constraints on easy access to capital. MFIs are often accused of charging high interest rates as they are autonomous bodies and are at liberty to do so. Often risk management is compromised at the cost of rapid growth and expansion which have created higher debt ratios and increased NPAs (Non-Performing Assets). Weak governance and absence of restructuring often leaves the intermediaries in dire straits as due to their autonomous status they are closed to transparency and thus fail to attract capital or funding.

CONCLUSION

The analysis of both the vertical channel and the horizontal channel of finance, that is, social banking and microfinance respectively reveals that vertical penetration by banks to every nook and corner of the country is a mammoth task. As we know, in management, decentralization generally helps in improved efficiency and effectiveness in work output and applying the same concept in financial inclusion we need to create a synergy between the vertical and horizontal subsystems. Both cannot work in isolation since banks have the advantage of easy access to capital and MFIs have the advantage of localized resources.

The application of the horizontal model has its advantages for all the exegetical purposes. Since the horizontal model necessarily envisages a system that is free from red-tapism, lexicographic approach and is driven primarily by the force of financial innovation, the horizontal model will nudge an otherwise Sisyphus task with vigor and zeal. The tools of financial innovation would metamorphosize an otherwise procrustean approach of state centric model. It is pertinent to mention here that investment in social capital is the shibboleth of the post-modern market scenario.

Thus the government banks and MFIs can constitute a public private partnership model to promote financial inclusion of rural areas. The government can save on the expenses incurred on massive expansion of bank branches to unbanked rural areas and utilize this fund to mobilize credit in the rural areas through MFIs. Instead of investing too much manpower in promoting banking habit, the government and RBI can utilize it to keep vigil over the MFIs so that they do not charge exorbitant interest rates on credit or mis-utilize funds. It should also conduct regular surveys to map the progress of the lending process and keep a tab on NPA creation and initiate immediate remedial measures in such cases to save people from falling into the vicious circle of debt. The government and nationalized banks should thus perform the task of market regulators and build a support system for the MFIs for a transparent and effective financial market system. This symbiotic relation can be of great advantage as it will save both parties from duplicity of work and improve efficiency of the financial system.

It may be concluded that in order to ensure that each and every eligible individual in the country becomes a part of the mainstream banking, all the interested peers should ensure their sincere participation in building a participatory banking process.

In order to fulfill the microcredit needs of the economically weaker section of our society, microfinance institutions are the best solution but then steps should be taken by the regulatory authorities to bring down the rate of interest the possible lowest level to make it affordable for both creditor as well as the borrower, a win-win situation for all.

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