New Approaches Towards Financial Inclusion in India

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Current Status and Challenges

- Low GDP per capita; Continuing challenges of poverty both in urban and rural areas.
- Small size of Banking / Financial system relative to GDP (70% Credit to GDP ratio).
- Extremely large regional variations in financial access and depth (0% to 120%).
- Cash transactions dominate Payments. Standardised products dominate credit.
- Banks facing risk and profitability concerns.

Extent of Coverage
47% of Indian adults do not have bank accounts. 43% of bank accounts are dormant[$].
An average of 12 Commercial Bank branches available for every 100,000 adults[$].
29% of Indians are internal migrants with restricted access to identity documentation, social entitlements and financial services.

Enabling Infrastructure
74% of Indians with Unique Biometric Identity. Goal of 100% by end of 2016.
Wireless tele-density* of 77%. Continuing to expand rapidly. Over 5 million recharge points.
28% of villages have broadband coverage with a goal of 100% by the end of 2016^.

[$]World Bank *Wireless subscribers/population, TRAI ^BSNL broadband

Current Banking System
Horizontally Differentiated

Design	**Regional Focus**	**Business Focus**
National Bank	No	No
Regional Bank	Yes	No
National Consumer Bank	No	Yes
National Wholesale Bank	No	Yes

- All institutions licensed as full-service banks with differentiation only on regional and business dimensions.
  - Proved to be unsuccessful in extending reach and were very high cost even when the use of Agents was permitted.
  - Challenges in finding "fit and proper" candidates.
  - Regional banks proved to be very high risk.
- Non-Bank Finance Companies for credit and Pre-Paid Instrument providers for payments, with truncated capabilities, added on to supplement the core design as partners of the Banks.
  - Made a very limited impact since Banks viewed them as competitors and not as true partners.
  - Also left significant opacity linked contagion risks issues unresolved.

Banking System Proposed by the CCFS Committee Vertically Differentiated

Design	**Credit**	**Retail Deposit**
National Bank	Yes	Yes
Payments Network Operator	No	No
Payments Bank	No	Yes
Wholesale Bank	Yes	No

- A few, large, highly de-risked, closely supervised, National Banks to be allowed to emerge as highly diversified risk aggregators.
- A large number of vertically differentiated highly specialized banks and operators who are not allowed to “cross the floor” to be permitted to enter the banking system.
  - Fewer challenges of contagion risks and reduced Moral Hazard concerns. Easier to find “fit and proper” candidates who could bring critical “adjacencies”.
  - Strong incentives to partner with banks that have complementary capabilities.
  - Full product suite possible in their areas of specialization.
- Risk Origination, Risk Transmission, and Risk Aggregation to be viewed as distinct functions.

The Case for Payments Banks

- The shared “liquid asset stockpile” efficiency argument of Kashyap, Rajan, and Stein (2002) dominated by effectiveness and risk management arguments in the Indian context.
  - Does not have the “nesting” problem of a Pre-Paid Instrument provider and therefore sharply curtails contagion risk.
  - Does not have the “crossing the floor” feature of a full-service bank therefore entry of corporates poses fewer comingling and self-dealing risks.
  - The existing presence of a strong technology and transactions intensive business seen to be more “adjacent” to payments and deposit taking than a lending business.
- Could take full advantage of Aadhaar’s real-time authentication capabilities (e-KYC) and emerging Indian broadband and telecommunications infrastructure.
- Could become a model for clearing houses allowing for instantaneous DVP transactions.
- Could provide a critical “highway” for diverse credit players to emerge that can serve more sharply defined sub-sectors with highly innovative models, without the burden of setting up a full cash-handling infrastructure.
- Opens up the possibility of a sharp reduction in the usage of cash, cards, and ATMs as merchant transactions move towards digital payments.
- Opens up a powerful channel for the penetration of insurance and mutual funds and for the government’s ambitious plans for conditional and unconditional cash transfers.

Payments Bank Recommendation Accepted

- To be licensed as full commercial banks under the Banking Regulation Act by the RBI with two key regulatory restrictions.
  - No commercial lending is permitted.
  - All assets must be placed in Government Bonds or in commercial bank deposits.
- Minimum Rs.1 billion (US$15 million) capital, to ensure entry of only serious players.
- Minimum 3% capital adequacy required (expressed as a leverage ratio of 33.33) to cover Operations Risk, instead of the 2% under the Basel Standardised Approach.
- Real sector companies permitted to apply as also non-bank financial sector companies, to set up licensed payment banks as subsidiaries.
- Permitted to distribute other financial services.
- 11 in-principle Payments Bank licenses announced by the RBI on August 19, 2015 with MNOs, Corporate Houses, Business Correspondents, a Depository, and a PPI, among the awardees.

Implications for Development and Growth

- Payments Banks and Digital Payments are powerful enablers for improved transactions efficiency, economy wide allocation of resources, and transmission of monetary policy.
- However, there is need for comprehensive financial inclusion which can now be built around the "spine" of Payments Banks.
- Wholesale consumer banks (without deposit taking) and a variety of non-bank finance companies would have a critical role to play in the provision of comprehensive financial services.
- Product designs would need to move away from simplicity as a design principle to one incorporating suitability with the goal of simplifying the lives of consumers of these services and not those of providers.
- There will be a need for specialised originators of risk, transmitters of risk, and aggregators of risk.
  - KGFS emerging as a new form of risk originator which provides comprehensive financial services.
  - IFMR Capital and MUDRA emerging as new forms of specialised risk transmitters.
  - Mutual Funds, Insurance Companies, and National Banks playing the role of risk aggregators.

Thank you

http://foundation.ifmr.co.in/cfs/