Call for an Inclusive Banking Structure for India by 2019, Fifty Years after Bank Nationalization

DISCUSSION PAPER

Vijay Mahajan
Founder and CEO,
BASIX Social Enterprise Group

UKaid from the British people

SIDBI
भारतीय लघु उद्योग विकास बैंक
SMALL INDUSTRIES DEVELOPMENT BANK OF INDIA

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SAMRIDHI Program

The Samridhi programme is being implemented by the Small Industrial Development Bank of India, supported by UK Aid through the Department for International Development (DFID), UK. It aims to enhance poor and vulnerable people's income, especially women, in four low income states, so they benefit from economic growth through enhanced private investment and better access to financial services in India. In the above context, this programme has a significant potential to support the existing models and service providers in scaling up, invest in development of new products and delivery mechanisms where required and support policy influencing and convergence at sectoral level for a conducive enabling environment for holistic financial inclusion. While some of these strategies are relevant at national level, the programme has focus on the four poor states of M. P., Odisha, Bihar and U. P.

Expected Results of the Program:

- 12 million poor people, reached with financial services, of which three-fourth are women. Over 9 million to experience increased incomes, by at least one-third over people who do not obtain project benefits.
- Over 5 million women clients testify improvements in social status and mobility.

Outputs:

- Facilitate policy and institutional environment that encourages provision of financial services to poor people.
- Institutions providing diverse financial services promoted.
- Women's capacities to tackle financial and gender issues enhanced

The programme has two separate interlinked components:

Component 1: Micro Finance and Women's Empowerment

£30 million will be available for financial inclusion and women's empowerment including programme management & monitoring, across 4 poorest states of Bihar, Madhya Pradesh, Orissa and Uttar Pradesh. Expansion to other states may be considered.

SIDBI will: (a) prepare the ground for delivery of Microfinance services, by building community based and microfinance institutions. SIDBI's grants and capital at affordable rates will make microfinance operations catering at scale to poorer people a viable proposition, attracting mainstream loan funds from the market.; (b) encourage these institutions to provide diverse financial services, that promote incomes and livelihoods and meet the needs of women; (c) help minimise costs to clients, innovate, apply lessons; and ensure commercial sustainability so that services sustain even after donor support is withdrawn; (d) support policies and mechanisms that lead to services being provided in a responsible manner, e.g., dialogue with local and central regulators; adherence to standards & regulations.

SIDBI will also support collectives of women organised for Microfinance to promote women's empowerment by: (i) recruiting specialist women's organisations and/or training staff; and (ii) training women clients in financial and business practices; and (iii) promoting improved household health and nutrition practices .

Component 2: Impact Investing

£35m will be for promoting Impact Investment across Rajasthan, Jharkhand, Chhattisgarh and West Bengal, in addition to the above mentioned 4 states.

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Call for an Inclusive Banking Structure for India by 2019, Fifty Years after Bank Nationalization

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1 Banking Structure and Financial Inclusion in India

This paper is being released into the public domain in the backdrop of the Discussion Paper, "Banking Structure in India - The Way Forward", issued by the Reserve Bank of India (RBI) in August 2013[2]. The scope of the RBI Discussion Paper is necessarily wider, as it not only covers the issue of financial inclusion but also looks at banking models, structures and licensing policy, legal framework for banks, financial stability, resolution mechanisms and deposit insurance, consolidation and emergence of large banks and ways to help India build at least a few global banks, government ownership of a significant part of the banking system and the issues of cross-border banking (both foreign banks in India and Indian banks abroad). While we welcome the RBI's efforts to seek public opinion on the various issues it has listed are welcome, this paper is largely confined to the topic of financial inclusion.

1.1 Financial Inclusion Efforts, Since Long and Since 2007

The Indian economy witnessed high levels of economic growth following the economic reforms that were introduced in the 1990s. Within the first few years, it became clear that if reforms have to work, growth will have to be inclusive. Then it was realized that financial inclusion is a necessary, though not sufficient condition for inclusive growth. Data released by the RBI indicates that 58.7% of households in India avail of banking (savings) services, with the figure being 54.4% for rural areas and 67.8% for urban areas.[3] The number is much lower, at 21%, if one talks of credit. For over a century, the Indian state has tried to address the financial needs of the masses. We give a brief history of these efforts in Annexure 1 and move below to 2007.

With the appointment in 2007 of the Committee on Financial Inclusion, chaired by Dr C Rangarajan, the former Governor of the RBI, the government began a second round of efforts for financial inclusion, 15 years after economic reforms began. The author was a member of this committee. The report of this committee led to a National Financial Inclusion Plan and the establishment of a Financial Inclusion Fund and a Financial Inclusion Technology Fund of Rs 500 crore each. The 2008 report of the Committee on Financial Sector Reforms chaired by

[1] The author would like to thank Access Development Services and its Director, Mr Vipin Sharma, for nudging him to write this paper and supporting the work. The author acknowledges the work done by Shashank Shekhar, Young India Fellow, 2012 and his colleagues in some of the data collection for this paper. The author also thanks Shri Y P Nanda, former Chairman, NABARD; Ms Ragini Chowdhry, DFID, Dr Tara Nair, Mr Ajay Tanka, Mr Vijay Nadkarni, Mr MSV Prasad and Mr Suman Laskar for comments on earlier drafts.
An earlier version of this paper was presented at the day-long Policy Roundtable on Small Banks held by the Think Tank of the DFID, UK supported Poorest States Inclusive Growth (PSIG - Samriddhi) project managed by the Small Industries Development Bank of India and Access Development Services on Sep 25, 2013. The author is thankful to the participants of that roundtable for their comments.

[2] http://www.rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=29405, consulted on 3 Sep 2013

[3] http://rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=813 consulted on 14 Jun 2013

Dr Raghuram Rajan gave a further fillip to financial inclusion, holding it as the third criterion – in addition to promotion of growth and price stability – by which the effectiveness of the financial sector should be judged in a developing country. The author was a member of this committee as well, so was able to participate in cutting-edge thinking on this topic.

The RBI has articulated that financial inclusion is much beyond just opening a no-frills account. The definition is broad based and begins with financial education and covers at the minimum four products - a basic "no-frills" banking account with overdraft facility; business credit such as general credit card, or a kisan (farmer) credit card; a remittance product for electronic benefit transfer and other remittances; and a pure savings product ideally a recurring or a variable recurring deposit. For enabling people with bank accounts to carry out small deposit or withdrawal transactions without having to visit bank branches, the RBI approved the concept of "business correspondent" outlets (BCOs), with non-bank entities such as grocery shops and telephone booths acting as transaction agents (BCOs).

Overall Progress in Financial Inclusion since 2009

SR	Particulars	Year ended Mar 10	Year ended Mar 11	Year ended Mar 12	Year ended Mar 13	Progress April 10 - March 13
1	Banking Outlets – Rural Branches	33378	34811	37471	40845	7467
2	Banking Outlets – BCs	34174	80802	141136	221341	187167
3	Banking Outlets - Other Modes	142	595	3146	8424	8282
4	Banking Outlets –Total	67694	116208	181753	270610	202916
5	Urban Locations covered through BCs	447	3771	5891	27124	26677
6	BC-ICT Accounts (in lakh)	132.65	316.30	573.01	810.38	677.73
7	BC-ICT A/cs - Transactions (in lakh)	265.15	841.64	1410.93	2546.51	4799.08

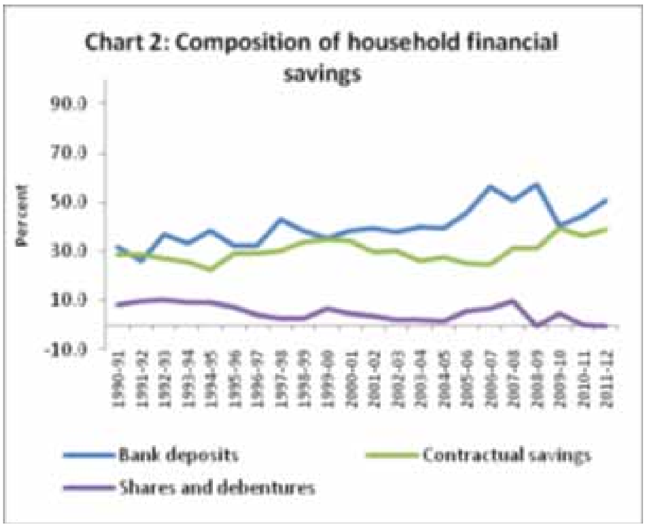
Source: http://rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=813 consulted on 14 Jun 2016

Millions of "no-frills" bank accounts have been opened under the national financial inclusion plan. There are reports that a substantial proportion of these accounts are dormant. In most cases, bank branch staff was reluctant to service these new customers. The occasional customer, who came to the branch, had a discouraging experience. This led to the popularization of friendlier BCOs and as many as 221,341 BCOs were established by Mar 31, 2013. Their usage, however, has still to pick up, with the average number of transactions per account per annum being as low as 3.14 per annum, or less than one per quarter.[4] A June 2012 survey[5] showed that 75% of the BCOs, numbering about 80,000 by March 2012, were earning below Rs 5000 per month while their median expectation was Rs 6500 per month.

The RBI Discussion Paper claims, in the very third sentence that "the banking structure played a major role in the mobilisation of savings and promoting economic development". Yet, data shows that this is far from the facts. One of the peculiar characteristics of the Indian economy is that while the savings rate is high as a percentage of GDP, running at well above 30% since 2000, the extent of savings in financial terms (bank deposits, bonds, insurance, mutual funds, pensions, etc.) is usually only about half

[4] Based on data from http://rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=813 also given above.
[5] Chen and Thoumoung, National Survey of Branchless Banking in India, June 2012, CGAP.

of the savings rate. The rest is saved in the form of physical assets like gold and silver jewellery, land and buildings, livestock, durable goods and just hard cash. (See diagram from The *Economist*[6]). This dramatically reduces the possibility of utilising the surplus of one household or enterprise to meet the investment needs of another and therefore the growth prospects of the economy. To make matters worse, the banking system is able to attract only about 50% of the financial savings, the rest going into "contractual savings" (like insurance and pensions and non-bank recurring deposits) and shares and debentures (very small proportion). This is based on the RBI's own data charted in the Discussion Paper (p. 83), and reproduced below:



Thus, we cannot conclude that the banking sector has played a major role in the mobilisation of rural savings. In fact, the Post Office with 96.5 million savings clients and Rs 34,068 crore of deposits in Mar 2012, as also many so-called residuary non-bank finance companies (till stopped a few years ago) has been the mainstay of savings by the lower income groups and the rural households. Had the banks been more pro-active, a larger share of savings would have come to them.

1.2 Four Forms of Financial Exclusion

The RBI Discussion Paper in para 3.5 states:

"Notwithstanding the development of various types of banks, Indian banking sector is yet to meet the desired banking penetration and inclusion as witnessed in most advanced and some of the emerging economies. Based on data given in Basic Statistical Returns, it is estimated that rural India had only 7 branches per 1,00,000 adults in 2011 in sharp contrast with most of the developed and even BRICS economies having over 40 branches. Regionally, north-eastern, eastern and central regions are more excluded in terms of banking penetration."

[6] http://media.economist.com/sites/default/files/media/2013InfoG/WIC-contacts/20130511.pdf

Though this is a candid admission, the RBI paper does not analyse the breadth or depth of exclusion along several dimensions. We make up for that deficiency in this paper. There are at least four dimensions to financial exclusion we have identified and we will present data along each of them.

1. Spatial – metro-urban-rural and across regions, states and districts
2. Sectoral – agriculture, industry, services and sub-sectors within them.
3. Segmental – sections of population – women; scheduled tribes, scheduled castes; minorities; and the disabled
4. Size and Status – large and formal/organized vs small and informal/unorganized

1.3 Spatial Inequality and Pervasive Exclusion

The most obvious spatial inequality is across the rural-urban spectrum. Before we go into the detail of this, we hasten to add that "urban" does not mean "included", and indeed there is a lot of lower-income population in metropolitan areas which suffers from financial exclusion as much as the rural people do. Unfortunately, urban exclusion is not measured since urban data gets aggregated across wards.

Table 1 : Spatial distribution of deposits and credit, by number of accounts and by amount, across rural, semi-urban, urban and metropolitan areas

Amount in Rupees Billion — No. of Accounts in Thousands

Year	Rural		Semi-urban		Urban		Metropolitan	
	No. of A/cs	Amt Outstand-ing	No. of A/cs	Amt Out-stand-ing	No. of A/cs	Amt Out-stand-ing	No. of A/cs	Amt Outstand-ing
DEPOSITS								
2007	149,663	2,530	132,808	3,574	113,422	5,326	123,306	14,540
2008	168,034	3,034	148,361	4,303	128,021	6,577	137,241	18,585
2009	199,695	3,639	169,725	5,298	142,272	8,229	150,611	22,054
2010	224,155	4,203	189,457	6,140	152,323	9,450	168,934	25,817
2011	250,254	4,933	212,043	7,168	168,037	11,105	179,796	30,689
CREDIT								
Amount in Rupees Billion					No. of Accounts in Thousands			
Year	**Rural**		**Semi-urban**		**Urban**		**Metropolitan**	
	No. of A/cs	**Amt Outstand-ing**	**No. of A/cs**	**Amt Out-stand-ing**	**No. of A/cs**	**Amt Out-stand-ing**	**No. of A/cs**	**Amt Outstand-ing**
2007	31,029	2,357	22,099	2,128	13,254	3,502	28,060	11,484
2008	33,546	3,231	24,021	2,560	14,194	4,306	35,230	14,073
2009	33,823	3,096	24,793	3,111	14,750	4,986	36,690	17,284
2010	37,074	3,851	27,047	3,679	16,242	5,936	38,285	19,985
2011	40,018	3,924	28,772	4,520	16,896	7,795	35,038	24,517

Generally, policy makers think of exclusion in terms of lack of access to credit, but, as can be seen from Table 1 above even in the issue of savings, where the rural-urban differences should not be as stark, there is much lower deposit mobilization in rural areas. Thus rural areas account for only 9.2%

of the deposit amount, while metropolitan areas account for 56.9% of the deposit amount as on 31st March 2011.

A similar situation exists for credit – rural areas account for 9.6% of the outstanding loan amount, while metropolitan areas account for 60.4% of the loan amount as on 31st March 2011. The share of semi-urban credit was about 11.1%, the share of urban areas was 19.1% while metropolitan credit was about 60.2%. In terms of the number of loan accounts, again the inequality is less, with rural areas having 33.1% of the accounts whereas all the others have for 66.9% as on 31st March 2011. The CD ratio, however, for rural areas at 79.6% is better than the system average of 75.6% in 2011. This is largely due to the expansion of rural bank branches and setting up of the Regional Rural Bank network.

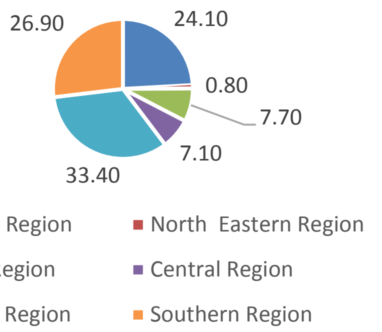
Maharashtra, which accounts for more than one-fourth of gross credit by banks in the country, has one of the lowest share of rural credit to total credit. The gross bank credit by banks in Maharashtra as on September 2012 was Rs 14,109 billion which is about 29% of India's gross credit. However, the share of rural credit in the credit given by banks in the state was Rs 289 billion or just 2% of the state's gross bank credit. In fact, it appears, the less urbanized a state, the lower is this inequality. Given below is the data on rural credit as a proportion of the total in the major states:

State	Percentage of **rural credit** of total credit	Percentage of **semi-urban** credit of total credit
Bihar	33	25
Uttar Pradesh	23	14
Madhya Pradesh	17	19
Rajasthan	15	16
Andhra Pradesh	13	14
Karnataka	11	10
Tamil Nadu	9	17
Gujarat	8	10
West Bengal	7	3
Maharashtra	2	2
New Delhi	0.87	0.07

Source: http://www.business-standard.com/article/finance/only-8-of-gross-bank-credit-of-all-scheduled-commercial-banks-go-rural-areas-113061200564_1.html

The naïve way to look at credit availability across India is the pie chart in Fig 1 below:

Fig 1: Region Wise Proportion of Credit 2011-12



This does not tell us much except that the north eastern and the eastern regions get less credit. There are two deeper ways we can look at the inequality of distribution. One is the traditional CD (credit-deposit) ratio, and the other is the Credit to Gross State Domestic Product (GSDP) percentage. The former is indicative of how much of the savings mobilised from a state are used to promote economic activity there, while the latter indicates relative credit intensity across the states.

First let us look at these parameters across the four broad spatial classifications – rural to metropolitan. The table 2 below lists the two parameters across states. We find that for the CD ratio, the maximum is Tamil Nadu at 116.2%, while minimum is 22.6% for Arunachal Pradesh, the remotest and lowest density hill state in India. But all the northeastern states have a low CD ratio, with none crossing 38.1% and the region's average being only 33.8%. Only Bihar and Jharkhand are about as low at 29.1% and 33.6% respectively. The maximum to minimum ratio is high at 5.2. Bankers argue that the CD ratio reflects the economic potential of the place and the savers should be thankful for a nationally integrated banking system which enables them to save in a bank even when the money cannot be lent locally.

On 18th Jun 1980, Public Sector Banks were asked to achieve 60% CD ratio in Rural and Semi Urban areas separately on all India basis. Later, on 18th Feb 1995, the RBI reiterated the same, saying banks were not paying adequate attention. This was repeated on 20th Dec, 2003. Yet, as can be seen from the RBI data on 31st Dec 2012, while the CD ratio reached 68% in rural areas (on an all India basis), in semi-urban areas, it is still at 55%. Regional disparities in semi-urban CD ratio continue to be as low as 22% in West Bengal and 23% in Jharkhand. Regional disparities in the CD ratio for rural areas are even higher – Himachal Pradesh (35%), J&K (38%), Assam (48%), Bihar (38%), Jharkhand (31%), Odisha (46%), and West Bengal (34%), far less than 60% stipulated, even 33 years after the 1980 RBI circular.

Table 2 : Credit Deposit Ratio and GSDP to Deposit and Credit Percentages across

(Amount in Rs billion) (2011-12)						
Region/State/Union Territory	**NSDP**	**Deposit**	**Credit**	**Credit/ Deposit Ratio**	**Deposit as % of NSDP**	**Credit as % of NSDP**
Northern Region	12,987	12,875	11,601	90.1%	99.1%	89.3%
Haryana	2,806	1,467	1,498	102.1%	52.3%	53.4%
Himachal Pradesh	508	384	143	37.2%	75.7%	28.1%
Jammu & Kashmir	494	496	170	34.3%	100.4%	34.4%
Punjab	2,312	1,744	1424	81.6%	75.5%	61.6%
Rajasthan	3,700	1,520	1,370	90.1%	41.1%	37.0%
Chandigarh	190	400	454	113.6%	210.5%	239.2%
Delhi	2,978	6,863	6,543	95.3%	230.4%	219.7%
North Eastern Region	1,720	1,088	368	33.8%	63.2%	21.4%
Arunachal Pradesh	87	61	14	22.5%	70.4%	15.8%
Assam	1,036	675	252	37.3%	65.1%	24.3%
Manipur	91	42	13	30.1%	46.5%	14.0%
Meghalaya	149	112	28	25.3%	75.2%	19.0%
Mizoram	61	34	13	38.1%	56.6%	21.6%
Nagaland	112	58	16	26.8%	52.2%	14.0%
Tripura	185	105	33	31.3%	56.6%	17.7%
Eastern Region	10,520	7,399	3,697	50.0%	70.3%	35.1%
Bihar	2,431	1,413	412	29.1%	58.1%	16.9%
Jharkhand	1,015	889	299	33.6%	87.6%	29.5%
Orissa	1,949	1,254	588	46.9%	64.4%	30.2%
Sikkim	57	41	13	32.0%	73.4%	23.5%
West Bengal	5,027	3,781	2,377	62.9%	75.2%	47.3%
Andaman & Nicobar Islands	41	20	8	38.0%	49.2%	18.7%
Central Region	10,813	7,293	3,451	47.3%	67.5%	31.9%
Chhattisgarh	1,188	689	369	53.5%	58.0%	31.0%
Madhya Pradesh	2,900	1,690	966	57.2%	58.3%	33.3%
Uttar Pradesh	5,967	4,347	1,914	44.0%	72.9%	32.1%
Uttarakhand	758	567	202	35.6%	74.8%	26.6%
Western Region	17,963	19,402	16,128	83.1%	108.0%	89.8%
Goa	347	367	106	28.9%	105.8%	30.6%
Gujarat	5,132	3,061	2,134	69.7%	59.7%	41.6%
Maharashtra	12,485	15,937	13,878	87.1%	127.7%	111.2%
Southern Region	20,492	13,685	12,970	94.8%	66.8%	63.3%
Andhra Pradesh	6,758	3,468	3,827	110.4%	51.3%	56.6%
Karnataka	4,656	4,117	2,912	70.7%	88.4%	62.6%
Kerala	3,267	2,006	1,515	75.5%	61.4%	46.4%
Tamil Nadu	5,691	4,012	4,660	116.2%	70.5%	81.9%
Puducherry	121	77	55	71.6%	63.5%	45.5%
All India	74,495	61,741	48,215	78.1%	82.9%	64.7%

Source: RBI Statistics

The other parameter is the Credit to Gross State Domestic Product (GSDP) percentage which indicates relative credit intensity across the states. Here we find gross inequality – with Nagaland at 14.1% while Chandigarh is at 239.2%, yielding an unacceptably high maximum to minimum ratio of 17.1. The presumption that the Chandigarh borrower has "projects" which are 17 times more creditworthy than those of the Nagaland borrower is ridiculous and exposes the structural inequality perpetuated in the Indian economy by banking system captured by the incumbents.

1.4 Access to Finance across Sectors is Grossly Disproportionate

As can be seen from Table 3 below, the industrial sectorgets more than its proportion of the sectoral GDP, while agriculture gets less. Yet, agriculture gets credit more or less in proportion to its GDP share (about 14% each).

The share of credit to the services sector is far below the share of GDP. This is partly because a large part of the services sector, particularly health, education, public administration and defence services is government funded and does not use any bank credit. Also, the larger share of services is in the informal sector, where again credit, though needed, is not available.

Table 3: Sectoral GDP and Credit Availability

Amount in Rs. Billion (2011-12)

Sector	Avail-ability of Credit	Sectoral credit as % of total	Sectoral GDP	Sectoral GDP as % of total	Credit as a percent-age of GDP
1 Agriculture	5,225	14.9%	7,395	14.1%	70.7%
2 Industry	19,675	56.1%	14,425	27.5%	136.4%
3 Services	10,168	29.0%	30,616	58.4%	33.2%
Total	35,068	100.0%	52,436	100.0%	NA
Source: 1. Planning Commission 2. Central Statistics Office (CSO) website 01.03.12					

Within each sector, there is further inequality, as can be seen from Table 4 below. The Micro and Small industry (mainly small) accounts for only 6% of the 46% share of the credit to industry. Within services, trade (wholesale and retail) and financial services account for a lion's share of the credit.

Table 4: Sector-Wise Gross Bank Credit of Scheduled Commercial Banks as on 31st Mar 2012

Sector	Rs. (Billion)	%
I Non-food Credit (1+2+3+4)	**42,897**	**100%**
1 Agriculture & Allied Activities	5,225	12
2 Industry (Micro & Small, Medium and Large)	**19,675**	**46**
2.1 Micro & Small	2,592	6
2.2 Medium	2,056	5
2.3 Large	15,026	35
3 Services	**10,168**	**24**
3.1 Transport Operators	713	2
3.2 Computer Software	154	0
3.3 Tourism, Hotels & Restaurants	313	1
3.4 Shipping	89	0
3.5 Professional Services	639	1
3.6 Trade	2,209	5

3.6.1 W/sale Trade (other than food procurement)	1,280	3
3.6.2 Retail Trade	929	2
3.7 Commercial Real Estate	1,205	3
3.8 Non-Banking Financial Companies	2,218	5
3.9 Other Services	2,628	6
4 Personal Loans	**7,830**	**18**
4.1 Consumer Durables	88	0
4.2 Housing (Including Priority Sector)	4,027	9
4.3 Advances against Fixed Deposits	685	2
4.4 Advances to Indivls against shares, etc.	38	0
4.5 Credit Card Outstanding	204	0
4.6 Education	502	1
4.7 Vehicle Loans	949	2
4.8 Other Personal Loans	1,336	3
5 Priority Sector	**14,122**	**33**
5.1 Agriculture & Allied Activities	5,225	12
5.2 Micro & Small Enterprises	5,191	12
5.2(a) Manufacturing	2,592	6
5.2(b) Services	2,599	6
5.3 Housing	2,554	6
5.4 Micro-Credit	231	1
5.5 Education Loans	483	1
5.6 State-Sponsored Orgs. for SC/ST	19	0
5.7 Weaker Sections	2,563	6
5.8 Export Credit	377	1

Note:

1 Data are provisional and relate to select banks which cover 95 per cent of total non-food credit extended by all scheduled commercial banks.
2. Export credit under priority sector relates to foreign banks only.
3. Micro & small under item 2.1 includes credit to micro & small industries in manufacturing sector.
4. Micro & small enterprises under item 5.2 include credit to micro & small enterprises in manufacturing as well services sector.
5. Micro credit under priority sector includes loans below Rs.

Source: RBI Statistics

1.5 ….And Exclusion across Socio-economic Segments is Severe

There are certain segments of the population that are structurally excluded from participation in formal organised economy. These include women of any community, Scheduled Castes, Scheduled Tribes, Minorities and the Disabled. We will dwell on these population segments one by one.

1.5.1 Only One Woman Gets a Loan for Every Six Men

As can be seen from the Table 4 below, in 2007 only 0.21% of women had loan accounts and 21.2% had savings accounts, compared to 1.2 % of men for loans and 58.6% for deposits. Even when women managed to get bank loans, the amount they got was one-fifth of what the men got.

Table 4: Loan and deposit accounts per 10,000 persons, for women and men				
	Loan Accounts Per 10,000 persons		Deposit Accounts per 10,000 persons	
Year	Women	Men	Women	Men
2007	21	118	2123	5858
	(18)		(36)	
Year	Credit per capita Rs	Deposits per capita Rs		
	Women	Men	Women	Men
2007	1139	5652	5310	17721
	(20)		(30)	
Notes: 1. Figures in brackets indicate percentage share of accounts of women those of men. 2. Loan accounts for women for 2007 include individual loan accounts for women and loan accounts of Self-Help Groups (SHGs)				

Source: http://rbidocs.rbi.org.in/rdocs/Content/PDFs/4PCHBB060810.pdf

1.5.2 Many Muslims Exclude Themselves as Interest Free Banking Does Not Exist

Muslims as a community have suffered more than proportionate financial exclusion[7]– partly due to higher level of poverty in the community and partly as the Shariah prohibits the giving and taking of interest. On the basis of the difference in the CD ratio between Muslims and the general population, Syed Zahid has estimated that Muslims lost out on additional credit worth Rs 11,000 crore in Mar 2005. (For a detailed discussion, see foot note 7) But this understates the point that Muslims don't get loans proportionate to their number.

Table 5: Loans / Deposits to Muslims

	Rupees in Crores		**% to Muslims**
	All SRCs	**Muslims**	
1. Outstanding PS loan amount granted by 31 SCBs	328,755	15,685	4.9
2. Loans disbursed by SIDBI	26,592	124	0.5
3. Production refinance by NABARD	9,168	291	3.2
4. Investment refinance by NABARD	8,485	333	3.9
5. Total outstanding loans by 31 SCBs, SIDBI, NABARD	373,001	16,433	4.4
6. Total individual deposits at 31 SCBs	528,541	39,112	7.4
7. Total deposit loan ratio (7=5/6)	70.6%	42.0%	-28.6

1.6 Exclusion by Size and Status - Small is Squeezed, Informal is Ignored

Inequality of access to credit in agriculture is well-known. While large farmers grabbed a lion's share of the agricultural credit given by banks, marginal farmers, who constitute 70% of the farmers by number, got less than 25% of the total agricultural credit in 2006-07. Share-croppers and oral (unrecorded) tenants got no formal credit till recently.

[7] http://www.aicmeu.org/Financial_Exclusion_of_Indian_Muslims.htm

Category	Share in operational holdings	Share in operated area	Share in number of agri accounts	Share in agri credit disbursed
	2003	2003	2006-07	2006-07
Marginal	69.65	22.6	41.6	24.7
Small	16.28	20.9	27.9	22.9
Large	14.07	56.5	30.5	52.4

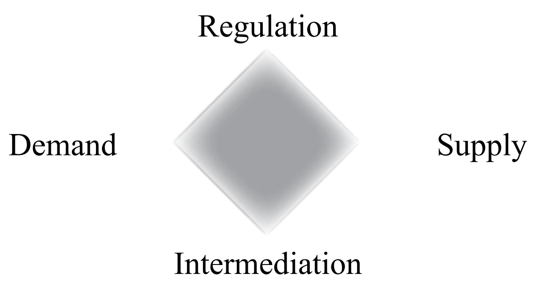
In the non-agricultural informal sector, as per the Economic Census, 2005, there were 51 million enterprises in India. Only 4.2% had credit from formal institutions (Banks, SFCs, SIDBI, etc.). There is a desperate shortage of financing for micro and small enterprises. Less than 3% of net bank credit goes to them. The amounts needed varied from Rs 25,000 to Rs 1 million, which is too small for most lenders.

2 Megatrends

The RBI Discussion Paper attempts to develop an appropriate banking structure for India without saying much about the nature or magnitude of demand in the future. It states on p3:

"The economic structure diversified substantially and the economy has been opening up and getting increasingly integrated with the global economy. As the real economy is dynamic, it is imperative that the banking system is flexible and competitive to cope with multiple objectives and demands made on it by various constituents of the economy. From the financial inclusion perspective too, there is a pressing need to extend the reach of financial services to the excluded segments of the society."

To remedy that, let us identify the fundamental changes or "megatrends" happening in the landscape of banking services and apply these to the four corners of the financial diamond[8], as a first step towards design of the new banking structure:

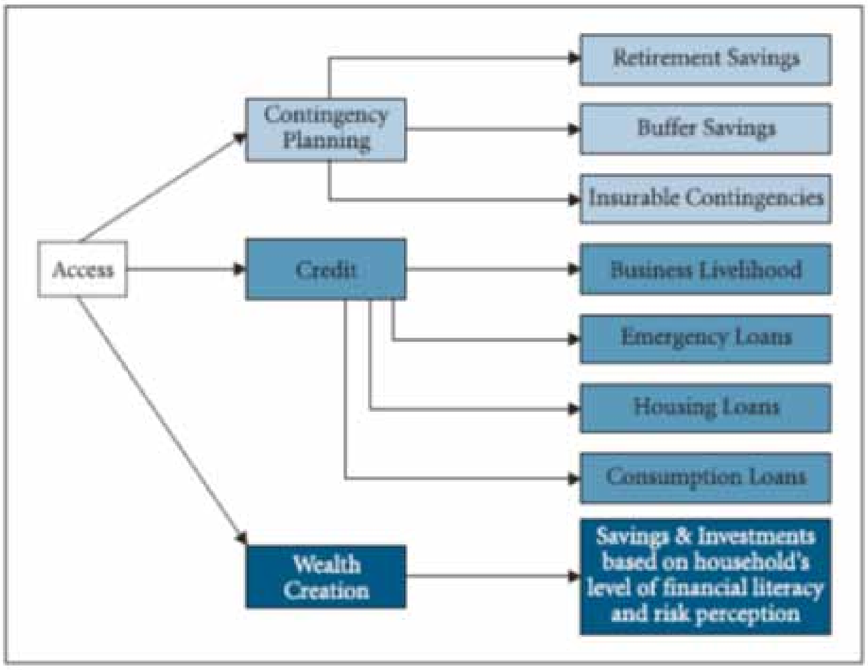


[8] Mahajan, Vijay, 2000, A Framework for Building a Sustainable Rural Finance System (RFS) for India

2.1 Demand is Robust and Growing

The diagram below shows the various financial needs of households, from debt to prosperity, to use Malcolm Darling's immortal phrase. An ideal financial system should not only be inclusive, but meet all these needs with appropriate products at reasonable costs.

Figure 1: Household Access to Financial Services



[9]

Source: IISS, 2007.

2.1.1 Incomes are Going Up

Gross National Income of India went up fifteen fold in the twenty years of liberalization, thereby creating a need for a much larger and more sophisticated and inclusive banking structure. For the first time in India's history, per capita annual income crossed Rs 50,000 or USD 1000 in 2009. Along with this, earnings are increasingly being channeled through the financial sector, rather than through informal cash transactions.

The latest data from the NSS shows a significant reduction in poverty. The number of India's poor declined to 21.9% of the population in 2011-12 from 29.8% in 2009-10 and 37.2% in 2004-05. The estimate, based on a survey of household consumer expenditure, showed rural poverty declined to 25.7% from 41.8% in 2004-05, while in urban areas it fell to 13.7% from 25.7%. The data showed that nearly 20 million people were pulled out of poverty every year from 2004-05 onwards, which resulted in a sharp drop in those below the revised Tendulkar poverty line to 270 million in 2011-12 from 407 million in 2004-05.

2.1.2 The Demand for a Wider Range of Financial Products is Going Up

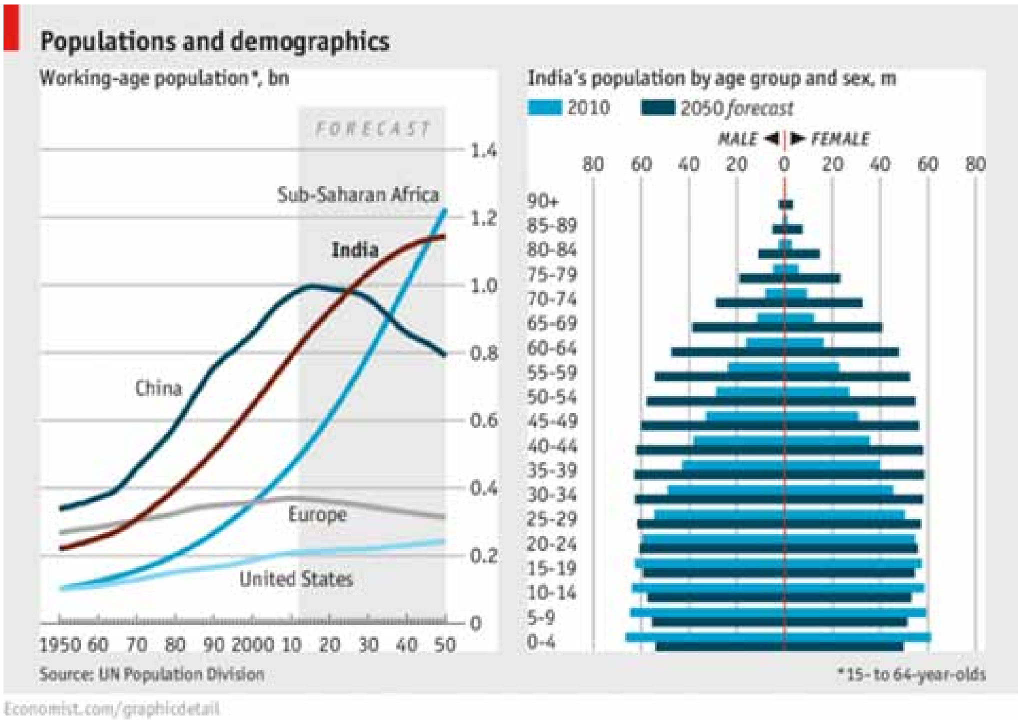
As income goes up, people will save but they will demand savings instruments which protect them from long-term inflation (such as units in mutual funds). They will also look for :

[9] The figure above is cited in the report of the Committee on Financial Sector Reforms, chaired by Dr Raghuram Rajan

- full-life cycle products (hence loans for self education, in case self-employed then for an enterprise, marriage, housing, durables, children's education etc.); and
- protection (hence life, health as well as property insurance); and
- financial advisory services.

2.1.3 The Number of Working Age Indian will Increase till 2030

Today India's median age is 26 years. This has implications for incomes and savings. More people will be in the working age and they would earn and save, and an inclusive banking system can mop this up. In the absence of such a system, the earnings will be frittered away or at least will not be aggregated for larger than household use. Demographically, this is the best time for India to introduce a universal pension system and a separate universal, lifelong health insurance system, since premiums will be about the lowest one can get. In another few years, the number of working age young as a proportion of total will start declining, and the contributions will increase. See chart below.[10]



2.1.4 Urbanization, Rural-Urban Migration and Remittances are Rising

The population in urban agglomerates will be increasing, as also in small towns. Rural population will shrink as a percentage and will see an increase in incomes. Poverty will increasingly become a small town rather than a rural phenomenon. There are places like southern Rajasthan, where studies[11] show that as many as three quarters of the households send out one or two family members.

The number of rural Indians who migrate every year from their village to a distant state or city for work, and stay away for more than three months, is not authoritatively known but is estimated to be between 30 to 50 million. These people need to send money home. Assuming that the amount being sent is Rs 10,000 per annum per migrant, the total amount of transactions will be Rs 30,000 to Rs 50,000 crore in a year.

[10] Source: www.economist.com/blogs/graphicdetail/2013/05/daily-chart-8
[11] Aajeevika Bureau (2005),

The megatrends seem to indicate that demand for financial services will increase, both in volume and scope. Incomes increasing and poverty reducing (and therefore savings becoming positive even among the lower income groups) will lead to increase in volume of demand for financial services. For this to be converted into bank savings, however, a massive financial education campaign will have to be carried out, in addition to coming up with interest rates which are positive, after taking inflation into account. The demand for credit – both for consumption purposes (with usage shifting from food to consumer durables), for long term personal use such as education and housing and for productive purposes in micro-enterprises, etc. will go up.

2.2 Supply is Responsive

In line with the demand megatrends, supply will have to increase but multiple institutions and distribution strategies will be needed. In general, whether it is for savings, credit or money transfers, the pyramid of demand will be such that it would be inappropriate for any single institution to try to address all segments of the demand. These strategies should begin with the bank branch network, but then should embrace wider networks such as that of the insurance companies, financial product distribution companies which market mutual funds and securities and of course, microfinance institutions and business correspondent outlets.

The national payment system would have to recognize how the profile of participants is changing and enable low transaction cost payments for small payments. Once a nationwide micro-payments system which enables small transactions to be done reliably at a low cost, is in place, then it would become possible to market low ticket entry level products for life insurance, health insurance and pensions. Today, these do not work because the cost of collection is high.

The good news is that supply has been responsive. A first step towards this has been made by the National Payments Corporation of India (NPCI) which has set up the interbank mobile payments switch (IMPS). The "know your customer" (KYC) regulations should be harmonized across regulators and made inclusion friendly, such as by enabling Unique Identification (UID) based KYC. The RBI has, all along, ensured that the transaction architecture for banks permits inter-operability at little or no cost to the customer. The lower income customers should also have the same rights on the inter-operability of touch points that high end bank customers have, including transacting through multiple touch points without any charges for a certain number of transactions. Thus, as has been done for ATMs, the RBI should consider making business correspondent outlets (BCOs) capable of inter-operability across multiple banks. Finally, it is necessary to extend the benefit of inflation beating investments – in equities. For this, mutual funds are the right device and the Indian masses will have to be introduced to them, while ensuring minimal risk to their savings. The banking structure should be able to play a role in this.

2.2.1 Mobile Phones and the Internet are Becoming Pervasive

Mobile phones, now exceeding 800 million, are more numerous than bank accounts and more importantly, thanks to the ubiquitous GPRS signal, they can operate even in remote areas. Thus, all that the RBI has to do is to permit linking mobile phone numbers to bank accounts, the same way UID Aadhaar card numbers are being linked to bank accounts. This will then create a near universal financial inclusion system. Thanks to the spread of internet, most Indian banks are fully using a core banking platform and integrating internet and mobile technologies as well as biometrics and credit information. The real time gross settlement (RTGS) has made "inter-bank reconciliation" an obsolete phrase. This will be further enhanced and data analytics would lead to customer profiling very quickly. Thus defaulters will find it hard to get anything from the system. The rate at which MFIs embraced the credit bureau system in India, going from zero use in 2009 to over 70 million borrower record being uploaded in bureau computers and nearly 100% credit check being done by MFIs before disbursing a loan, is an amazing example of how technology can change behavior.

2.2.2 Transaction Costs are Coming Down

Due to a combination of technological advances and increasing volumes, the latter partly due to inclusion, transaction costs are coming down, not only within the same technology, but also across technological leapfrogs. This is illustrated in the diagram below, which shows that a small financial transaction costs 50 times more if done in a branch as compared to when done on a mobile phone.

Source: http://ronnie05.wordpress.com/tag/mobile-financial-services/

2.2.3 Government Payments are Increasingly being Routed through Banks

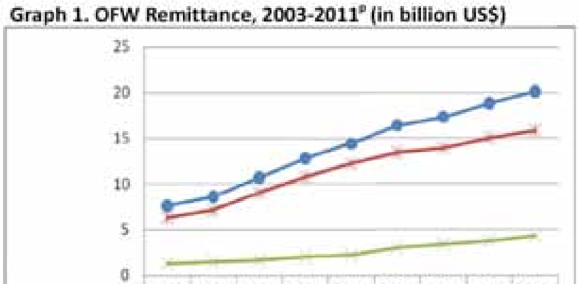
The outlay for NREGA alone is Rs 40,000 crore. In addition, payments under the various components of the National Social Assistance Program (NSAP) and newer schemes like the pension co-contribution and other direct transfers, will add another Rs 100 billion. The recipients are likely to be about 100 million and will receive at least six payments in a year, in other words, about 600 million payment transactions, with an average payment size of Rs 1000. There is no way this can be carried out in the old style way of sending out large chests of cash to rural payment centres with people lining up for hours in front of a cubby hole with a grill.

The Government of India (GoI) must be credited with having seen this and enforcing the condition that NREGA payments must be made into bank (or post office) accounts. But this solved only half the problem. The other half was solved by setting up the nationwide network of over 220,000 BCOs connected to the core banking system with on-line mobile connectivity, and authentication increasingly based on the Aadhaar card.

2.2.4 Financial Services are Globalizing

Due to the combination of enabling technologies and regulatory opening up on the one hand, and maximum return seeking behavior of capital on the other, financial services are globalizing. This is happening faster than the spread of foreign direct investments. India, the world's largest recipient of migrant remittances, should consider that these can sometimes be the main source for the globalizing of financial services in a developing economy, as the example of Philippines shows below.

Graph 1. OFW Remittance, 2003-2011[p] (in billion US$)



	2003	2004	2005	2006	2007	2008	2009	2010	2011p
TOTAL	7.6	8.6	10.7	12.8	14.4	16.4	17.3	18.8	20.1
Landbased	6.3	7.1	9	10.8	12.2	13.4	13.9	15	15.8
Seabased	1.3	1.5	1.7	2	2.2	3	3.4	3.8	4.3

[p] - preliminary
Source: Bangko Sentral ng Pilipinas

2.3 Intermediation is Becoming Accepted and Acceptable

The term intermediation in India invokes negative responses as the middleman is seen as an additional cost with no value addition. This is an incorrect perception, but it can be ameliorated by cutting the intermediation costs on one hand, and enhancing the value added by the intermediary on the other. Interestingly, in India, the intermediation architecture used by banks and insurance companies is almost opposite. Banks dislike intermediaries and tend to deal with customers directly through branches (with a miniscule proportion sourced through Direct Selling Agents for housing and car loans). On the other hand, insurance companies do almost all their business through individual agents (with a miniscule proportion done through corporate agents and banks).

It is time we developed the concept of a multi-product financial services distributor, with a corporate agent and franchised individual sub-agents, who sell the whole range of products- from term deposits to fixed income securities to mutual funds to equities to insurance and pension products of all kinds. Today's regulatory framework does not permit such distributional unification. For example, an insurance brokerage cannot engage in any other business, just as a securities broker cannot do any other business. Only by providing composite services from the same outlet can the transaction costs of manpower, technology and outlet rental be reduced to a reasonable level. Unless this is done, financial services will remain the preserve of the rich.

2.4 Regulation is Still Not Focused on Inclusion…as the RBI Paper Shows

To look at a futuristic regulatory framework for inclusion, we need to go beyond today's regulatory mindset, reflected in the RBI Discussion Paper, which assumes that financial inclusion is just one item in the ever-increasing list of responsibilities of the banking system. In contrast to the RBI Discussion Paper, inclusion was given the highest priority as a goal, the same status as growth and stability, in the report of the Raghuram Rajan Committee in 2008.[12]

"The underlying theme behind all our proposals is the need to enhance inclusion, growth, and stability by allowing players more freedom, even while strengthening the financial and regulatory infrastructure." (page 1, Chapter 1)

We hope, now that Prof. Raghuram Rajan is the Governor of the RBI , he will give necessary importance to inclusion in the thinking about banking regulation. This goes well beyond licensing

[12] Raghuram Rajan, Chairman (2008). Report of the Committee on Financial Sector Reforms, Planning Commission, Government of India, New Delhi.

policies and priority sector norms, and must include the payments system as well as the provision of other financial services such as insurance and pensions, which fall within the purview of other regulators.

As a first step, the RBI's Annual Report should contain a separate chapter on financial inclusion, along with a detailed statistical annexure. As a second step, to guide its policy making, the RBI could consider instituting an annual or biennial survey on financial inclusion and establish an Index of Financial Literacy, Inclusion and Transactions (IND-FLINT). This would cover the entire gamut of issues related to inclusion -from individual capability to access to usage, and by giving up to date data, it would enable regulation to be pro-active. A detailed concept paper on this was submitted by the author to the RBI in 2009.[13]

3 Banking Structure in Some Other Countries

Internationally, the demand for financial inclusion has been heard. The Alliance for Financial inclusion (AFI), was founded in 2008 as a global network of financial policymakers from developing and emerging countries working together to increase access to appropriate financial services for the poor. In its Pittsburgh declaration in 2009, the G20 established a working group on financial inclusion.[14]

In this section we look at the banking architecture in the United States, Germany, South Africa and Indonesia from the point of view of financial inclusion. Starting with data from the G-20 sponsored Basic Set of Financial Inclusion Indicators[15], we compare the four foreign countries in this section with India and try to understand if their banking structure has helped inclusion and if so, how.

3.1 United States – the Land of Small Banks

In 2011, 50.4% of adults in the United States saved in a formal financial institution, as against 11.6% in India. This data is from the G-20 sponsored annual survey of financial access across all countries of the world.

The USA has five categories of savings institutions – large banks, mid-size banks, community banks, savings and loan associations and credit unions.

Particulars	Number	Assets USD billion
All FDIC-supervised institutions	6,048	13,362
Large banks – national	45 out of 537 below	About 9,000
All Commercial Banks - Assets more than $1B - National 3/31/2013	537	12,190
All Commercial Banks - Assets $100M to $1B - National 3/31/2013	3,596	1,060
Commercial Banks - Assets less than $100M – National 3/31/2013	1.915	112
Federal savings associations	637	
All OCC-supervised institutions, total assets	$9.6 trillion	
Total U.S. commercial banking assets All OCC-supervised institutions		

Source: FDIC, USA Statistics on Depository Institutions and Annual Report, 2012, Office of the Comptroller of Currency (OCC), USA

[13] Vijay Mahajan and Suman Laskar, 2008. Measuring Financial Access – Some Lessons for India. Mimeo, BASIX, Hyderabad, India.
[14] G-20 Leaders' Statement at Pittsburgh Summit, 2009 http://www.pittsburghsummit.gov/mediacenter/129639.htm
[15] http://databank.worldbank.org/data/views/variableselection/selectvariables.aspx?source=g20-basic-set-of-financial-inclusion-indicators

As per Independent Community Bankers of America, in 2011,

"There are almost 7,000 community banks[16], including commercial banks, thrifts, stock and mutual savings institutions, with more than 50,000 locations throughout the United States. Assets may range from less than $10 million to $10 billion or more. Community banks constitute 96.6 percent of all banks in the US. Of all U.S. banks, more than 90 percent have assets under $1 billion and 31.2 percent have assets under $100 million.

Community banks are the primary source of lending for small businesses and farms. Even though they compose just 10 percent of the banking industry by assets, community banks with less than $1B in assets made 37.5 percent of outstanding bank loans to small businesses. Community banks with less than $10B in assets made 57.9 percent of outstanding bank loans to small businesses.

Community banks' boards of directors are made up of local citizens who want to advance the interests of the towns where they live and where their banks do business. Most community bank loans benefit the neighborhoods where depositors live and work. Community banks offer a wide range of banking services and products designed to meet the needs of consumers and business including internet banking and ATMs, credit and debit cards, mortgage- and consumer-loan products, checking, saving and investment products and rates, and small-business and agricultural lending."[17]

In addition to having a large number of local community banks, the US banking system is characterized by the Community Reinvestment Act (CRA), 1977, a federal law designed to encourage commercial banks and savings associations to meet the needs of borrowers in all segments of their communities. The CRA was meant to reduce discriminatory credit practices against low-income neighborhoods, a practice known as redlining. According to a United States Department of the Treasury study in 2001, of lending trends in 305 U.S. cities between 1993 and 1998,

"$467 billion in mortgage credit flowed from CRA-covered lenders to low- and medium-income borrowers and areas. In that period, the total number of loans to poorer Americans by CRA-eligible institutions rose by 39% while loans to wealthier individuals by CRA-covered institutions rose by 17%. The share of total US lending to low and medium income borrowers rose from 25% in 1993 to 28% in 1998 as a consequence."[18]

The CRA has been controversial since having been enacted and even academics seem to differ on its effectiveness in enhancing access to credit. In a 2005 paper for the New York University Law Review, Michael S. Barr, professor at the University of Michigan Law School, presents evidence to demonstrate that the CRA had overcome market failures to increase access to credit for low-income, moderate-income, and minority borrowers at relatively low cost. He contends that the CRA is justified, has resulted in progress, and should be continued.[19] … Speaking to the Congressional Committee on Financial Services in Feb 2008, New York University economics professor Larry White stated that

[16] There were as many as 17,000 in the 1960s. The author is thankful to Mary Houghton, founder President of the Shorebank, Chicago for explaining the US Banking Structure.

[17] Community Banking Facts, Independent Community Bankers of America, 2011

[18] Litan, Robert E.; Nicolas P. Retsinas, Eric S. Belsky, Susan White Haag (2000-04-19). "The Community Reinvestment Act After Financial Modernization: A Baseline Report" (PDF). U.S. Department of the Treasury. pp. pp 16–17. Retrieved 2008-10-12.

[19] Barr, Michael S. (May 2005). "Credit Where it Counts: The Community Reinvestment Act and Its Critics". New York University Law Review 80: 513. Cited in the Wikipedia entry on CRA

regulator efforts to "lean on" banks in vague and subjective ways to make loans is an "inappropriate instrument for achieving those goals."[20]

3.2 Germany, where Savings Banks and Cooperative Banks Thrive

In 2011, 98.1% of German adults had a bank account in a formal financial institution. Germany has a three-pillar banking sector comprising savings banks, co-operative banks and private banks, which are a handful of big institutions, such as Deutsche Bank, Commerzbank and HypoVereinsbank (HVB)[21] . There are 423 savings (Sparksen) banks and 1,116 co-operative (Raiffeisen) banks, which cater to a bulk of the consumers. Each of these sectors already has a system of joint and several liability, which means that an individual member bank is supported by the others in case of liquidity pressures.

The savings banks and co-operative banks provide about two-thirds of all lending to Mittelstand (mid-sized) companies and 43% of lending to all companies and households. The Landesbanken, which act as wholesale banks for the savings banks, and DZ Bank and WGZ Bank, which do the same for the co-operative banks, step in to provide more sophisticated services, such as hedging and offshore financing.

3.3 South Africa has Moved Determinedly against Black Financial Exclusion

In 2011, 53.6% of South African adults had a bank account in a formal financial institution. South Africa is characterized by a high degree of income inequality just as India - the top deciles accounts for 58 percent of the country's income while the bottom deciles accounts for 0.5 percent. Income Gin coefficient remains around 0.70. Incidence of poverty in rural areas is more than twice of that in the urban areas. The proportion of the population living below US$1.25 (PPP) per day was 13.8% in 2011.

Till a decade ago, South Africa had a low level of financial inclusion. The proportion of the population with access to a bank account has increased significantly in recent years—from 33 percent in 2005 to 45 percent in 2007 for the lower income brackets. This was changed with the adoption of Financial Services Charter (FSC) in 2004, coupled with a directive that all government welfare payments to households be done through their bank accounts.

Low balance Mzansi transactional accounts were encouraged to be opened. The FSC's objectives include providing effective access to adequate financial services for all, improving racial representation in ownership, and fostering corporate governance that is representative of the community. The Mzansi Account is issued by the several South African banks. By August 2006, 3.3 million Mzansi Accounts had been opened across the five issuing banks.

The banking structure consists of large commercial banks and numerous smaller mutual savings banks. One remarkable thing is that a major telecom company, MTN has set up a bank called MTN Bank, which provides both retail savings and credit services. The credit system is also populated by non-bank finance companies and regulated moneylenders. A separate regulator, the National Credit Regulator (NCR), which operates under the National Credit Act, regulates the granting of consumer credit by all credit providers.

[20] Jump up - Prepared Statement of Lawrence J. White, Professor of Economics, New York University – Stern School of Business, before the Committee on Financial Services, U.S. House of Representatives, February 13, 2008. Cited in the Wikipedia entry on CRA.

[21] The Economist, Nov 10, 2012

3.4 Indonesia – which Fixed its Banking Architecture Two Decades Ago

In 2011, 19.6% of Indonesian adults had a bank account in a formal financial institution. Indonesia has four state owned banks, of which Bank Rakyat Indonesia (BRI) is the largest. It has an extensive rural division called the Unit Desa. In addition, there were 79 private national banks in Indonesia in 2011, mostly urban commercial ones. These were supplemented with 1,837 rural credit banks, both public and private, mostly serving a local region smaller than a province. This number was achieved after a major consolidation exercise among more than 5000 BPR (private rural banks) that had come up in Indonesia since a 1993 Regulation.

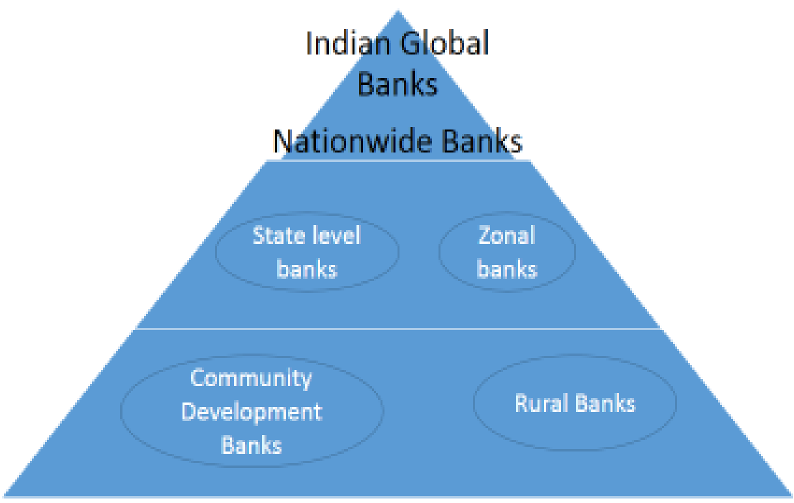
Deposit insurance is a key element in financial system stability. The Indonesian Deposit Insurance Corporation (IDIC) guarantees bank customer deposits and resolves cases of problem banks. An interesting part of Indonesia's banking structure is the prevalence of Islamic banks –a national state-owned one, 14 regional ones owned by provincial governments, 1 private commercial one and 157 rural Islamic banks. These came up after a 2005 Regulation was enacted to license Sharia banks. While it seems appropriate to do this in a Muslim majority country like Indonesia, one should take into account that the population of India's Muslims is of the same order of magnitude as Indonesia's total population, and yet India has no provision for Sharia banking, despite persistent demands for it from the Muslim community.

3.5 Lessons from other countries

3.5.1 Different Types of Bank are Needed to Meet Different Needs

This lesson is the most obvious one – from the US, from Germany, from Indonesia and from South Africa. The diagram below from the Bank of Indonesia captures this point very well. An additional point being made is on the y-axis – that the minimum level of capital needed is different by orders of magnitude. An international bank needs 500 times more capital in Indonesia than a rural bank. By that token, can we think of hundreds of rural banks with just Rs 1 crore capital in India? Even our local area banks, the closest thing to private rural banks, are required to have an entry level capital of Rs 25 crore.

Given below is a graphic representation of the banking structure we think will address inclusion in India.



3.5.2 Inclusive Banking Must Provide Access to a Full-range of Financial Services

The Indian financial sector policy makers have been obsessed with credit. This is understandable, as could be seen from the history of the Indian financial system traced above. What the policy makers have failed to learn, however, is that rural households, including poor households, need a whole range of financial services, which includes, among others:

- Bank accounts and transaction outlets (no-frills accounts with large number of business correspondent or BC type outlets)
- Payments (from government, like NREGA and to utilities, like Electricity bills)
- Remittances (from family members who have migrated to cities for work)
- Savings (to enable small amounts to be saved)
- Credit (both for consumption and for working capital and asset creation)
- Insurance (including life, health, crop, livestock and assets)
- Pensions (can be seen as very long-term savings, with life insurance)
- Mutual Funds (as inflation protected savings)

The implication of the last three is that -banks must learn to retail products other than those that they manufacture. This would improve their branch profits, so there is no reason, except resistance to change, why they should not embrace this opportunity. Another implication is inter-regulator collaboration for inclusion. This is so far uncommon, due to turf and culture issues, but it needs to be enhanced if inclusion has to be promoted.

3.5.3 Inclusive Banking Must be Both High-tech and High-touch

To give credit where it is due, it has been recognised by the policy makers that financial inclusion in India will have to be high tech, using information technology, mobile telephony and biometric identification. This has been institutionalised in the establishment of the Unique Identification (UID) Authority of India, under the leadership of Nandan Nilekani, who has been quick to recognise that enabling financial transactions will be a major attraction for people to get an UID, or its parallel the National population Register (NPR) number.

Thus, while the UID/NPR will only enable identification of a person, the devices to do so are being designed in such a way that they would serve two other steps necessary to complete any financial transaction – after authentication of the customer, a balance enquiry and authorization to withdraw, and finally an acknowledgement of receipt of cash to ensure non-repudiation. Though these are simple steps, a majority of users will require assistance in completing these actions, just as telephone calls from STD PCOs were often assisted by the PCO operators. Thus, in addition to being high tech, the financial inclusion system will have to be high touch.

Customers should be served near their homes or work places, to avoid spending on travel and losing wages. This can be achieved by using MFI style mobile agents or through fixed location BCOs. They provide user-friendly service with a smile. Competition among service providers will create product innovation and customers will also be more aware about different products and financial systems. Banks can keep on serving the medium and high level of customers for bigger transactions, while MFIs and BCOs can reach smaller ones.

4 Reconfiguring India's Banking Structure to Enhance Inclusion

Opening more large banks with a national footprint and a universal banking mandate, as the RBI Discussion Paper also agrees, will not help the cause of enhancing inclusion. Instead, like in several other countries with a good track record of financial inclusion, setting up a range of different banks for different purposes is the more desirable solution.

4.1 We Must Take a Multi-tiered Approach

Going by the three criteria by which we judge the success of a banking system, those of contribution to inclusion, growth and stability, we suggest that the RBI may look at six different levels of banking, namely the Community, Region, State, Zone and the Country as a whole and one for International banking. The table below makes assumptions about GDP growth, thus estimating the credit demand and its profile before recommending different banking institutions for each level. The capital adequacy requirements cum the size.

Details of assumptions and parameter	Units	Rs cr	USD bn
GDP in 2013 at 2004-05 prices		11,100,000	1,850
GDP in 2019 assuming 6% pa real growth		15,745,562	2,624
No of states 2019	30		
No of districts 2019	600		
Excluded districts 2013 - 50% still remain	500		
Excluded districts 2019	300		
GDP share of excluded districts 2013	20%	2,220,000	370
GDP share of excluded districts 2019	20%	3,149,112	525
GDP of excluded districts 2013		4,440	0.74
GDP of excluded districts 2019		10,497	1.75
Credit required per excluded district in 2019 (100% of GDP of district)		10,497	1.75
Of this, market share of regional banks	60%		
No of banks sharing the market – at least	4		
Credit outstanding per Small Finance Bank per excluded district		1,575	0.26
Capital required to underpin this credit	15%	236	0.04

Using the assumptions in the table above, we can see that India needs six types of banks:

- Community Development Banks must be accessible institutions, numerous, at least four per district so that they compete. Their deposits must be insured, with differential pricing based on rating. Most of the current urban cooperative banks engaged in this type of banking, as do many of the small NBFC MFIs, will also qualify. The argument that these banks will be too small to afford technology, professional human resources and mobilise capital, can all be countered by adopting a hybrid structure, where they share key functions, much like Scandinavian banks share IT.

- Small Finance Banks was a solution that was clearly articulated in the Raghuram Rajan Committee Report, as cited below (p.7):

- "Proposal 3: Allow more entry to private well-governed deposit-taking small finance banks offsetting their higher risk from being geographically focused by requiring higher capital adequacy norms, a strict prohibition on related party transactions, and lower allowable concentration norms (loans as a share of capital that can be made to one party)... The small finance bank proposed above emulates the Local Area Bank initiative by the RBI that was prematurely terminated, though the details of the Committee's proposal differs somewhat. The intent is to bring local knowledge to bear on the products that are needed locally, and to have the locus of decision making close to the banker who is in touch with the client, so that decisions can be taken immediately. It would also offer an entry point into the banking system, which some entities can use to eventually grow into large banks."

- Indian states are large and many are larger than the smaller of the top 30 countries. State-level banks are thus both desirable and viable. The candidates for state-level banks are the 64 Regional Rural Banks crated from merging 196 RRBs belonging to one sponsor bank in each state. The next step would be to merge all RRBs across one state to create a state-level bank, already owned 15% by the State Government and where they cannot be merged, leave them to be Regional Banks, as defined above. But in all cases, these banks should be brought out of the Regional Rural Banks Act, 1976 and brought under the Banking Regulation Act, 1949. The 371 odd licensed District Central Cooperative Banks and 27 State Cooperative Banks, can also be merged into one State level bank per state. Many of them are effectively run under a unified management and share IT systems. The thousands of Primary Agricultural Credit Societies (PACS) can also be integrated in the banks, while retaining their local character.

- Zonal Banks are needed to get out of the co-variant risk of state politics and as of neighbouring agro-climatic zones. Some of the smaller private banks and larger RRBs (after merger among themselves) can become these. Some of the larger MFIs can also become Zonal Banks.

- Nation-wide banks – we need fewer but bigger banks. The 27 public sector banks can be merged into about 10 and should be permitted to swap branches to develop geographical or sectoral comparative advantage.

- Global banks – India perhaps needs two or three of these and they can be created by merging the overseas branches of those Indian banks which have just a few international branches into those which have a substantial number of overseas branches – State Bank of India and Bank of Baroda, for example.

Level of banks	Covering	Main focus	Entry level capital	Capital by 2019, so, loans o/s	By 2019 loans mainly in range of
Community Development Banks (1800-2000) – need not be stand alone; federal	One district at a time; additional districts possible with more capital	Poor but economically active households, small farmers; self-employed	INR 6 cr (USD 1 mn)	INR 24 crore (USD 4 mn); loans o/s INR 150 cr	INR 1,500 to INR 150,000
Level of banks	Covering	Main focus	Entry level capital	Capital by 2019, so, loans o/s	By 2019 loans mainly in range of
Small Finance Banks (200-300)	One or more states, eventually even nationwide	Households, agriculture farms and micro and small enterprises	INR 24 cr (USD 4 mn)	INR 240 cr (USD 40 mn); loans o/s	INR 10cr to INR 100 cr
INR 1,500 cr	INR 150,000 to INR 15 Cr	Above plus infrastructure, large enterprises and exports	INR600 cr (USD 100 million)	INR 2400 cr (USD 400 mn); loans o/s INR 24000 cr	INR 10crore to INR 240 cr
State-level Banks (30-50), which could also be the "holding co" for regional banks	One full state	Above plus housing, medium enterprises	INR 120 cr (USD 20 million)	INR 1000 cr (USD 163 mn); loans o/s	INR 100 crore to INR 2400 cr
INR 15,000 cr	INR 10 cr to INR 100 cr	Full range, but loans mainly above INR 50 cr	INR 24000 cr (USD 4 billion)	INR 120000 cr (USD 20bn); loans o/s INR 1,200,000 cr	INR 100 crore to INR 12000 cr
Zonal Banks (20-30), which could also be the "holding co" for regional/ state level banks	Two to four large states or four to eight smaller contiguous states.	Above plus infrastructure, large enterprises and exports	INR 600 cr (USD 100 million)	INR 2,400 cr (USD 400 mn); loans o/s	
INR 24,000 cr	INR 10 crore to INR 240 cr				
Nation-wide Banks (8-10)	All India	Full range, but loans mainly above INR 50 cr	INR 6,000 cr (USD 1 billion)	INR 24,000 cr (USD 4 bn); loans o/s	
INR 240,000 cr	INR 100 crore to INR 2,400 cr				
Indian Global Banks (2 or 3)	All over the world, as needed	Full range, but loans mainly above INR 50 cr	INR 24,000 cr (USD 4 billion)	INR 120,000 cr (USD 20bn); loans o/s	
INR 1,200,000 cr	INR 100 crore to INR 12,000 cr				

4.2 All Banks Must Have Sustainable Business Models

We are of the firm belief that in the long-run, inclusion must pay for itself and indeed, improve the profitability of an inclusive bank. There is some cost disadvantage in the initial years in pursuing inclusion while the average balances are small. To offset this, the RBI should not just deregulate the interest rates I but should also legitimize pricing in the range of 18% (base rate plus 1000 basis points) for small loans (Rs 100,000 to 1 million), and 24% (base rate plus 1600 basis points) for micro loans (below Rs 100,000), enable banks to cover their costs and make adequate returns so as to attract capital continuously as they grow. On the other hand, high interest rates on SLR deposits should be discouraged so that not too much money is parked into those "safe" investments.

The pricing of both loans and investments should be such that it discourages banks to park wholesale funds rather than lend to retail customers locally. This is easier said than done since returns on investments are largely driven by government borrowings. But assuming the government will be responsible and move towards reducing the fiscal deficit, this should be possible.

In addition, the RBI should incentivize inclusion by reducing statutory liquidity reserve (SLR) requirements which are lower for more inclusive banks. How would that be measured? One simple way is to measure the average deposit and average loan size. The smaller these are, the more inclusive the bank is likely to be. Thus, a community development bank which has an average loan size of Rs 10,000 would have an SLR of only one fifth as much as that of a bank whose average loan size is Rs 10 crore. Thus if the present level of SLR at 25% prevail, then a Regional Bank should have an SLR requirement of only 5% of demand and time liabilities.

4.3 Safeguards are Essential along with Inclusion

While suggesting an alternative banking structure, we are also specifying the necessary safeguards in licensing and supervising these entities. The safeguards are best summarized in excerpt below from the Raghuram Rajan Committee report (p.7):

"A large number of commentators believe, based on historical evidence, that small banks will be unviable in India. They question the honesty of small promoters, as well as the profitability of these banks given high fixed costs. This Committee recognizes that small banks have not distinguished themselves in India in the past, often because of poor governance structures, excessive government and political support as well as interference, and an unwillingness/inability of the regulator to undertake prompt corrective action.

These are not the banks the Committee wants, and the Committee would call for substantial care in who is licensed, as well as greater regulatory oversight. There is, however, no necessary link between size and honesty, as the recent experience with large banks suggests. Indeed, the larger number of potential applicants for small banks suggests the regulator can be far more selective in applying 'fit and proper' criteria. Moreover, technological solutions can bring down the costs of small banks substantially, even while increasing their transparency.

Finally, the failure of even a few small banks will not have systemic consequences, unlike the failure of a single large bank. In sum, the Committee believes there has been sufficient change in the environment to warrant experimentation with licensing small banks."

The RBI traditionally filters out banking applicants by specifying a high capital requirement at entry level. This is highly exclusionary. Instead, the RBI could specify a high capital adequacy which can be reduced as these banks become mature. In Indonesia, for example, the capital adequacy was specified at 100%, 80%, 60%, 40% and 20% for the first five years for BPRs - private rural banks in 1995. Thus if an institution failed in early years, it would have lost mainly the shareholders' capital as it matched the risk assets. No depositors would have lost nor too many lenders.

The community, state and zonal level banks would have to take compulsory deposit insurance and pay a higher premium for it. Another precaution would be that no loan would be more than one percent of the capital of a bank. This means a district level bank in 2012 will not be able to lend more than Rs 500,000 to any borrower or a group. Loans to financially excluded segments should be guaranteed by the government, with a first loss default borne by banks, so as not to create a perverse incentive. Thus, if banks have a loan loss of 1.0% on normal loans, perhaps the first 1.5% of loss on loans to financial excluded segments should be borne by banks and the rest guaranteed by the government. The same principle should be applied to the proposed new Women's Bank.

4.4 Specialised finance institutions are needed to supplement banks

Experience has shown us that banks are nowhere near the sole or best providers of all types of services. Even in the other specialized segments of credit, like housing finance, truck financing and SME financing, we find that there are niche players providing niche services. So, in addition to banks, we need specialised institutions that focus on one or more of these niches while embedded in general banking, so that viability is assured. The regulatory framework should provide scope for such players to operate, with three types of niches:

- Sectoral – agriculture, SME, housing, infrastructure, education and vocational training. One would have to rethink the role of financial institutions like NABARD, SIDBI, IFCI, NHB and the IIFCL and quasi financial ones like the National Small Industries Corporation (NSIC), the National Skill Development Corporation, and so on, all of which are mandated to serve sectors important for inclusive growth.

- Spatial – financially excluded regions – mainly the Central, Eastern and Northeastern Regions in the RBI classification; special regions such as Hilly and Mountain States; Urban low income regions, etc. The role that the erstwhile chain of State Finance Corporations used to play needs to be filled by some institution.

  One important element of reducing spatial exclusion would be to encourage banks to use non-branch outlets such as the 220,000 BCOs and the nearly 150,000 Common Service Centres (CSCs) which is a nationwide chain of internet connected kiosks already providing government to citizen services. These outlets would enable micro-payments at a very small cost (as low as One Rupee) and UID authenticated, core-bank system approved withdrawals at a cost of less than 1%. With that, all other financial services – small savings, micro-insurance, micro-pensions, mutual funds, remittances, etc will become possible for low-ticket users. These would be a precursor for the next cost-cutting revolution – the ushering of m-money and the elimination of currency.

- Segmental – for financially excluded population segments such as women (a bank has already been announced for them!), Muslims (Islamic banks should be permitted, so as to ensure that those who wish to operate on interest-free but profit-sharing basis can do so legitimately), Dalits, Tribals, and the Disabled. Already, both the Centre and most states have a Development Finance Corporation for each of these socio-economic segments. Those need to be revived and run on professional lines.

4.5 A Call for Action

Let us all in the financial sector take a pledge to usher Universal Financial Inclusion for all Indians by 2019. There are scores of well-thought policy recommendations waiting to be implemented. There are hundreds of pilot projects, full of lessons for technology, methodology and regulation. There are thousands of professionals, many willing to be entrepreneurs in the new inclusive financial sector. Most importantly, we have a world class economist leading our lead financial regulator. In other words, this is the golden moment – let us seize it and redesign India's financial system for inclusion. This includes:

1. A nationwide campaign for financial literacy and ongoing financial education
2. Enactment of the new generation of financial laws as recommended by the Financial Sector Legislation Reforms Committee headed by Justice Srikrishna.
3. The banking system with the revised structure proposed above and a much wider network than branches – comprising BCOs, ATMS an POS devices and eventually also offering mobile money transactions
4. A re-engineered Deposit Insurance Corporation
5. A new resolution mechanism for banks whose capital is deeply eroded
6. The payments system, including internet based and mobile based
7. Credit Bureaus with mandatory coverage of individuals, farms and firms
8. Bankruptcy protection laws and/or mechanisms for debt restructuring
9. Non-Bank Finance Companies or specialised sectoral/segmental credit providers for niche financing
10. Insurance providers and regulator
11. Pensions provider and regulator
12. Mutual Funds and securities regulator
13. Equity for small and medium enterprises including an exchange
14. Warehouse receipts providers and their regulator – for farmers
15. Commodity derivatives and their regulator – for processors
16. A Financial Sector Ombudsman with the power to protect consumers
17. An annual survey to measure the Index of Financial Literacy, Inclusion and Transactions (INDFLINT).
18. An annual report by the RBI to the Parliament on Financial Inclusion
19. A robust financial media to report and analyse everything significant
20. An active network of multiple research and academic institutions and scholars

If all these fall in place, and for most of them, beginnings have already been made, there is no doubt that India would not only be a leader in financial inclusion but would also unleash the potential for sustainable, inclusive growth.

To conclude, while we appreciate the RBI's openness at putting out a Discussion Paper on the proposed Banking Structure of India, its proposals are quite inadequate from the point of view enhancing financial inclusion. Merely licensing a few more banks or even creating a new category of small finance banks will not be enough. As the list above shows, we need to work on the entire financial eco-system to ensure meaningful universal financial inclusion.

5 Annexure - History of Financial Inclusion Efforts in India

5.1 Era of Moneylenders and Early Attempts at Alternatives

Access to credit has for ever been a major constraint for farmers in India, even during the British colonial days. Traditionally, the poorer peasants depended on large farmers, merchants and middlemen, pawn brokers and moneylenders for meeting their credit needs. The relationship between money lenders and the peasant was usually that of patron-client, meaning that the transaction affected their social and economic relations more widely. Unable to pay high interest rates, the peasants often ended up forfeiting their land, eventually becoming bonded labourers to moneylenders or landlords or becoming homeless wanderers. Abusive practices were quite common and there seemed to be no escape from this situation.

Many attempts were made to break dependence on Money Lenders through provision of institutional credit. In the famine years of the 1860s, after peasants rebelled in some areas, the British colonial administration started giving "tacavi" loans out of the land revenue, in years of drought. These were not widespread and became prone to patronage and corruption of lower revenue officials. In the 1890s, some British administrators tried to experiment with the Raiffeisen, Germany style savings and credit cooperatives and the colonial government passed the Indian Cooperatives Act in 1904. The cooperatives were, however, largely run by rich farmers and were embroiled in local power politics. The poor could receive loans only if they worked for lower wages for the rural elite. In addition, unlike the German cooperative system, the Indian cooperatives were not based on savings and were merely seen as a channel for disbursing government loans. Thus, the people had little stake in the health of the cooperatives and slowly the system become dysfunctional.

5.2 Post-independence Efforts (1947-68)

The need to produce enough food to feed the growing population was a priority for the newly independent India. In the initial two decades 1947-67, cooperatives became less and less important as an answer to provision of credit for agriculture.

After the All-India Rural Credit Survey (Gorawara Committee) report in 1954 showed that only 7 percent of rural credit came from institutional sources, the Government asked the then Imperial Bank of India (later SBI) to open 400 branches outside of big cities and extend credit for agriculture. The RBI established a Rural Planning and Credit Division and later the Agricultural Refinance and Development Corporation to extend wholesale loans to banks. But none of this proved adequate and when the high yielding variety package of intensive agriculture was launched in the mid-1960s, it became imperative to upgrade the rural credit system as well. It should be noted that right till the late

1960s, the focus was on rural meaning agricultural, and not yet rural meaning poor, which happened only a decade later in mid 1970s.

5.3 From Bank Nationalization to Financial Sector Reforms (1969-1992)

With banks on their own not able to address the credit needs of agriculture, the government first put banks under "social control" in 1967. But within two years, in 1969, the then Prime Minister Indira Gandhi nationalized the top ten banks and mandated them to open a large number of rural branches. As a result, even in 2012, of the 100,189 scheduled commercial bank offices in the country, 63,082 offices or 62%, are in rural and semi-urban areas.

Then in 1975, after money-lending was abolished during the Emergency, the government set up a network of Regional Rural Banks to reach out to the rural poor, specifically small and marginal farmers, rural artisans and agricultural labour. With a focus on physical expansion of banking services the branches grew rapidly during 1969 to 1990.

Year	Rural branches	Total branches	Population per branch (in 1000s)	Priority sector credit as % of total credit
1969	1833	8262	64	14
1980	15105	32419	21	33
1990	31114	55410	14	43.8

(Source: Progress of Commercial Banking at a Glance – RBI Statistical Returns)

Despite the best of intentions of policy makers, the actual beneficiaries of the expansion of banking network turned out to be medium and large farmers, both in their own names and indirectly in the name of small farmers by using social connections and bribes to capture cheap loans. The emphasis of the government was always on disbursement of loans, often by organizing "loan melas" (fairs) and the hapless bankers were left to their own means when it came to recoveries. By 1989, the build-up of defaults had reached such a level, that the then Deputy Prime Minister, Choudhary Devi Lal, himself a large farmer, announced the first nationwide loan waiver – the Agricultural and Rural Debt Relief (ARDR) Scheme, 1989. This became an example of patronage that was copied by several state governments every time they wished to please the electorate. The culmination of this was the Agricultural Debt Waiver and Debt Relief Scheme, which during the financial year 2008-09, waived loans worth Rs 71, 680 crore (about USD 15 billion), covering some 43 million farmers.

Year	Rural branches	Total branches	Population per branch (in 1000s)	Priority sector credit as % of total credit
1995	33,004	62,367	15	33.7
2000	32,734	65,412	15	35.4
2010	32,624	85,393	13.8	35.1

(Source: Progress of Commercial Banking at a Glance – RBI Statistical Returns)

Though the last column in the table above looks impressive, the fact is that the so-called priority sector includes many non-poor sectors, such as large farmers, commercial agriculture, small-scale industry, self-employed professionals and exports.

The introduction of financial sector reforms since 1992 saw a reduction in the share of small borrowers (below Rs. 25,000) to total bank credit decline from 18.3% in 1994 to 5.3% in March 2002 and 1.3% in March 2010. Even the number of small borrower accounts reduced from 55.8 million to 37.3 million in March 2002 to merely 1.9 million in March 2010. This was partly because most small loans began to be given through Self Help Groups (SHGs) or MFIs rather than directly by banks. We describe those efforts below:

5.4 Post 1992 Efforts at Inclusion – the SHG Bank Linkage Model

The banking system had limited ability to reach the small borrowers as was evidenced by the fact that in 2004, only about 5 percent of bank credit went to small borrowers. With insistence on collateral, only the well-off were seen as a bankable proposition and large number of poor remained excluded from the financial system.

In order to enhance access to credit to the poor, since the mid-1980s, NGOs started experimenting with credit groups. MYRADA, an NGO in Karnataka since 1986 and PRADAN in Rajasthan since 1987, began setting up Self Help Groups (SHGs) for encouraging savings and credit and training on the principles of self-help . These SHGs consisted of 10-20 members who pooled savings monthly and lent to members from the pooled savings after a few months. In 1992 the RBI approved a pilot project of linking SHGs to banks, which eventually led to the SHG-Bank Linkage Program (SBLP) in 1996.

The SBLP received major policy and promotional support, both from the central and various state governments, in particular, Andhra Pradesh. It was scaled up nationwide through support from National Bank for Agriculture and Rural Development (NABARD) and World Bank loans. By March 2011, around 7.46 million SHGs around India have been linked with banks in what is the world's single largest microfinance program. About 4.78 million SHGs have loans outstanding worth Rs 31,221 crore (about USD 6 billion). The direct benefit of the SBLP, in terms of income enhancement of poor households, and the indirect benefit in terms of women's empowerment, has been enormous.

Though a great leap forward in terms of enhancing credit access by the poor, the SHG model suffers from a major lacuna - it is subsidy driven, with at least three types of subsidies – needed to organize the SHGs; lower interest loan funds and the bad debts that banks have to write off. The recovery rates of SHGs in early years were 95% plus and have steadily fallen as the poor sensed the program becoming one of political patronage. In the wake of the MFI Ordinance in AP, which led to mass default of MFI loans, initially SHG loan repayments increased but have in a year fallen to 60-70%. The increasing subsidy has also led to increasing cornering of credit by the better-off members, corruption and reduction in repayment rates in expectation of loan waivers.

5.5 The Alternative – the Bank Lending through MFI Model

After the 1989 loan waiver, banks had already got put off from poverty lending. With the advent of the economic reforms in 1992, banks became more oriented to their financial health than to their social obligation. Ela Bhatt, the founder of Mahila SEWA Cooperative Bank in Ahmedabad (since 1976), and of the wholesale lender, Friends of Women's World Banking (FWWB), who was also a member of the Planning Commission, led the demand for alternative credit channels for the working poor. GoI established the Rashtriya Mahila Kosh (RMK) as an apex lender to NGOs on-lending to women's groups. NGOs, which were registered as not-for profit societies or trusts began borrowing from RMK and donors and lending to the poor in groups, following the SHG methodology as that was the one favoured by the RMK.

Realising the limitations of borrowing and lending as a non-profit NGO, the author established India's first commercial microfinance institution (MFI), Bhartiya Samruddhi Finance Ltd, registered as a non-bank finance company (NBFC) with the RBI in 1996. The growth of MFIs was since 1997 supported by state owned Small Industries Development Bank of India (SIDBI) and loans from commercial banks under the priority lending quotas since 2000. Initially, they lent to NGO-MFIs but within a few years, as the amounts outstanding increased, they sought some equity as a risk cushion. This is when the larger NGO-MFIs began transforming into for-profit NBFCs.

In the next step, by 2006, these NBFCs started attracting equity investments from specialized microfinance investment vehicles and pri¬vate equity funds. For example, SHARE got equity from Legatum, Spandana from JM Financial and SKS from Sequoia, by 2007, within a few years of having been NGOs. By 2010 the MFI growth in India had reached its peak growth at 80% per annum and the outreach had reached around 27 million.

SHGs and MFIs emerged as two alternatives to meet the credit needs of the poor and initially the two models complemented each other. In certain districts of Andhra Pradesh (AP), however, the models began to compete and lend to each other's clients. In the run up to the SKS IPO in August 2010, this became a reckless rush to build portfolio and the multiple lending led to over-indebtedness in a small proportion of the borrowers. Many poor families were overwhelmed by the repayment obligations. As they began to skip instalments, MFI staff, accustomed to near 100% on-time repayment, increased pressure on recoveries. Reports of coercive recoveries and in some cases, suicides by borrowers, began to appear in the media.

This led to a political backlash and the AP state government enacted a law in October 2010 to curb MFIs. Though the law was aimed to protect MFI borrowers from coercion and over-indebtedness, it virtually stopped MFIs from functioning in AP. Two crucial provisions were – MFI staff could not go to the residence or work place of the borrowers for recovery, but instead had to sit in a "central place" hoping for borrowers to come there. Second, no further loans were allowed without government permission for each individual loan. This by itself slowed down the recoveries drastically. But Opposition leaders, particularly former Chief Minister Chandrababu Naidu, used this as an opportunity to win popularity by saying the law had not done enough and told the poor not to repay MFI loans. This led to a mass default. Over 9.2 million loans worth Rs 72,000 million (about USD 1.5 billion at that time) became overdue and 90% remain unpaid till Apr 2012. Banks panicked and stopped lending to MFIs all over India and the outstandings of the MFIs shrank by half.

Before being felled by the AP crisis, MFIs could achieve what the banking sector could not achieve over the years. Within a short period of 15 years borrowers from MFIs increased from merely 3,000 in 1995 to 31.7 million in 2010. In the corresponding period, the banking sector, with its huge infrastructure, only showed a decline in terms of lending to small borrowers. MFIs brought down dependence on money lenders. In addition to lending for petty trading and livestock rearing, the more innovative MFIs devised products for agriculture, non-farm activities, housing, water and sanitation, energy products, etc. MFIs also introduced micro-insurance to cover borrowers' lives and health. Some innovative MFIs offered weather index based crop insurance as well as livestock insurance. MFIs have been criticised for multiple lending, creating indebtedness of clients and charging high interest rates.

A study by the National Council for Applied Economic Research (NCAER) indicated that Indebtedness was more a result of informal sector activity rather than microfinance activity. While over half of sample clients had informal source as a dominant source of lending, in less than one-fourth among sample clients MFI was the dominant source of lending. Even in terms of loan size a little less than half originated from informal sector whereas only about one-eighth of loan originated from MFIs .

In a recent paper , Renuka Sane and Susan Thomas, two senior researchers from the Indira Gandhi Institute for Development Research, Mumbai, show "that consumption in AP fell by 19%, when compared with controls, as a consequence of the ban. There was a sharp fall in expenditure on food and education. There is some evidence of increased volatility in consumption after access to finance was hampered. A notable feature of the results is that even though the demise of the microfinance industry in AP directly impacted around 40 percent of the households who were borrowing from MFIs before the ban, the negative impact is seen for all households." Can there be a worse example of State action, ostensibly in the interests of the poor?

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