Semi formal financial institutions

Finance

Are formal and semi formal financial institution partnerships a viable option for serving the underserved in India Xavier Institute of Management Bhubaneswar 10/6/2010 Indu Paramita Mahapatra and Malay Harsh The essay tries to identify the potential problems with financial sector and does a gap analysis that leads to potential opportunities in the sector.

It also takes a look at the challenges faced by the different financial institutions, thegoalsachieved, the targets to be achieved and how the partnership between the different formal and semi formal institutions can create a synergy for serving the underserved of the country. Introduction: The reach and availability of finances determine the growth and development of any enterprise. Then how could the development of a nation be any different from it?

It must be duly noted that majority of the country's populace is out of the purview of the financial services which means more than half of our nation lacks access to savings and credit facilities among other financial securities and services such as investment options and insurance policies. Where we the urban literati state ourselves to be heavily hassled by the innumerable calls and emails trying to sell us a loan or investment options, these very same options are visibly amiss in the large rural pockets, places where they might be actually be needed.

The fact is, there is a gap between the financial services needed and what is available. Problem With financial services in India: Current scenario India's Economy Growth rate has been around 8. 5% - 9% (last 5 years). Our growth primarily has been in the industry & services sector which has grown by about 16. 8 percent. Even though agriculture is the principal means of livelihood for over 58. 4% of India's population, the growth in this sector is limited to around 2. 8%.

Of the many factors that attribute to poor growth in agriculture, a major reason is lack of access to properfinance. Limited access to savings, loans, remittance ; amp; insurance in rural/ unorganized sector are major constraints to agricultural and SME growth. Financial access enlarges livelihood opportunity ; amp; empowers the poor. And empowerment in turn aids socio-political stability. Financial inclusion provides formal identity, access to payments system ; amp; deposit insurance.

Types of Financial Exclusion: (i) exclusion from payment system: not having access to bank accounts (ii) exclusion from formal credit markets leading to approaching informal/ exploitative markets The marginal farmers, the landless labour, the self employed, the unorganized sector, urban slum dwellers, migrants, ethnic minorities, socially excluded groups, senior citizens and women are often not covered under the financial services. The North Eastern Region and the eastern ; amp; central regions are most excluded. Financial Inclusion and RBI’s role:

For the past few years one of the important new objectives of the Reserve Bank of India has been financial inclusion. Financial inclusion is the delivery of financial services at affordable costs to vast sections of disadvantaged and low income groups. Unrestrained access to public goods and services is the sine qua non of an open and efficient society. It is argued that as banking services are in the nature of public good, it is essential that availability of banking and payment services to the entire population withoutdiscriminationis the prime objective of public policy.

The movement towards financial inclusion rose to a crescendo in the current year, partly because of the Platinum Jubilee Celebration of RBI and partly because the demand for financial inclusion has become a national and a governmental imperative. According to Annual Policy Statement of RBI, 2004-05 "…banks should be obliged to provide banking services to all segments of population on equitable basis. " In 2005 RBI advised banks to provide basic bank " no frills" accounts with low or minimum balance/ charges so as to expand anking outreach to larger sections of society. KYC principles were simplified to open accounts for customers in rural ; amp; urban areas for people intending to open accounts with annual deposits of less than Rs. 50, 000. General purpose Credit Card (GCC) facility was available up to Rs. 25000 at rural ; amp; urban branches . Revolving credit was encouraged and withdrawal up to limit sanctioned was based on household cash flows . No security or collateral was needed for the same. Interest rates were deregulated.

In January 2006 banks were allowed to use services of NGOs, SHGs, micro finance institutions, civil society organizations as business facilitators/ correspondents (BC) for extending banking services. BCs were allowed to do " cash in-cash out" transactions at BC locations ; amp; branchless banking. Pilots were set up to provide credit counseling and financialeducation. In June 2007, RBI launched multilingual website in 13 Indian languages providing information on banking services.

For the financial inclusion drive, in identified districts, survey was conducted based on electoral rolls, public distribution system etc to identify households with no bank accounts. Banks were required to open at least one account per house. Mass media was deployed for awareness/ publicity. Bank staff/ NGOs/ volunteers took ration cards/ Electoral ID/ photos for fulfilling KYC norms ; amp; opening accounts. The different financial institutions and their roles:

The government institutions fuelling the growth in the financial sector for the purpose of extending the banking services to the underserved in India are Regional Rural Banks, Primary Agricultural Credit Societies, LAMPs, Commercial Credit Co-operative Societies, State Cooperative banks and Commercial banks. But then the entire system of lending must be self sustaining. Most of the above agencies are loss making units and need to be supported by the government with seed funds. The wide availability of such units extends the outreach of governments financial benefits to the large rural population.

The commercial banks try and keep themselves distant from extending their financial services of credit, savings etc to the villages owing largely to the heavy cost of operation and servicing in the deep pockets and would rather cough up the penalty imposed on them by the Reserve bank of India for not meeting credit targets set for Priority sector lending. The cost of reaching the customer unto itself is too high and added to that is the high cost of transaction and servicing of small ticket loans and to top it all there is a high default rate on such loans issued.

On the contrary the Non banking financial service companies operate on a much lean structure. The models on which the financial service extension is operating these days is constantly evolving into more and more innovative structures. Unlike the banks, the MFIs may furnish loans without collaterals or security deposits as they have exercise a social obligation on the loan applicant to repay the loans on time. As the loans are issued only through SHGs or JLGs, the liability of each loan rests entirely on the shoulders of the entire group and not just the individual.

Thus the ticket size of the loans increase in size and cost of servicing the loans also gets appropriated. The NBFCs and MFI also sell out their loans to the Commercial banks who finance them thus ensuring that the commercial banks also end up meeting their target of priority sector loans that too at a profitable scale. The role played by the NGOs is also worth mentioning when we talk about the financial services in the rural pockets. There has been a rise in the number of SHGs owing to the capacity building and awareness activities taken up by the NGOs.

The SHGs are informal bodies formed by the coming together of a homogenous group of people (preferably women) such groups actively promote mandatory savings among their members. From the funds collected loans are issued at nominal rates to its group members while loans can be sought for livelihood purposes largely, loans may also be sought for consumption needs. The SHGs are also trained for developing enterprises and businesses to fuel their growths. The other tangential benefits of women's SHGs are the increase of social status and say a woman has in the community

Partnership of banks with organisations like " A Little World" and " FINO" has been a groundbreaking innovation where the above organisations in partnership with the banks extend no frills bank accounts to the rural areas and their people. The benefit is two pronged. It must be noted that the cost per transaction incurred per transaction on a bank teller amounts to roughly

$1. 07 USD, while the cost of transaction per ATM transaction costs the bank around $0. 27 USD. The costs are prohibitively high for a commercial bank to operate on lower ticket size transactions and hence can't enter the rural market directly.

The partnership models that FINO and ALW have adopted ensure that the underserved get access to the banking services by means of innovative rural ATMs that are all but hand held devices operated by either a village person or their own employee. The costs of such operations are low due to the absence of infrastructure needs. The above organisations take a cut from the account opening fee and a certain fee for operations costs. Goals achieved by the financial drive: No frills accounts: 6 million new " no frills" accounts were added between March 2006 ; amp; 2007.

About 45000 rural ; amp; semi-urban branches of Regional rural banks (RRBs) ; amp; Public Sector Banks (PSBs) showed highest performance after the drive. SHG-Bank linkage: Access to banking system was provided through SHGs (groups pooling savings ; amp; providing loans to members). National Bank for Agricultural and Rural Development (NABARD) extended support in group formation, linking with banks, and promoting best practices. As a result, the recovery was excellent – 2. 6 million SHGs were linked to banks touching 40 million households. SHGs were given loans by banks against group guarantees (Joint liabilities).

With smaller loan sizes and reasonable rates of interest, SHGs were encouraged to take loans for consumption and to set up smaller business initiatives. IT Solutions: IT solutions were essential for doorstep banking. Pilot projects were started by SBI using smart cards for opening a/c with biometric identification. The smart cards were linked to mobile/ hand held connectivity devices to ensure transactions were recorded in banks' books on real time basis. State governments started making pension ; amp; other payments under NREGS through smart cards. Other financial services (low cost remittances, insurance) were also provided through cards.

IT solutions enabled large transactions like processing, credit scoring, credit record ; amp; follow up etc. Role of Government: Some state governments played a proactive role by issuing identity cards for a/c opening, through awareness campaigns by district/ block level officials. Financial literacy drives were conducted and India Post was roped in as BCs. FM's Budget Speech 2007-08 allocated a budget of $125 mn each to 2 funds (i) Financial Inclusion Fund for developmental/promotional work (ii) Financial InclusionTechnologyFund for technology adoption/innovation Challenges Faced

With the rates of interest being high the customer is sometimes still apprehensive in approaching for credit, as the poor do not have collateral to offer and are hence not always eligible to loans from govt. banks. The stronghold of themoneylenders too is very strong as the loan servicing time of a money lender is very low and can be furnished at any hour of the day. Imposition of rate restrictions by the government may also render MFI businesses inefficient owing to high operations cost and defaults, the govt. Promotes defaulting each time there is a loan waiver issued by it.

Such actions promote defaulting nature amongst the farmers. There is a disinterest of the rural population in taking insurance policies as there is no understanding of the same in the large rural pockets. The seasonality of the crops and harvest too impose a challenge to the lending and repayments to the financial institutions. Way forward: There's a need to link the impact of the financial institution to the 8 Millennium Development Goals (MDGs). The impact analysis can be done by evaluating how far the financial institutions have been effective in contributing, directly and indirectly, to all the eight MDGs.

Microfinance contributes to improving income and reducing hunger (MDG 1), providing children school education and training (MDG 2), and paying forhealthservices (MDG 4 – 6). The main beneficiaries of microfinance services are women, so financial institutions contribution to women's empowerment andgender equality(MDG 3) can be studied. As for theenvironment(MDG 7), financial institutions are increasingly combining environmental programs with their financial services, although the contribution may be indirect.

For MDG 8, since Target 12 calls for the development of open, rule-based, non-discriminatory financial systems, the expansion of financial programs themselves is the achievement of MDG 8. Hence the future of financial outreach lies on the synergy of formal and semiformal institutions to bring about a positive change. References: 1. http://timesofindia. indiatimes. com/business/india-business/Highest-industrial-growth-recorded-in-20-yrs-at-168/articleshow/5566436. cms 2. India. gov. in/sectors/agriculture/index. php 3. http://www. tradingeconomics. com/Economics/GDP-Growth. aspx? Symbol= INR 4.

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