Financial Inclusion – Market Model

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Abstract:

Financial Inclusion has been in the top of the agenda of the Central Government and RBI. Financial inclusion is a flagship programme of the Reserve Bank. Its objective is to bring people, hitherto excluded, under the ambit of formal financial institutions. While RBI feels that financial inclusion can be brought about only by mainstream institutional players this article explores the possibility of taking on board the financial markets also so as to considerably shrink the time frame for financial inclusion. Empirical research on the comparative merits of 'bank-based' and 'market-based' financial systems has centered on Germany and Japan as 'bank-based systems' and the United States and the United Kingdom as 'market-based systems'. Financial markets have advantages such as cost of delivery. While the cost of delivery of brick and mortar branch of a bank is the highest and cost of delivery of Non-Banking Finance Company is lower the cost of delivery of trading and broking services is the lowest. In addition, the market model has other advantages like transaction cost, flexibility etc. Financial markets could supplement and complement the efforts of banks in their financial inclusion endeavour. Hence there is merit in the financial markets model and needs to have a closer look.

Key words:

Financial Inclusion, Financial Markets, Brick and Mortar Branch, Cost of Delivery, Financial Literacy, Capital Requirements, Franchise Shoppe, Ease of Transaction, bank-based system, market-based system.

Introduction: The financial sector regulator- The Reserve Bank of India (RBI) has made Financial Inclusion as a flagship programme of the RBI and made it mandatory for all banks to formulate Financial Inclusion Plan (FIP). According to RBI, financial inclusion can be brought about only by mainstream institutional players and hence this article explores the possibility of taking on board the financial markets also which could supplement and complement the efforts of banks in their endeavour and further it will also considerably help in reducing the time frame for financial inclusion.

Financial Inclusion – Definition: RBI has defined Financial Inclusion as the "process of ensuring access to appropriate financial products and services needed by all sections of the society in general and vulnerable groups such as weaker sections and low income groups in particular, at an affordable cost in a fair and transparent manner by **regulated, mainstream institutional players"** (Dr. K.C. Chakrabarty, September 6, 2013)

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

"The first three-year FIP of banks for the period 2010-2013 has ended. Although there has been reasonable progress in the penetration of banking services and opening of basic bank accounts, the number of transactions through ICT-based BC outlets is still very low." (RBI, page 81 RBI Annual Report 2012-13, 2012-13).

This has been the dominant model of Indian banking for several decades. In aggregate, there are 105,753 branches across all scheduled commercial banks in India. Of these, about 39,336 branches are in rural India. While this branch network is inadequate relative to the vision of one credit access point for every 10,000 population………… (Mor D. , Jan 2014)

A number of studies have sought to examine whether the nature of the financial structure matters for the economic growth of a country. While some studies have suggested that financial structure did not matter for economic growth, the others studies establish that the structure of the financial system can matter for growth. In this debate, Rajan and Zingales (1998) observed that rather than the nature of financial structure, it is the financial system's overall level of development that matters for growth. Empirical research on the comparative merits of 'bank-based' and 'market-based' financial systems has centered on Germany and Japan as 'bank-based systems' and the United States and the United Kingdom as 'market-based systems'. Despite their differences various models exhibit similarities.

According to Reid (2010), some financial structures may be better suited to growth at certain stages of development but they may be less well suited in other circumstances. The above thinking points out to the fact that developments in the macroeconomic environment and structural changes in the economy are crucial variables that may decide the banking structure and the changes in it required from time to time (RBI, Discussion Paper on Banking Structure in India – The Way Forward, 2013).

"Banks are important financial intermediary, but our problem is that banks access is not there, today out of 600,000 villages only 40,000 villages have bank branch;.... banks penetration is very important," (Dr.K C Chakrabarty, September 24, 2013)

For economic development of a country widely there are two different models that can be adopted. It could be either 'bank-based' or 'market-based'. Banks are well known financial intermediaries. However, as per the above report even after the launch of FIP by the financial sector regulator for banks there are only 40,000 villages which have bank branches.

Brick and Mortar Branch and cost of delivery: It is common knowledge that the setting up a brick and mortar branch would involve rent payable (as most of the bank branches are taken on lease), furniture and fixtures, electricity, back-up gensets, software and hardware (as all banks are now on core banking solution), security costs and ultimately the ever increasing staff costs. In addition, banks also install on-site ATMs.

For every loan of Rs.10,000/- made through a Public Sector Bank rural branch, it costs them about Rs.4,150/-. The same number for a Private Sector Bank rural branch is about Rs.3,210/-. Little wonder then that rural branch expansion meets with so much resistance. What is important to note here is that the same Rs.10,000/- loan to the rural customer has very different costs of delivery across various channels.

By prescribing that bank branches ought to be the dominant delivery channel, the financial sector gets saddled with steeply higher costs without any proportionate welfare gain. Flexibility to the participants in the financial system in choosing the lowest cost channel has the potential to achieve the outcome of rural credit delivery with far lower costs. After all, shouldn't policy making be more about outcomes and less about instrumentality? (George, 2013)

As mentioned by Anand and Deepti the cost of delivery is quite high in case of brick and mortar branches.

Non-Banking Finance Company and cost of delivery: Also, the cost of setting up a Non-Banking Finance Company (NBFC) seems to be much lower. The cost of setting up a Pudhuaaru branch -- interiors, counters, biometric devices, safe, connectivity, burglar alarm, 2 PCs and inverter, among other things -- is about Rs.3.50 lakh. The running cost of the branch – rent, salaries and utilities – is about Rs.35,000 a month. A head office for a 250-branch setup costs about Rs.50-75 lakh, which adds another Rs.10,000/- to the operating cost of every branch. In other words, the operating cost of a branch is about Rs.45, 000/- a month, or Rs.5.4 lakh a year. (M.Rajshekar, 2010).

Trading and Broking services cost of delivery: However, the investment required and the operating expense of a franchise model for trading and broking services is cost effective. To get local entrepreneurs up and running with their franchise, the franchising model for trading and broking services structured by most investment firms is very simple and direct. For any interested individual, the franchisors require an initial investment that includes the safety deposit amount, a retail space as well as staff and equipment.

The costs vary according to the city, location of the office and the volume of business handled. Usually, the investment amount falls near and about the ballpark figure of Rs.25, 000. At Motilal Oswal, the investment ranges from Rs.25, 000/- to Rs.4 lakh, with the deposit amount being redeemable. On similar lines, Sharekhan has a requirement of Rs.1 to Rs.3 lakh as investment on a contract that is renewable every five years. Sharekhan, that has about 2,000 franchisees across 500 cities, even offers a 100 percent refund on the deposit. Other firms have pretty much the same parameters. Sources from the sector say that on an average for a franchisee in this sector, it takes six months to break even. The profit sharing ratio for the franchisee and the franchisor on an average is about 60:40, where 60 percent of the earnings accrue to the franchisee. For most of the franchisees, the return on investment falls in the range of 20-30 percent, sources say. Equity Trading and Broking Services going the franchise way (Ambre)

Bombay Stock Exchange has not prescribed any minimum brokerage, and hence the same is negotiable. Though the maximum brokerage allowed is 2.5% percent of the contract price, the brokerage generally charged by the Members is much lower. A Member may have different scales of brokerages for delivery transactions, trading transactions and the like. Hence, the cost of setting up such franchise Shoppe particularly in far flung rural areas could be a viable proposition as the cost of delivery could be quite low.

Ease of transacting business: Customers would be willing to use bank branches for transactions if the same is available within a reasonable distance of say 5 kms radius. As per Dr.Mor Committee - "Universal Electronic Bank Account (UEBA): By January

1, 2016 each Indian resident, above the age of 18 years, would have an individual, full-service, safe, and secure electronic bank account. Also "by January 1, 2016, the number and distribution of electronic payment access points would be such that every single resident would be within a fifteen minute walking distance from such a point anywhere in the country. Each such point would allow residents to deposit and withdraw cash to and from their bank accounts and transfer balances from one bank account to another (Mor D. N., Vision Statement Page 26, Committee on Comprehensive Financial Services for Small Businesses and Low Income Households, January 2014).

In India has around 6 lakh plus villages and it is to be pondered over as to whether it would be viable to set up a bank branch in each of these villages.

Alternative to brick and mortar branches model: While the financial sector regulator has urged banks to set up ultra-small bank branches in villages and supplement the same with the Banking Correspondents (BC) and though progress has been made in this front, still it seems much more needs to be done. Further, "Today, all BC companies are in the red because of unrealistic pricing," says PN Vasudevan, MD of Equitas Microfinance. "To make the point-of-delivery channel sustainable.........the cost a customer will have to pay, for a small deposit or withdrawal, would need to be upwards of 5%." Adds Aruna Sharma, additional chief secretary, Madhya Pradesh: "The cost of delivery should not be passed on to consumers (Sivaramakrishnan, Exploring feasibility of Nachiket Mor panel's road map for financial inclusion by 2016, 2014**)**.

Though there are attempts to set up electronic/unmanned bank branches this could also prove to be unfeasible in a rural area where the literacy levels are quite low and financial literacy levels are also sub-optimal.

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

Even ignoring the component of supervisory capital requirements, the RBI assessed that public sector banks are expected to require additional capital of Rs.4.15 lakh crore — equity capital of Rs.1.43-lakh crore and non-equity capital of Rs.2.72-lakh crore — over the phasing-in period of Basel III (Bureau, 2014)

Hence it can be observed that the capital requirement has gone up between the two periods.

Further, as per Dr.Mor Committee - By January 1, 2016, each low-income household and small-business would have convenient access to providers that have the ability to offer them suitable investment and deposit products, and pay reasonable charges for their services (Mor D. N., Vision 4, Chapter 7.4 Page 202, Committee on Comprehensive Financial Services for Small Businesses and Low Income Household, January 2014)

Given the capital constrains for banks to open one brick and mortar branch in every village in the next couple of years seems to be a tall order. This will also lead to savers facing difficulties in accessing institutions and with no instrument providing a positive real rate of return on financial savings. This would only make people move away from financial assets to physical assets.

Since small businesses and a majority of the population hardly have access to finance it is felt that financial markets also have a role to play in financial inclusion.

Financial Markets role in growth and financial inclusion: Financial markets can also bring the users of capital and savers together at low cost, eliminating layers of intermediation, and thus costs. One virtue of bond market finance over bank finance, for example, is that it allows investors to bear the credit risk of the firm they are investing in directly, without going indirectly through a bank. For high quality firms, this could entail substantial cost savings. Since the poorer sectors are hurt most by high costs, this effect can be a substantial force for greater inclusion. (Rajan, 2009)

Hence it would make sense to develop the financial markets to aid in the mammoth task of financial inclusion.

Issues and Challenges in the Market Model: Adoption of a pure market driven model has its own challenges.

Financial Literacy: Given the sub-optimal financial literacy levels in India adoption of a market driven model to pose challenges. As per a survey India ranked almost last in this regard (masterintelligence.com/content/intelligence/en/research/reports/2013/mastercard-Index-of-financial-literacy-report, 2013).

In addition, the risk bearing capacity of the poorer sections of the society would also be a cause for concern. However, these can be overcome by suitable regulatory changes and offering suitable products. Security and Exchange Board of India (SEBI) has permitted the issuer of security to voluntarily offer a ‘safety net’ for retail investors and later on had floated a discussion paper on 'Mandatory Safety Net Mechanism' in September 2012 wherein the same was to be made mandatory (SEBI, 2009).

Further, the capital protection schemes being offered by mutual funds too would go a long way in protecting the interests of the investors. Market participants can also offer innovative products. For instance, Kshetriya Gramin Financial Services (KGFS) offered a money market mutual fund - a category of debt funds that offers a high degree of safety of principal and liquidity (Rajshekhar, 2010)

Conclusion: Financial Inclusion is a long journey for any country. The importance of financial inclusion cannot to undermined and left to the main stream institutional players alone. Financial markets too have a role to play in this regard. It is not to suggest that we move away from the mainstream institutional players and depend on financial markets to take over. Financial markets have a role to play and they could supplement and complement the mainstream institutional players in their endeavour. A proper blend of mainstream institutional players and financial markets could further the cause of financial inclusion and would considerably shrink the time frame for financial inclusion. The pros of the financial markets include reduced set-up and operating costs leading to lowering cost of delivery, ease of transaction, flexibility of products, innovation, better use of technology, lower capital requirements etc. Hence it can be concluded that there is merit in the financial markets model and needs to have a closer look.

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