Challenges in Inclusive Finance

Transforming India Magazine Interview with

Dr. Nachiket Mor - By Sanjeev Kumar Singh.

Dr. Nachiket Mor heads the RBI committee on Comprehensive Financial Services for Small Businesses and Low-Income Households. From October 2007 to August 2010, he played a key role at ICICI in setting up a philanthropic foundation, the ICICI Foundation for Inclusive Growth and served as its founding President. He is a director of SughaVazhvu Health Care Pvt. Ltd.

A Yale World Fellow, he has a Ph.D. in Economics from the University of Pennsylvania with a specialization in Finance from the Wharton School; an MBA from the Indian Institute of Management, Ahmadabad; and an undergraduate degree in Physics from the Mumbai University. While completing his Ph.D., he was associated with a Philadelphia based hedge fund (Quantitative Financial Strategies) for three years. He has worked with ICICI from 1987 to 2007 in a variety of jobs, including, Corporate Planning, Project Finance, Rural Finance and Treasury and was a member of its Board of Directors from 2001 to 2007.

Mr. Sanjeev Kumar Singh: Poverty reduction has always been among the top agenda of the planned economy of India. Why then the financial system has failed to reduce poverty in India?

Dr. Nachiket Mor: Your first question is a good one. However, we have to be careful about how we frame the response. It is not true that there is no link between finance and poverty. Or those efforts in the financial system have not reduced poverty. There is a seminal paper by Pande and Burgess which examines the evidence from the Bank Nationalisation initiatives and finds that wherever branches were established poverty reduced unambiguously.

The challenges have been to find ways in which the original notion can be taken to every last human being in the country. Many more experiments are on. One set of experiment is being carried on by the IFMR Trust (www.ifmrtrust.co.in) where they are trying to work on the village level branch-based models with comprehensive (savings, insurance included) services.

SKS: India is witnessing the adverse effects of the global recession. The business scale of many industries has reduced in the last two quarters causing loss of livelihoods and jobs. What role the financial institutions should play for the livelihood security of the poor during the global recession?

NM: The big challenge for the financial system has in general been to find a way to have longer term perspective. For instance, move slowly when things are good but to be aggressive when things are bad. Unfortunately this is not actually how the banks and other financial institutions operate.

The Reserve Bank of India has injected large amount of liquidity into the system, post the crisis, and the Government and the RBI together have used as much moral suasion as possible to get Banks lend money. This has worked very well for the larger, better capitalised and highly rated companies. The problem for our client base has unfortunately been that they are not considered to be highly rated and the US sub-prime notion associated with microfinance has even further colored the perspective of the lenders.

I feel that the true solution lies in recognising first that the larger institutions and banks will be comfortable only with large volume and high risk transactions. For our communities, we will need to build high quality originators and high quality bridge institutions. The IFMR Trust Guarantee Company is a bridge institution that the IFMR Trust is seeking to build into a larger national entity.

SKS: Traditional money lenders and traders have provided excellent access to finance, of course at a rate of interest that is not good for enhancing livelihoods. The MFIs are supposed to replace the money lenders and so any model to finance livelihoods has to replace traders at favorable terms.

NM: What you have raised is a real concern. The way I see it, money lenders and traders have been providers of venture finance: high risk - high return. The formal system still does not have a good answer to substituting that kind of finance. However, what you say is entirely correct that despite clear evidence, providing leverage to the low income household can be done in a low-risk manner. Why have rates remained so high?

SKS: The Marginal Farmers (MFs) are 70% and Small Farmers (SMs) are 10%, and the collective landholdings of MFs and SMs are 43.5 % as of 2003. As 80% of the agriculture is rainfed, a large part of our country faces perennial drought and flood. The Farmers are engaged in high risk agriculture, how best their security can be covered by the financial system?

NM: My understanding is that the role of finance is to allow people to deal with the reality that they face and to respond to it without any friction. If indeed the occupations that they are engaged in are not viable then finance cannot solve that but what it can do, when it works well, is to provide protection instruments, credit access, insurance, student loans, etc. which could make it possible for the household to shift occupations, seek training and move from one location to another. In fact, the opposite often tends to happen in the absence of good financial systems: low income households are locked into low return occupations because of poor performance of financial systems.

SKS: About the next 10 years as decay of urbanization: India's slum-dwelling population had risen from 27.9 million in 1981 to 61.8 million in 2001. India's largest slum population is in Mumbai, where an estimated 6.5 million people – at least half the city's residents – live in slums. Delhi, the national capital, has the country's second-largest slum population, totaling about 1.8 million people, followed by Kolkata with about 1.5 million which is 40% of its city population. The slum dwellers live no tenancy life and without address proof. What financial mechanism should we have to reach slum dwellers?

NM: Great question! The challenge in providing access to urban slum dwellers in large measure will be in establishing identity for KYC. The key systemic question is: who takes responsibility - the government or the banking system? The view of the financial systems regulators clearly is that this is the job of the government. But in the face of large scale migrations, the traditional mechanisms that the government uses (such as home visits by the Police) are not able to cope. One systemic answer is to start with the rural area directly and create biometric ID systems that are valid nationally. That is what a technology like FINO enables.

Another idea we are examining is removal of KYC requirements for accounts where individual transaction amount is less than Rs.250. After a “cooling period” of a year, the bank with which this low-value account has been maintained may certify KYC for the individual upon which he/she transits to a regular savings bank account without any transaction gaps. This is meant to credibly differentiate between individuals who have genuine difficulty in obtaining KYC documents and those seeking to evade KYC.

SKS: Over to insurance. I think the formal way of working on risk is very weak as a framework. We are only talking of risk mitigation mechanisms which do not solve the problems of poor. The poor require risk diversification and risk reduction products and services. Simple example for rainfed farmer weather insurance is of little use because it does not solve the subsistence requirements but the traditional mechanism of sowing diversified seed varieties works for them.

NM: There is great deal of value in what you say about insurance. Financial products are not the only way to diversify and that the household needs to explore as many ways as possible. However, if we create an environment in which well-designed insurance products are made available then the household has a benchmark against which to evaluate his other options. In many cases (such as Catastrophic Health Insurance), financial products are the best way to move forward but in others such as rainfall insurance in rain-fed areas, given the price of rainfall risk at 10%, it is obvious that finding ways to irrigate more cheaply or diversifying away from water-hungry crops may be a much better answer.

SKS: Clearly you have pointed out that when we talk of livelihoods finance where we have talked of investment in promotion, fixed investment and working capital, we need new products and instruments. At the larger level in India, Equity markets have moved ahead but Debt market which is the key for financing groups and individuals for the poor, there has not

been much development. Even as the current group of social investors is talking about equity finance alone, many originators like the Producer Companies, Cooperatives and Groups will require more debt financing.

NM: To me the reasons are two fold: (a) without benefitting from economies of scope (serving the rich as well as the poor in a location), the cost of operations of just serving low income households cannot be brought down; (b) we need a larger debate on how growth in operations is financed. Should entities that are growing at 300% per annum seek to finance their growth through increased rates/revenue or should equity investors finance this growth? Currently, the answer seems to be that revenue collected from one poor family should finance access to finance for another poor family and not the equity investor.

Both are required and in general it is equity that is often in short supply so that role for social investors to provide equity is very important. I think the answers on the leverage question are actually simpler but need a lot more operational capability on the ground which needs to be built. No lender will recklessly commit their savings account balances without that.

For savings there is big legal constrain at origination level as current legal systems does not provide scope to accept Savings - Deposits except for Cooperatives and Banks. Therefore obviously there is lack of outreach.

SKS: There are two issues that are interlinked: poverty and access to finance. The fact that they are interlinked makes delinking complex. Is it possible to create asset from a zero asset base or even a negative asset base done through a micro finance intervention on a mass scale?

NM: Good conceptual point. I guess it is a matter of how you define an asset. I think of it as a store of capacity that is redeployable. Spare labour at home is as much an asset as is a bank balance. If indeed one accepts this broad definition then only the sick and the dying have no "assets". Now what can one do with such an asset? One could look after a buffalo; another could run a tea-shop, or could potentially seek some training. Financial access, in this case, say a loan, could allow the person to smooth her stochastic income, acquire a complementary asset (like a cow), which, when combined with the "asset" that she already has (spare labour capacity) could turn that "asset" from one that is under-utilised and idle to something that starts to generate revenue.

There is actually a microfinance institution that does exactly this with this class of clients - it is called "Credit and Savings for the Hardcore Poor" (CASHPOR). They may be worth looking at much more carefully.

It is my view, and the work that I am doing with the IFMR Trust in Thanjavur, Tamil Nadu is focussed on testing this view, that creating an appropriate financial access mental state amongst the members of the local community (I can borrow when I want, save when I want, withdraw the savings when I want) would definitely have welfare impact. Will it entirely solve all the problems, without any other exogenous inputs? I don't think so. There is genuine new work to be done as well as there is a strong need to build on the work of the numerous NGOs that have struggled on the ground, before us.

SKS: Originators and Bridge Institutions traditionally have been of three kinds: Primary Agriculture Cooperatives, Regional Rural Banks and Grameen Banks - Several National Banks have them. Yet
the reach has not been much primarily because the poor farmer doing lease farming on a land is not financed because he does not have collateral and also access to banks as they are either out of reach or costly to transact.

NM: In the way I understand them, the ones you refer to are originators and clearly we need better performing originators and a lot more experimentation is needed to figure out the best ordination model. The MFIs are doing a wonderful job. The NGO-SHG-Bank linkage model has had a big impact as well. A part of the work of the IFMR Trust is also focused on this issue - creating ground up originators that are able to run and operate a branch at the village level.

By bridge institutions I meant players like National Housing Bank and National Bank for Agriculture and Rural Development. They are currently the bridge between the commercial banks and these originators.

The collateral issue has to be understood in the large context of Moral hazard. The group model has been very successful in addressing this for smaller loans. For larger loans however, there is no clear answer yet on how one may go about doing it.

Warehouse receipts could provide an answer; jewelry could provide another. "Step-in-Rights" provides another answer. We are also keen to experiment with "Wet-Leases" as a model for capital assets so that the problem of Moral hazard is mitigated.

SKS: We haven't touched upon the issue of providing thrift-based banking to the poor and the unbanked. It is foremost in the absence of such facilities for the poor that they can't think of their future beyond an uncertain tomorrow or at best not beyond the next 30 days. Isn't providing means to thrift, the foremost pre-requisite for promoting financial inclusion. Why banking correspondent model hasn't taken off and the challenges and opportunities thereof? What has the government done in this light and what is it thinking?

NM: Banking Correspondent-led bank accounts are now being opened across the country at the rate of 10,000 new accounts per day by FINO alone (www.fino.co.in). So it is not clear to me that "it has not taken off". Can it move faster, I am sure it can. However, we need to solve the very severe co-mingling, bankruptcy remoteness and Herstatt Risks.

Savings are clearly important but, unfortunately, on a standalone basis very expensive to offer. There is also the safety/ease of access trade-off. We feel that the Banking Correspondent model is designed exactly to address these issues. The IFMR Trust is working on a new money market mutual fund linked savings/investment products for very small amount that they hope will pay more money to the household, will be cheaper to operate and will not have the barriers that the savings accounts with bank necessarily need to have.

One of the main purposes for promoting FINO was to act as an ASP to provide cheap CBS access to small financial institutions such as RRBs and Cooperative Banks.

I also do not think that the answers in the financial system (unlike in health care and education) lie necessarily with the Government or with subsidies. Our effort on the ground is to use the power of financial engineering and good technology to try and provide universal access on a sustainable basis without the need for subsidies. Only time will tell though if we have been able to pull it off.