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Financial Inclusion in Developing Countries: Evidences from an Indian State

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Abstract

Financial Inclusion poses policy challenges on a scale and with an urgency that is unique for developing countries which house more than 90% of the world's unbanked population. Developed countries policy makers have recognised that there are complex and multi-dimensional factors that contribute to financial exclusion and therefore require a comprehensive variety of providers, products and technologies that best suits the socio-economic, political, cultural and geographical conditions in these countries. India's experience as a developing country towards ensuring financial inclusion and weeding out financial exclusion has been unique. Indian economy has achieved a phenomenal economic growth during the last decade or so. But this growth has not been inclusive. Mobile phones, E-Mail, E-Commerce, Swanky Cars, trendy dresses, plastic money and 24-hour banking through ATMs have all become a reality in the country but only in the cities and towns. One of the reasons for this exclusive growth witnessed in the country has been attributed to the failure of the second generation reforms which were broadly related with financial sector reforms aimed to achieve greater financial inclusion. The problem of 'Financial Exclusion' is severe in the country. The State of Jammu & Kashmir is no exception to this socio-economic problem. An effort has been made in this paper to assess how serious the problem of financial exclusion is in the state? What has been the impact of the initiatives taken by RBI towards greater 'Financial Inclusion' & what more needs to be done to achieve full & meaningful financial inclusion?

Keywords: financial inclusion, developing countries, no-frills account, unbanked population, SHGs

1. Introduction

In developing countries the access to formal financial services for the poor majority population remains limited. Government tries to create access for the poor by way of interest rate ceilings designed to make more affordable, through direct lending and by way of requiring banks to expand branch network in rural areas. There are a host of reasons responsible for limited availability of financial services.

services in developing countries e.g., high levels of government debt have constrained the access of credit to firms and individuals, high inflation has discouraged savings, poor physical and institutional infrastructure has raised the costs of provision, most poor people do have collateral or credit record and many countries lack credit bureaux-all of these deter lending (Ellis, 2007).

1.1 Financial Inclusion

The importance of sound and effective social inclusion policies have been in vogue and widely accepted for more than a century. However, one aspect of social inclusion that has received limited attention until recently has been financial inclusion. Financial inclusion means that the majority of the population has broad access to a portfolio of quality financial products and services which include loans, deposit services, insurance, pensions and payment systems, as well as financial education and consumer protection mechanisms.

According to an estimate around 2.5 billion people worldwide are currently without access to basic formal financial services. Financial exclusion in advanced economies tends to be low as compared with developing countries. In Germany, for Example, 4% and in United States 9% of the population are without basic access to

financial services (Peachy & Roe, 2004). But in developing countries financial exclusion is exorbitantly high. 88% of the financially excluded live in Latin America, Asia and Africa. As a matter of fact financial inclusion poses policy challenges that are unique in developing countries (Chaia et al., 2009).

1.2 Policy Instruments for Financial Inclusion in Developing Countries

Financial inclusion cannot be addressed by a single policy instrument. Therefore, policy makers are focussing on a set of solutions appropriate to their national contexts to increase financial access to poorer masses. Based on unique socio-economic, politico-financial position and institutional support system, the developing countries are using multi-pronged approach to tackle financial exclusion. Thus while El Salvador is exploring how publicly owned banks can play a more critical role in reaching out to the unbanked, Jordon is using macroeconomic measures and the promotion of interbank bond markets with the aim of increasing the availability of credit to poor people. While countries like Brazil and Egypt are focussed on strengthening channels for delivering new products, others like Peru and Indonesia are empowering people so that they can make better use of already existing products (The World Bank, 2007). In nutshell, the process of financial inclusion policy creation in developing countries is undergoing profound changes. Instead of adopting wholesale solutions, these countries are calibrating the standard policy measures as per their own requirements. However, some policy measures like Microfinance, New Technology innovations, Savings as a corner stone, Critical role of banks for ensuring financial inclusion have been widely used in developing countries. Of all these measures, the banks play a major role in mitigating financial exclusion. In most of the developing countries it has been observed that a handful of small, specialised non-banking institutions are not enough to serve the purpose of financial inclusion. In India, Indonesia and Egypt banks are expected to be the backbone of the system that reaches to the poorest. In India, banks have been advised to self-set the financial inclusion plans and seek approval for these plans at the board level.

Financial system regulators are seeing that the financial inclusion is a distribution issue and often stipulate loosening of licensing requirements for opening new branches as a step towards facilitating the outreach of banks to the otherwise inaccessible areas. In Pakistan, the revision and liberalisation of branch licensing policy of the State Bank of Pakistan will facilitate branch expansion by allowing their branch housing decision within the board policy parameters. Kenya, in addition to the successful regulatory openings for mobile payments is also extending their outreach through the use of technology such as mobile phone and correspondents.

1.3 The Indian Economic Scenario

The millennium has heralded the arrival of the Indian economy on the global stage on account of steady and impressive economic growth and during the last few years, the Indian economy has been growing at an impressive rate of 8 percent to 9 percent which is comparable with the best in the world. The forex reserves which were just sufficient to meet one weeks import Bill in 1990 have swelled to more than 400 billion. The phenomenal economic growth achieved during the last decade or so has resulted into more than sufficient growth in per capita income. However, most of the economic growth has resulted from the secondary and territiary sectors of the economy. The primary sector, on which 65% of the population depends, however, is moving on low growth path. On an average during the last decade or so it has grown at a dismal rate of 2 percent. As a result of this, the benefits of economic prosperity have not trickled down to all the sections of the society and all regions in the country.

1.4 Statement of the Problem

To revive and uplift sluggish economic growth in the country major reform programmes were initiated in two phases. It is a fact that the 1st and 2nd generation reforms have put Indian economy on high growth trajectory, but the other fact is that the growth has not been inclusive. According to P. Sing & S. Kour, (2003) the benefits of first and second generation reforms are visible only in big cities and towns. Mobile phones, E-Mail, E-Commerce, Swanky Cars, trendy dresses, plastic money and 24-hour banking through ATMs have all become a reality in the country but only in the cities and towns. There is no doubt that the gains emanating from the process of socio-economic modernisation of the country has not been shared evenly by different states of the country and also by different sections of the society (M. R. Khurana, 2003). One of the reasons for the exclusive growth witnessed in the country has been attributed to the failure of the second generation reforms which were broadly related with financial sector reforms also to achieve full financial inclusion. Large section of population, in particular unprivileged class which are in large numbers still lack access to affordable financial services like credit, insurance, saving safety net etc. which are equally important for importing impetus to the economic growth and to enlarge the viable opportunities for livelihood.

The problem of financial exclusion is one of the serious socio-economic problems the country is facing. As per the available data on saving bank accounts on all India basis, only 59% of adult population have bank accounts which

in other words means that 41% of the adult population in the country lack access to the modern payment system. This figure of unbanked adult population in the country lacks access to the modern payment system which is more than the unbanked population of the comparable developing countries. The picture of financial inclusion looks much more shabby on formal credit system front. As per the available data, only 14 percent of the adult population have loan accounts. The problem is more serious in rural areas where only 9.5 percent of adult population have loan accounts. The problem of exclusion from formal credit system and its serious consequences can be judged form the data that the share of non-institutional sources in the rural households credit still accounts for 43% which simply reveals the extent of the problem of financial exclusion. More disheartening trend is that the share of non-institutional sources of credit in particular from money lenders in the debt of rural households has registered an uptrend from 17.5 percent in 1991 to 29.6 percent in 2002. But in urban areas, the share of non-institutional sources in the total credit has declined which is a healthy sign. India as a developing country has been severely facing the problem of non-accessibility of affordable credit. This has been more true of the people living in the rural areas of far flung states like the state of Jammu & Kashmir.

1.5 Silver Lining

The problem of financial exclusion is more severe in rural India where people are mainly connected with the agriculture and related activities. Further the people who run SMEs are subject to greater difficulties when it comes to the easy access to the affordable credit. These two sectors enjoy enormous growth potential and at the same time are important contributors to GDP. The *Silver Lining* in the cloud is that the policy makers are well aware of this fact and the problems of financial exclusion in general. In order to impart growth impetus to these vital sectors of an economy and more importantly to ensure access to affordable financial services to the un-privileged class in the country have taken number of initiatives. The Reserve Bank of India (RBI) issued various instructions to banks to bring in inclusive growth through financial inclusion like:

- To open *'No frills'* savings accounts with low or nil minimum balance as well as charges for opening and maintaining an account.
- Relax *'Know Your Customer (KYC)'* norm for openning a bank account with self declaration of address and introduction by an account holder of a bank in order to expand the outreach of bank accounts to even weaker sections of the society.
- In order to ensure easy credit flow to individual beneficiaries of rural households, banks have been asked to introduce *'General Purpose Credit Cards'* (GCC) facility the holder of which is entitled to credit up to 25,000 on revolving credit system basis at their rural and semi-urban branches.
- Banks were suggested to adapt a simplified mechanism for one time settlement of over due loans upto Rs. 25,000. Further banks were asked that after one time settlement the concerned beneficiary shall be treated eligible for fresh credit.
- In order to achieve greater degree of "Financial Inclusion" banks were allowed to utilise the services of Non-governmental Organisations (NGOs), Micro-Finance Institutions, Self-help Groups (SHGs) etc.
- In addition to above measures pilots for credit counselling and financial education have been initiated.

As a strategy towards achieving financial inclusion in the country given districts were assigned banks and were instructed to achieve *'Full Financial Inclusion'* in the identified districts in the form of opening of *'No Frills Accounts'* and by way of issuance of *'GCC'* etc.

1.6 Objectives of the Paper

This paper specifically aims to study:

- The severity of the problem of Financial Exclusion in the State of J&K.
- The specific reasons for the problem of financial exclusion in the State of J&K.
- To suggest measures to achieve greater degree of Financial Inclusion in the country in general and in the State of J&K in particular.

1.7 Problem of Financial Exclusion in J&K State

The term *'Financial Exclusion'* is used in different ways but it is generally related to a lack of access to affordable financial services to individuals, households and communities who are generally unprivileged in term of wealth, education and location. Figure 1 outlines the key components of financial exclusion.

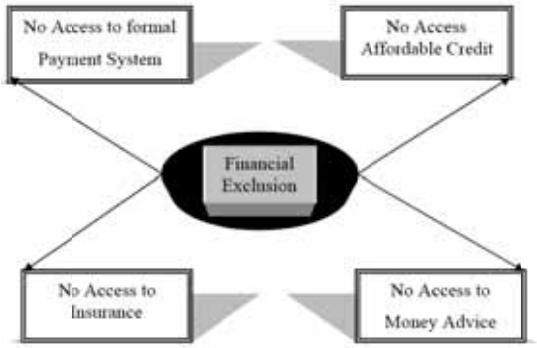

Figure 1. Components of Financial Exclusion

As already stated that the problem of Financial Exclusion is severe in the country. The State of Jammu & Kashmir is no exception to this socio-economic problem which has been analysed in some detail in the following para's. To analyse the problem of Financial Exclusion in the State, Access to Banking Services, Affordable Credit and Money advice to adult population in the state has been studied.

1.8 Access to Banking Services

Full (100%) Financial Inclusion requires that all adults/households have access to formal payment system and savings safety net. This would require that each adult should have a bank account for making and receiving payments and parking savings through deposits and insurance. But as per the available data, unexpectedly large portion of the state's population is still *'Unbanked'* i.e. without a bank account of any kind. As per the available data, 54 percent of the adults or 8,37,954 out of 15,51,768 households in the state have been found without access to any kind of bank account which is more than the all India average of 41 percent. These figures are also more than most of the states in the country.

Further analysis of the data about unbanked population in the state reveals that unbanked households are mainly concentrated in the lower strata of the society. As can been seen from the Figure 3, 79 percent of the unbanked households in the state belongs to the lower income group. This finding corresponds with the findings at the national level as well at the international level. Further the data on locational distribution characteristics, highlighted in Figure 4 reveals that overwhelming majority of unbanked households are located in rural areas followed by sub-urban areas. As can be observed from the figure that 62 percent or 5,19,531 out of the total 8,37,954 unbanked households are located in rural Kashmir. It can also be observed that only 9% of the unbanked households belong to the urban Kashmir. This finding again falls in line with the general trend at the national level.

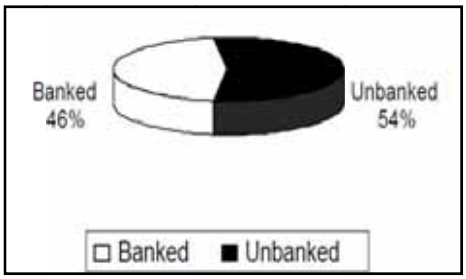

Figure 2. Banked and unbanked population

Source: Reserve Bank of India.

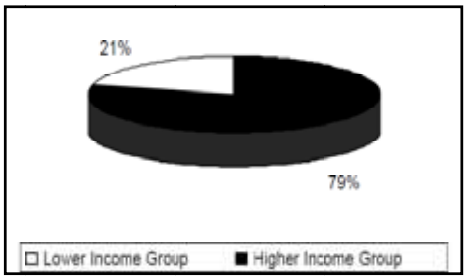

Figure 3. Distribution of unbanked population among lower income group and higher income group

Source: Reserve Bank of India.

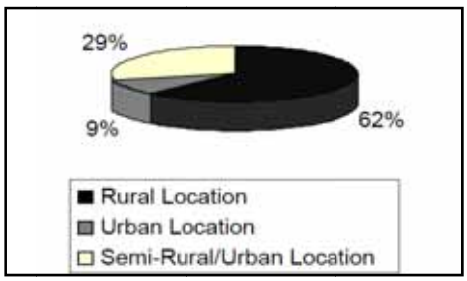

Figure 4. Locational characteristics of unbanked population of Kashmir

Source: Reserve Bank of India.

2. Access to Affordable Credit

The problem of Financial Exclusion in respect of access to credit is much worse than the problem of access to banking services in the state. The data on access to formal credit reveals that majority of the households in the state lack access to Formal Credit markets. As on 2006-07, out of the total 15,51,768 households, only 1,00,709 households enjoyed access to formal credit system which accounts for just 6.49 percent of the total households in the state. The comparative data on access to credit clearly reveals that the state of J&K is far behind to the national averages and also to the similar type of states like Himachal Pradesh etc. At the national level 9.5 percent of the total households as on 2006-07 lacked access to credit which is little better than the state of Jammu & Kashmir (J&K). On the whole the country suffers on this front of financial exclusion.

The problem of financial exclusion in respect of easy access to credit is more prevalent in rural areas than the urban areas of the valley. Out of the total 14,51,059 households which are without any access to a formal credit system, overwhelming majority i.e. 88.01 percent belonged to the rural areas. The reason for this more distribution towards rural areas is that 82.29 percent of total households are rural and also that the problem of financial exclusion is more in the farm sector. The more problem of credit exclusion among the rural households is not only the state specific problem but at the national level also more households without any access to formal credit system belongs to rural areas for obvious reasons.

Further analysis of the data reveals that most of the households without any credit coverage under formal financial system, raise credit from non-institutional sources like money lenders, relatives, friends and neighbours, however, money lenders constitute an important sources of all non-formal sources. Again the non-institutional credit is more prevalent in rural areas than the urban areas. It has also been found that the share of non-formal credit in urban areas has declined over the period which is somewhat pleasing to note.

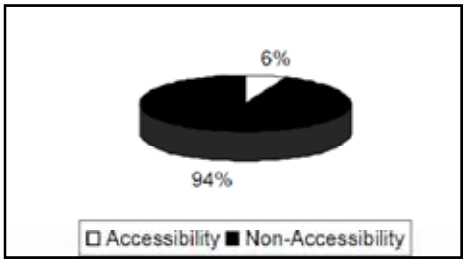

Figure 5. Accessibility and non-accessibility of households to formal credit system

Source: Reserve Bank of India

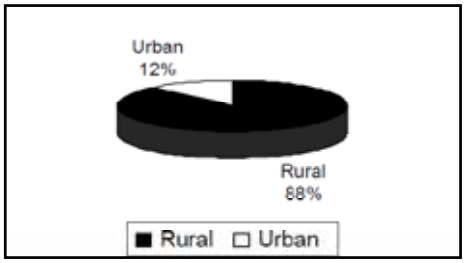

Figure 6. Non-accessibility to formal credit system among rural and urban households

Source: Reserve Bank of India

2.1 Initiatives for Total Financial Inclusion

From the above it becomes clear that the vast majority of people particularly those belonging to farm sector and the artisans lack access to affordable financial services in particular access to cheap bank credit. This is also acting as a constraint in the much needed socio-economic development of the unprivileged sections of the society in the country. Ms U. Throat (2007) has held that the limited access to financial services to the people belonging to farm sector and unorganised sector is acting as an impediment to growth in these sectors, thus acting as a dampener in the overall socio-economic growth scenario. The Central Bank of the country was conscious of this fact and has accordingly taken measures to obviate this situation by asking designated banks in each state/region to achieve *"Greater Financial Inclusion"* in their respective districts/regions by implementing the measures initiated by RESERVE BANK OF INDIA. In 2006, one district in each state was identified by the State Level Bankers Committee (SLBC) for 100% Financial Inclusion.

In J&K State as a pilot project, the erstwhile *'Pulwama District'* was selected for total (100%) financial inclusion. Accordingly the district was allotted to various banks operating in the district viz, J&K Bank Ltd., SBI, PNB and Co-operative Bank Ltd. Only J&K Bank has taken a challenge of achieving the targets towards total Financial Inclusion. It is unfortunate to state here that other banks have miserably failed to achieve their targets. To achieve greater success in its mission of achieving total financial inclusion, J&K Bank Ltd. used the following strategies:

- In the first place, it mainly focussed on bringing the excluded people into banking savings net by opening no frills account.
- To achieve the targets for opening the no frills accounts; the bank launched vigorous campaign in the district by holding awareness camps. The bank also utilised the services of *'Village Level Worker'* (VLWs) to mobilise people for awareness camps in different villages.

- DLRC/DCC meetings on quarterly basis were held in order to assess the progress in financial inclusion where generally defaulting banks were impressed upon to bring forth the results.
- Organised loan camps for the farmers where loans were sanctioned on the spot.

2.2 Impact of Financial Inclusion Drive

The analysis of achievements made on the *'Total Financial Inclusion'* front in the designated district by the various banks reveals some success and some failures. It can be seen from the data contained in table 1 that of the different banks entrusted with the responsibility of achieving greater financial inclusion in the district, only J&K Bank Ltd. has achieved some worthwhile results. It is disheartening to note that other banks viz, SBI, PNB, ACC Bank and ED Bank have failed miserably towards achieving their targets of financial inclusion. As can be seen from the said table that PNB, ACC Bank and ED Bank have failed to open even a single *'No-frills Account'* while as State Bank of India (SBI) could open just 81 'No-frills Account' which account for just 0.0007% of the total households in the district. These banks seem to have failed to achieve their targets partly due to poor branch network and more importantly due to the lack of any serious initiative to achieve greater financial inclusion in the designated district. J&K Bank Ltd., a premier financial institution in the State has been the only bank to have made greater strides towards total (100%) Financial Inclusion in the district. In just less than two years, the bank has succeeded to convert 66.91 percent of the total families in the banking services net by opening 67071 *'No-frills Accounts'* which by all means is a remarkable achievement (see table 1 for details). However, on the credit front, the performance of the bank has not been upto to the mark. In the two years period, (2006 - 07 & 2007 - 08), the bank could issue General Credit Cards (GCC) to 291 households only which account for 0.00254 percent of the total households in the district. The total amount of Credit disbursed through GCCs by J&K Bank has been a meagre amount of Rs. 65.13 lacs. SBI which has opened some no-frills account in the district, but has totally failed on the credit front by not issuing any GCC.

Table 1. Impact of Financial Inclusion in Pulwama District of J&K State

Banks	**2006 -07**	**2007 -08 (30-09-08)**	**Total**
J&K Bank Ltd.			
No. of no. frills accounts	13,550	53,521	6,7071
o Amount Mobilised	4.98 cr.	71.38 cr.	76.36 cr.
o % age of families covered	11.87%	62.54%	66.91%
o % age of Village Covered	60%	34.90%	94.9%
No. of GCCs Issued	130	161	291
o Amount of loan sanctioned	29.53 lacs	35.6 lacs	65.13 lacs
o % age of families covered	0.00094%	0.0014%	0.00254%
State Bank of India (SBI)			
No of no frills Accounts	62	19	81
o Amount Mobilised	0.11 lacs	0.07 lacs	0.18 lacs
o % age of families covered	0.00054%	0.00016%	0.0007%
o % age of villages covered	NA	NA	NA
No. of GCCs Issued	Nil	Nil	Nil
Punjab National Bank	Nil	Nil	Nil
ACC Bank	Nil	Nil	Nil
ED Bank	Nil	Nil	Nil

Source: Official Records of J & K Bank Ltd.

3. Conclusions

From the above, the following three important inferences can be drawn about the total financial inclusion in the designated district:

- Except J&K bank Ltd. all other banks have failed completely towards achieving total financial inclusion in the district. The J&K Bank Ltd has succeeded in achieving its targets in opening the 'no-frills' accounts.
- All the banks including J&K Bank Ltd. have failed in achieving total financial inclusion in terms of providing affordable credit to the people. Like other parts of the country, banks in the state have unfortunately focussed mainly on opening of No-frills accounts and less on providing affordable credit to the unprivileged classes of the society which is rather more important aspect of total financial inclusion. As such making total financial inclusion more meaningful, ensuring affordable credit calls for more attention on the part of banks.
- Perusal of records and discussions with the officers of J&K bank revealed that the bank has also targeted students of colleges and schools in order to bring them within the banking realm for the purpose of achieving targets

towards total financial inclusion is objectionable. This is owing to the fact that only those shall have to be included for financial inclusion whose family has no previous bank account. Further, only adults are required to be covered for financial inclusion but the fact is that most of the college/school children are minors.

- Towards achieving the total financial inclusion in some states, banks in association with insurance companies have also taken steps to provide social security to unprivileged social class through innovative insurance schemes. But in Kashmir Valley, banks have totally ignored this aspect of financial inclusion.

4. Suggestions for Greater Financial Inclusion

Although many of the banks in the state have failed to achieve their targets towards total Financial Inclusion, yet J&K Bank through its large branch network has helped the state to achieve financial inclusion to a satisfactory level, in the selected district, however, to the extent of opening of 'no-frills' accounts only. In fact, all other banks in the state have failed miserably in bringing the financially excluded into *'Credit Net'*. The failure of the banks in the state is being partly attributed to the lack of any serious effort on their part towards the same and partly due to the lack of any well conceived strategy to cover the financially excluded under the affordable credit net. The fact is that the most important element of financial inclusion is to ensure access to affordable credit to the financially excluded people to uplift them economically. As such banks in the state would need to pay equal attention rather more attention to this aspect of financial inclusion. Towards this goal, the following few suggestions are made:

In many states, banks have involved SHGs to achieve greater financial inclusion which has proved successful. Similarly, banks in the state should use the mechanism of SHGs to cover financially excluded under the banking net. The successful use of SHGs would require taking the following steps:

- Conduct Awareness-cum-training Programmes for SHGs to educate the groups about the rationale of financial inclusion and train how to plan and control their finances.
- Ask SHGs to prepare the *'Micro Credit Plans'* (MCP) for each member of the group which should include capital investment and working capital for proposed economic activity. It may also include credit needs for social activities. The bank official may participate in the deliberation of a Group, however, as an observer only.
- Branch Manager should convene meetings with each member along with group leader to validate the MCP.
- On the basis of MCP fix credit limit. The limit should meet the requirement of the member fully. Further the loan should be tailored to meet the specific needs of members. It is also important that the loans should at provided at concessional rates and without any requirement of a collateral.

SHGs are presently meant for women only. However, for the purpose of total and meaningful financial inclusion, men also should be allowed to form SHGs which would enable to enlarge the canvas of financial inclusion.

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