ET 24 Oct '06

# Nobel art of financial inclusion

Populist and prejudicial considerations are limiting the inclusiveness of the financial system and cramping the economic growth process, says **Sanjay Sinha**

INCLUSION is one of the buzz words of the world financial system today. Inclusion is the term used to delineate the extent to which all sections of a society have access to the formal financial system. The Norwegian Nobel Committee has given a substantial fillip to the objective of financial inclusion by awarding the 2006 Nobel Peace Prize to Prof Md Yunus and his Grameen Bank. Worldwide, Yunus and Grameen are acknowledged as having made the most path-breaking impact on access of the world's marginalised families to formal financial services. Awarding them the Nobel is a dramatic reiteration for the general public of the role played by them in promoting financial inclusion in today's world.

In India too, microfinance has played a substantial role in promoting financial inclusion. Starting with a significant upward movement in the late 1990s, microfinance through independent microfinance institutions (MFIs) and through the linking of self-help groups to banks has now reached some 15 million families. This number is large by any considerations but the detail does not allow room for complacency about the outreach of financial services to the population as a whole.

The limits to financial inclusion are set by the sheer numbers of India's poor, over 70 million families, meaning that, at best, 21% of the poor are reached by microfinance. This limit is further constricted by the knowledge that not all those excluded by the financial system can strictly be described as poor and, as a result, many of those served by microfinance have incomes that are well above the poverty line. Indeed, according to information from the 2001 census, only 36% of all the families in the country have access to any form of formal financial services.

The Nobel committee has lauded Yunus and Grameen for enabling "large population groups (to) find ways in which to break out of poverty." But in India, little has been done to facilitate similar ways; the banks even with branches spread all over the rural areas are reluctant lenders even to the relatively well off in rural areas, the cooperatives are poorly run and have lost the confidence of the public, and the microfinance institutions are limited by restrictions on deposit taking, on the one hand, and by government pressure on the interest rates at which they lend on the other.

SALAM

Yet the fact that the economy is reportedly growing at around 9% per annum should make us pause awhile and think of the wider question of inclusion of the majority in the process of economic growth. Greater access to the financial system would enable increasing numbers of people to benefit from the country's burgeoning economic growth. But how to promote that access presents a conundrum for policy makers. Populist considerations demand that lending interest rates should not be allowed to exceed 12-15%, while fears of fraud demand that deposit takers be carefully controlled by the financial regulator — the Reserve Bank of India. As a result, one recent measure allowed by the RBI — the circular allowing NGOs and other local institutions to act as correspondents for deposit taking and lending by banks — has been crippled by the limitation that the cost of the correspondent should not be passed on to the customer.

THUS, banks must pay correspondents above the 4% rates they pay clients for passbook deposits and within the 3-4% administrative costs they incur on lending. Given their cost structures, it is not surprising that banks are offering just 1-2% to correspondents for their services. Since the cost of servicing small sums of money tends to be high (in relation to the size of the transaction) it is small wonder that this measure has received a less than enthusiastic response.

So what is the answer to facilitating economic empowerment and enabling greater access to the human right to financial services? The answer must be to set aside populist and prejudicial considerations. The banks should be allowed to make small loans at whatever it costs to administer and recover such loans, and microfinance institutions should be allowed to operate in an environment of freedom from bureaucratic harassment.

Studies have shown that the banks could profitably make small loans at rates between 20-24%, the same rates that the more efficient MFIs charge on their lending. In any case, even today, in the much lauded bank-self help group linkage model, the average SHG member receives loans at around 24% interest. At the same time, MFIs should be given a legal framework to raise deposits from micro-clients at least up to half the level of their lending to those clients so that micro-deposit facilities become immediately available, on the one hand, and the MFIs are able to augment their on-lending funds, on the other.

Concerns about consumer protection in this system as in any other can be addressed by the regulator and it is likely that competition amongst and between MFIs and banks will lead to increasing efficiency and bring rates down perhaps to 20% or even 18% in the same manner that average MFI rates have declined from 30% to 24% over the past few years as experience and competition have improved efficiency. What is important here is that regular and formalised channels of credit and deposit services become genuinely available to the large majority of the population unhindered by policy level considerations of what is an appropriate price or what is an appropriate service.

The experience of the past 15 years has demonstrated conclusively that it is free consumer choice rather than official diktat that promotes growth. A more inclusive financial system resulting from free consumer choice will only accelerate the inclusiveness of the economic growth process. Achieving such financial inclusion will be a truly noble act and promoting it is a Nobel art worth pursuing.

*(The author is managing director, Micro-Credit Ratings International Ltd)*