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Inclusion and regulators' dilemma

The Raghuram Rajan Committee has made excellent recommendations to promote financial inclusion. Regulators need to take a few bold steps to release the energy of the financial system in favour of the excluded, says **Sanjay Sinha**.

SUPPORTING development and growth of the financial system at the same time as ensuring its smooth functioning is the role that all national financial regulators are required to play. The usually conflicting tensions between liberal rule-making and forbearance on the one hand and cautious restraint on the imprudent behaviour of mavericks on the other, is a dilemma that regulators must live with.

By and large, regulators are a conservative lot and tend to favour caution over liberal growth. Thus, in India we have seen the facilitation by regulators of a high capital financial system while alternatives with lower capital requirements are either limited to government ownership, as in the case of the regional rural banks, or disallowed altogether in the insurance sector. The result is a financial system that is skewed towards the needs of the largely urban, organised economy while smaller and more informal enterprises do not enjoy the same access to the formal system. The net result is a far higher cost of doing business for small and informal enterprise than would occur in a more liberal regulatory regime.

The dampening effect of regulatory conservatism on economic inclusion and ultimately on economic growth is a matter that can only be speculated upon. The excellent report of the Raghuram Rajan Committee on financial sector reforms estimates that a better functioning financial sector alone could release enough economic energy to add up to 2% to the rate of economic growth. This is not a release to be sneezed at.

For this, the Raghuram Rajan Committee makes a number of important proposals. First, the committee favours the introduction of what it calls "small finance banks": deposit-taking banks with far lower levels of capital than the Rs 300 crore of equity that conventional commercial banks are required to have. The risk associated with the limited geographical focus of such banks would be offset by higher capital adequacy norms and lower allowable concentration in loans to a single party. This is essentially a revival of the local area bank idea that was abandoned by the RBI amidst concerns about the honesty and viability of such banks. Yet, as the committee points out, recent experience in India and elsewhere shows there is no direct correlation between honesty and the size of banks. By being more selective in applying its "fit and proper" criteria to a larger number of applicants, the RBI can in fact ensure a better and more responsible management than is possible with the few applicants there are for large bank licences. Viability, the committee argues, can be improved by applying technological solutions that will also enhance transparency.

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Second, the committee recommends the liberalisation of the business correspondent regulation by allowing more diverse local agents to extend such services while using technology to reduce transaction cost and limit fraud. This would enable the tapping of various distribution networks such as cell phone kiosks and *kirana* shops for bridging the last mile between large banks and small, and sometimes geographically scattered, customers.

Third, the recommendations of the Vaidyanathan Committee on cooperative reforms are reinforced to emphasise that better management would result if members of cooperative institutions had their funds at stake since this would lead them to exercise real control because there would be no prospect of government intervention or interference. This would enable unviable cooperatives to be closed while the best ones could even explore the possibility of conversion to small finance banks.

Fourth, the committee argues for the liberalisation of the interest rate regime with appropriate safeguards such as full transparency on the effective interest rate and publication of annual average and maximum rates charged to the priority sector.

THE committee reinforces these excellent recommendations with an innovative proposal for the introduction of priority sector loan certificates (PSLCs) that would be tradeable so that banks deficient in the achievement of priority sector lending would be able to purchase PSLCs from those that have been able to exceed the targeted amount. This would provide a market-based cross-subsidy to priority sector lending.

These recommendations have excited surprisingly little public debate so far. In the initial discussion in the business media, the report was faulted mainly for being too far-sighted for the financial establishment to swallow. In the Indian context, this is a well worn argument that has, in the past, buried far less exciting proposals of official committees. In a time of reform, the needs of inclusive growth demand that such thinking be abandoned.

If anything, the committee's smooth prose is disarmingly polite so that less well-informed readers would be in danger of missing the point about the nature and urgency of reform to revitalise the growth process. Further, the proposals stop short of completing the financial architecture of the country. While last mile connectivity to customers is covered in proposals to liberalise the business correspondent regulation, the needs of the fast-growing microfinance sector find no specific mention. Yet, it is the microfinance institutions that have the potential to provide both consumer and enterprise finance to the really poor while small finance banks, reinforced by a liberalised interest rate regime, would lubricate small enterprise and trade with finance.

In addressing the regulators' dilemma, the committee does make the point that the failure of the odd small finance bank is hardly likely to have disastrous consequences for the financial system. What it might have gone on to say is that in order to serve the needs of the vast majority of people in India, regulators need to address every level of the financial architecture; there is little kudos in ensuring their own reputation if it means restricting the outreach of the system. Notwithstanding the collapse of a handful of small financial institutions, regulators in India have an exemplary record. A few bold steps that would release the energy of the financial system in favour of the excluded would only enhance that record.

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