

Chapter 2

A Brief Review of Literature

The literature that forms the backdrop of the study has mainly focused on issues revolving around the importance of financial inclusion and various challenges associated with it together with measures to tackle the problems.¹ The issues related to financial inclusion include availability of physical and financial infrastructure to provide accessibility to banking, technological and technical innovations to reduce transaction costs, and financial literacy to reduce the problem of information asymmetry and the problem of market imperfection in financial services.

2.1 Theoretical Argument for Financial Inclusion

Focusing on the importance of financial intermediation for different agents of an economy, Subbarao (2013) highlights that it provides opportunity for the poor to improve their incomes and quality of life. For the suppliers of the services viz., the banks, it provides steady low cost savings. State can also benefit from financial inclusion as it helps to better channelization of funds and thereby reduce poverty. All these aspects make FI good for the economy as a whole.

2.1.1 *Financial Intermediation and Information Asymmetry*

If the markets are perfectly competitive, characterized by perfect information, financial intermediation acts more like a veil and its role therefore cannot be considered as substantive. Over time however, it has been recognized that information asymmetry and moral hazard problems are integral parts of financial markets. This gave rise to theories that highlight the role of financial sector in

¹See also Schumpeter (1934) of a broader discussion on development.

augmenting growth. A number of channels can be conceived as to show how the transmission may work (Theil 2001).²

2.1.2 Financial Intermediation and Growth

Growth theory tells us that investment is instrumental for economic growth and financial intermediaries play the crucial role of allocation of capital. Generally relation between financial sector and growth is studied theoretically by several authors (see Harrison et al. 1999). Therefore financial inclusion which provides access to financial services to all can be an essential tool to ensure that some sections of society are not deprived and capital is allocated to all sections of society.

2.1.2.1 Role of Savings

Well developed financial sector help bringing savings into the formal system and thereby can aid to gather resources for investments. Diamond and Dybvig (1983) consider financial institutions as ‘coalition of depositors’ who get the resources to be dispersed to the people in times of adversities, risks and thereby provide insurance cover. In developing countries where the poor saves through informal network often lose their money and a large amount of resources remain out of the formal financial system.

2.1.2.2 Improving Productivity and Efficiency

Financial intermediation helps to improve productivity and efficiency by a number of channels. As mentioned by Thiel (2001) by selecting profitable projects they help to improve their productivity further. Provision of liquidity and allocation of risks are other channels where productivity improvement and efficiency can take place.

In the context of developing nations it is observed by many that the poor are unable to use the basic necessary technology due to lack of funds and financial help can improve their productivity helping them to adopt such methods. In case of Indian agriculture NSSO data can be used to show that the farmers with credit have higher productivity than the non borrowers (see Rajeev 2011).

²Theil, Michael (2001) Finance and Economic Growth: A review of theory and the available evidences, European Communities, ECFINC3/469/01-EN, http://europa.eu.int/economy_finance.

2.1.2.3 Financial Intermediation and Human Resource Development

An accessible financial system can help the poor to access resources for education and thereby improve the human resources of a nation. Human resource development can help knowledge building and innovation leading to a situation of increasing returns and further enhance productivity and growth. The relation between human resource and growth has been well established in the growth theory literature (see Romer 1986, 1990). Galor and Zeira (1993) argue that the poor are unable to invest in human capital due to financial market imperfections (particularly due to high cost of borrowing) and therefore forced to continue in unskilled work which diminishes their lifetime earnings and that acts as a vicious cycle. Similarly, restrictions in occupational choice due to lack of education and training is highlighted by Banerjee and Newman (1993) through their model on credit market imperfections.

2.1.3 Policy Transmission Argument

Several policies especially such as monetary policy aims at impacting the economy through interventions in the money/credit market through financial intermediaries like banks. In particular, interventions of the Reserve Bank of India in terms of changing the repo rate, CRR etc. is frequently experienced in the Indian economy. But if half of the population is out of the banking net such interventions cannot be as successful as they are intended to be (Mehrotra and Yetman 2014).

2.2 Importance of FI: Empirical Studies

Empirical studies have shown that financial inclusion is both pro-poor as well as pro-growth. It provides benefits to the households as well as small and microenterprises in the country, and facilitates economic transactions for a large number of new economic agents. Financial inclusion helps low income families to access financial services like savings, credit, insurance etc. These financial services can be used to gain access to education, health care and other necessities to improve their quality of life. With access to financial services, small and microenterprises get an opportunity to use their savings and credit to make productive investments. This in turn fosters financial independence and thus enhances economic growth. (Sarath Chandra and Manju 2010).

Improved financial services not only enhance growth but also reduce poverty and income inequality (Beck et al. 2009). A cross country regression analysis suggests that countries having low GDP per capita, relatively higher levels of income inequality, low rates of literacy, low urbanisation and poor connectivity seem to be less financially inclusive (Sarma and Pias 2008).

Despite having such apparent advantages, innumerable practical issues come in the way of expansion and extension of financial services to a large population. In context to this, the following literature review is divided into a few major concerns associated with financial inclusion.

2.2.1 Infrastructure and Financial Inclusion

One of the major issues associated with financial inclusion is infrastructure. Availability of infrastructure both financial as well as physical should grow parallel to each other. Inefficient accessibility to credit sources weakens the financial status of the economy. Hence, to ensure access to the available credit sources, there is need to create equally efficient financial infrastructure. Studies show that, besides availability of infrastructural facilities and urbanisation of a state, greater availability of banking services can foster financial inclusion, particularly among the low income households (Pal and Pal 2012). Availability of financial infrastructure can help asset recognition by the poor from financial investments (Sarath Chandra and Manju 2010). But in terms of financial infrastructure, there are lacunas with the banking sector such as lack of national and commercial bank branches in rural areas, inaccessibility to ATM's etc., and hence the need to set up more financial institutions like banks, credit bureau, property registries, etc. In order to ease the access to financial sources, Raghuram Rajan Committee made recommendations and suggestions like introducing unique national ID number with biometric information, providing existing subsidies and cash transfers to the poor via banks etc. to encourage use of banking infrastructure by the people.

But the existence of financial infrastructure wouldn't be advantageous if there is no accessibility to it. Therefore to access the available facilities, there should also be a well-established physical infrastructure connecting people to the financial services.

Empirical studies suggest that Physical infrastructure like the network of paved roads, telephone, internet subscription etc. is highly positively significant for enhancing financial inclusion (Sarma and Pais 2008). Chattopadhyay (2011) in his study has cited how improvement in infrastructure in rural West Bengal in terms of electricity, roads, telecommunications, etc. would establish a better overall supply chain management and enhance productivity of physical resources in the rural areas, and lead to greater demand for banking services among the rural population. But infrastructure connecting to banking services is very scarce in nature in many less developed nations. Demirgüç-Kunt and Klapper (2012) in their study in Kenya have found that poor infrastructure and telecommunications and heavy branch regulation, have indeed restricted the geographical expansion of bank branches in that country. Also in India, poor infrastructure has led to poor market linkage which in turn has caused inaccessibility to financial services in poor states like Madhya Pradesh (Rather and Lone 2012).

2.2.2 Innovations and Financial Inclusion

The lack of access to adequate physical infrastructure can be compensated by innovations in banking.

In this context technological innovations are important as technology not only enhances the competitive efficiency of the banking sector by strengthening back-end administrative processes; it also improves the front-end operations and helps in bringing down the transaction costs for the customers. Information and communication, technology (ICT) solutions continue to help banks in providing seamless systems to capture customer data, ensure unique identification, and facilitate financial transaction services using remote connectivity. These systems also ensure uninterrupted service delivery, consumer data protection, customized products, dissemination of information on credit operations, and offer multiple financial products in local languages (Prabha et al. 2013). Use of technology such as payment cards or mobile phones helps easy identification of customers and record transactions electronically and also enables customers to initiate transactions remotely through third party outlets such as post offices and small retailers as agents (Handoo 2010). Technology has the potential of furthering financial inclusion by making small ticket retail transactions cheaper, easier and faster for the banking sector as well as for the small customers (Gupta 2011; Thorat 2008). Innovations such as mobile banking have reduced the cost of transaction and have made payments electronically transferrable and cheaper (Raghuram Rajan Committee Report 2008; Ismail and Masinge 2012).

Using econometric analysis Ismail and Masinge (2012) have identified some of the factors that have influenced introduction of mobile banking by Banks in South Africa, such as perceived usefulness, perceived ease-of use, perceived cost, and the level of customer trust in mobile banking. A major technological development in banking sector is the adoption of core banking solutions which entails networking of branches, enable customers to operate their bank account and avail services regardless of the location, while the advent of ATM's, e-payments, NEFT etc. seamlessly connects people to financial services (Gupta 2011). Another approach is of "banks on wheels" in which a vehicle-mounted bank counter visits areas without regular bank-branches at regular intervals to enable people to make transaction. This model has been found successful in Kenya (Dupas et al. 2012).

Besides technological innovations, the introduction of Business correspondent model and Agency banking by RBI have also revolutionised banking sector in India (Thorat 2010). Bank-led and technology driven Business Correspondent (BC) model was launched in 2006 in India for expansion of branchless banking and to bring about financial inclusion. Handheld models like Business correspondent (BC)/business facilitator model (BF) formulated by RBI have helped to strengthen financial access by extending banking network to far-flung off rural areas in order to provide door to door service to the local populace (Sarath Chandra and Manju 2010). Banks should be enabled to tie up with non-banks through appropriate agency arrangements in order to equip/empower pharmacies, post-offices and super markets not only as agents of banks but also as agents of financial inclusion.

On the lines of the roles and responsibilities of business correspondents (BC's) the contracted entities can undertake the preliminary work relating to account opening formalities, but responsibility for ensuring compliance with know your customer (KYC) norms should remain with the banks. BCs should also aim to create awareness about savings and other products and provide education and advice on managing money and perform debt counselling (Oxford Policy Management Ltd 2011).

Though the BC model was implemented to enhance financial inclusion, there are various unresolved issues associated with it. Prabha et al. (2013) in their study have stated that the BC system lack commercial viability and also adversely affect the Customer service point (CSP) employed by the BC. The other problems associated with it were the selection of BC through bidding system, lack of financial literacy program, operational risk, poor banking knowledge etc. In contrast to the problems associated with BC models, Prabha et al. (2013) make certain recommendations, which include provision for a thorough review of business correspondents by RBI or Indian bank federation before selecting them, promoting viability gap funding to increase investments promoting financial literacy, rewarding BCs who perform better by authorising more products like small loans, etc. and to develop alternate channels like ATM's, internet banking etc. The remuneration structure of BC's has been very flexible since its implementation. From 2006 to 2009 the BC's were not allowed to charge anything to the consumers, but this restriction was removed in 2009 to encourage uptake of BC model; since then banks and BC's have been charging a reasonable sums from customers as service charge (Oxford Policy Management Ltd 2011).

A cross country analysis suggests that agents have been found to offer cheaper (Peru in particular), more accessible (Brazil in particular), and appropriate financial products (Kenya in particular). Therefore, agents can be a key tool for enabling more and more people to open bank accounts, particularly where they have been used to receive CCT payments. Agent networks can also be instrumental in providing important feed-backs to their Banks about their customers. (Oxford Policy Management Ltd 2011).

2.2.3 Financial Literacy and Financial Inclusion

Innovations alone cannot solve the problem of financial inclusion. To utilise the services provided by the banks, it is important that the individuals have the knowledge and skill to use those services. Therefore, financial literacy is one of the very important aspects in promoting financial inclusion. Without financial literacy, and the knowledge to use financial services provided, the financial infrastructure put in place would remain under- used, and therefore result in huge wastage of scarce resources. Hence, financial literacy and customer education has to run parallel to the programmes like Business correspondent models (Prabha et al. 2013). One of the studies by Diaz and Zekri (2013) on Bhutanese population

shows that in spite of having a long term saving goal, most of the respondents couldn't reach it due to poor financial management skills and therefore remedial steps had to be recommended to increase the management skills that would improve the ability to access formal financial services.

Collard et al. (2001) reported widespread lack of knowledge about financial products and services and basic money management skills as the issues related to financial literacy in Bristol, and recommended initiation of school based schemes which provide money management skills and financial education as the remedial measure. Other suggestions they provided include independent advice and explanation on financial instruments by an individual who understands finance, face-to-face programmes for adults etc.

Though a number of studies highlight existence of financial illiteracy among rural population, there are also evidences which show that financial illiteracy among large segments of urban population has limited their access to financial services (Sarath Chandra and Manju 2010). Considering these problems arising out of financial illiteracy, the Rajan committee (Rajan 2008) emphasises the need of providing financial literacy from early schooling years by introducing children to financial terms such as income, expenditure, savings, deposits etc. In addition, TV channels could also be encouraged to run educational programmes on household budgeting etc.

In context to the importance of financial literacy, Rai and Saha (2010) have not only emphasised the importance of financial literacy on the demand end, but also on the supply end where proper training should be provided to bank staff and the field staff to communicate with the customers. Also emphasised is the need to eliminate financial illiteracy at the demand-side by educating the masses of the availability of new banking products like No-frill accounts, etc. and the flexibility of the system to suit the specific needs of the customer. With an aim to spread financial literacy, RBI has formulated a Model scheme for Financial Literacy and Credit Counselling Centres (FLCCCs) and advised Lead Banks to open a Financial Literacy and Credit Counselling Centre (FLCCC) in conformity with the Model Scheme in every district where they have lead responsibility. The objectives of this scheme have been to educate rural and urban population about financial products, to provide face to face financial counselling, to formulate debt restructuring etc. (RBI 2010).

Thus we observe from the review that literature on financial inclusion is either general in nature or rural centric and that there is a lack of studies that focus on urban exclusion, the nature of which is quite different from its rural counterpart. This study is meant chiefly to fill this gap, using both secondary and field level primary data. However, before going to the Indian experiences it is useful to get a global perspective of the problem of financial exclusion and measures taken by different countries to address the problems. Some of these measures we present in the following Chapter; they need not necessarily be for urban populace alone, but nonetheless provide valuable information regarding endeavours of different countries especially developing and emerging nations in this regard.

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