CHAPTER TWO

FINANCIAL INCLUSION:
CONCEPTUAL ISSUES AND EMPIRICAL DEBATES

2.1 The theoretical and empirical literature available on financial inclusion and financial exclusion deals with a number of dimensions. The present review of this literature has been organized under the following seven subheads, each dealing with one specific issue: concepts and definitions of financial inclusion/exclusion; determinants/factors of financial inclusion/exclusion; nature of demand for financial inclusion, consequences of financial exclusion, rationale for financial inclusion, role of financial inclusion in rural development and relevance of financial inclusion in the present day context.

2.2 Financial Inclusion and Financial Exclusion: The Concepts and Definitions
Defining financial inclusion is considered crucial from the viewpoint of developing a conceptual framework and identifying the underlying factors which affect it. A review of literature reveals that there is no universally accepted definition of financial inclusion. The definitional emphasis of financial inclusion varies across countries and geographies, depending on the level of social, economic and financial development of that place and priorities of social concerns. Broadly, financial inclusion means access to finance and financial services for all in a fair, transparent and equitable manner at an affordable cost (Thingalaya et al, 2010). The term ‘financial inclusion’ was coined in the British lexicon as they found that nearly 7.5 million persons did not have a bank account (Raju, 2006). In the Indian context the concept emerged prominently in the
post-liberalization period with the rising exclusion in the country. Hence, it is necessary to understand the concept of financial exclusion before defining financial inclusion.

One of the early definitions by Leyshon and Thrift (1995) describes financial exclusion as the process that serve to prevent certain social groups and individuals from gaining access to the formal financial system. According to Sinclair (2001), financial exclusion means the inability to access necessary financial services in an appropriate form due to problems associated with access, conditions, prices, marketing or self-exclusion in response to negative experiences or perceptions. Carbo et al. (2005) have defined financial exclusion as broadly the inability (however occasioned) of some societal groups to access the financial system. For Mohan (2006), it signifies the lack of access by certain segments of the society to appropriate, low-cost, fair and safe financial products and services from mainstream providers.

RBI (2008) has categorized the definitions of financial exclusion in terms of various dimensions, such as ‘breadth’, ‘focus’ and ‘degree’ of exclusion. The ‘breadth’ dimension is the broadest of all definition linking financial exclusion to social exclusion, whereas the ‘focus’ dimension is in the middle of the spectrum that links financial exclusion to other dimensions of exclusion. The definitions laying emphasis on the ‘focus’ also vary significantly to include various segments of population such as individuals, households, communities and businesses. The narrowest of all definitions, ‘degree’ dimension defines financial exclusion as exclusion from particular sources of credit and other financial services. Moreover, there are certain definitions that define it in relative terms, i.e., the problem of financial exclusion emanating from increased inclusion, leaving a minority of individuals and households behinds. However, this
kind of phenomenon is observed mostly in developed economies with high degree of financial development.

By default, in contrast to financial exclusion, financial inclusion broadly means *universal access* to a wide range of financial services at a reasonable cost (Raghuram Committee, 2008). In a more concise manner it can be defined as *delivery of* basic banking services at an affordable cost to all sections of the society, especially the vast sections of disadvantaged and low income groups who tend to be excluded (Leeladhar, 2005). The Committee on Financial Inclusion in India defines financial inclusion as the process of *ensuring access* to financial services and timely and adequate credit where needed by vulnerable groups such as the weaker sections and low income groups at an affordable cost (Rangarajan Committee, 2008). Along the similar lines, Chakravarty (2006) has defined financial inclusion as *extending the benefits* of banking to the have-nots. When put simply, it means that banks will offer a basic account to anyone who wants to have one (Raju, 2006).

To put differently, financial inclusion implies a coordinated effort in order to *deepen financial services* among a large number of customers (ISED, 2006) and aims at *providing* appropriate, low-cost, fair and safe financial products and services or instruments like bank accounts, affordable credit, assets, savings, insurance, payments and remittance facility as well as money advice from mainstream providers to all (Mohan, 2006). Similar views have been expressed by Thorat (2007) to whom financial inclusion means the provision of affordable financial services (viz., access to payments and remittance facilities, savings, loans and insurance services) by the formal financial system to those who tend to be excluded.
Bernanke (2006) adds a new dimension to the understanding of financial inclusion by saying that it requires substantial efforts in understanding the needs of the customer, counseling, financial literacy, screening and monitoring. Dev (2006) in his definition broadens the scope of financial inclusion by emphasizing the role of new institutional partners such as SHG-linkage and microfinance institutions.

In a broader sense, financial inclusion should not only focus on financial services like credit, savings, etc. but also on an increase in productivity and sustainability of farmers and other vulnerable groups (Dev, 2006). Arunachalam (2008) has also expressed the similar view. According to him, financial inclusion should be about going beyond savings bank accounts and consumption credit, to devise/deliver financial products that can help in overcoming market imperfections and facilitate risk/vulnerability management by (and for) the poor in the context of their fragile livelihoods and the vicious cycle of poverty, often caused by structural weaknesses and other factors.

World Bank (2008) has presented the concept of financial inclusion in a comprehensive manner. It defines financial inclusion or broad access to financial services as absence of price or non price barriers in the use of financial services. It does not, however, mean that all households and firms should be able to borrow unlimited amounts or transmit funds across the world for some fee. It makes the point that creditworthiness of the customer is critical in providing financial services. The report also stressed the distinction between access to and use of financial services as it has implications for policy makers. Access essentially refers to the supply of services, whereas use is determined by demand as well as supply. The Report also highlighted the need of a clear distinction to be made between voluntary and involuntary exclusion among the
non-users of formal financial services. ‘Voluntary exclusion’ refers to those who claim that they do not want a financial service, even if they are not disallowed by the institutions. Whereas ‘involuntary exclusion’ refers to all those who would like to avail the financial services but are unable to do so because of some barriers. The challenge of financial inclusion is the ‘involuntarily excluded’ as they are the ones who, despite demanding financial services, do not have access to them (Bhavani and Bhanumurthy, 2012; Mehrotra et al, 2009).

It is evident from most of the definitions that availability and accessibility are two important dimensions of financial inclusion/exclusion. However, an inclusive financial system does not only imply availability and accessibility. It should also take into account the usage of the services available and accessible. Sarma (2008) also emphasizes these three aspects of financial inclusion. According to her, financial inclusion is a process that ensures the ease of access, availability and usage of the formal financial system for all members of an economy. However, unless a service is available, the question of accessing the service does not arise. Hence, financial inclusion can be redefined as a process that enhances availability, smoothens accessibility and ensures usage of the basic financial products and services for all sections of the society. It is this definition that has been used as a yardstick throughout this study.

The literature also points out that there are gradations of financial exclusion/inclusion. These range from those who are ‘hyper-included’ to those who are ‘unbanked’. The ‘unbanked’ are excluded by the banks and are without any form of transactional bank account and have no access to mainstream financial services. In between these
extremes, there are ‘underbanked’ or the marginally banked ones, i.e. those who have a bank account but do not use it regularly or adequately to manage their money (Kempson, 2006). A report on financial exclusion in Australia in 2004 by ANZ Banking Group has highlighted another group who are ‘included, but using inappropriate products’ – these individuals are sometimes “victims” of inappropriate financial products.

According to Leeladhar (2005), there may be various degrees of financial inclusion or exclusion. There may be some people who are denied access to even the most basic financial services. They may be called as ‘super excluded’. On the other hand, there may be some ‘super included’ people who have access to a wide range of financial services and products. In between are those who use the banking services only for deposits and withdrawals of money, who may have only restricted access to the financial system, and may not enjoy the flexibility of access offered to more affluent customers.

In view of the above discussion, the term ‘financial inclusion’ in the context of present study has been defined as a process that enhances *availability*, smoothen *accessibility* and ensures *usage* of the basic financial products and services for all sections of the society. During the course of study, the extent of financial inclusion/exclusion will be measured keeping all these dimensions in perspective.

### 2.3 Determinants of Financial Inclusion/Exclusion

The nature and forms of financial inclusion/exclusion are varied and so are the factors responsible for it. Therefore, no single factor explains the phenomenon. The nature and
extent of financial inclusion/exclusion are influenced by several factors which can be classified broadly into supply and demand side factors. The Reserve Bank’s Committee on the Financial Sector Plan for Northeastern Region (RBI, 2006) highlighting some of the major issues holds that the low level of financial inclusion in the region including Assam is mostly related to supply related issues, i.e. lack of appropriate financial services. Dev (2006) has expressed the similar view that there are many supply side problems for commercial banks, RRBs and cooperative banks. The number of bank branches in the state has increased marginally whereas population has increased at an alarming rate leading to high APPBO in the state. The distribution of bank branches in the states has been quite inadequate and uneven, and mostly located in and around the state capital and district headquarters. The unviable branch-intensive banking in rural areas, which happens due to a number of reasons, such as, the high cost of posting bank personnel to rural areas, the lack of local knowledge of bank staff, infrastructural and technology problems in rural areas, bureaucratic procedures, corruptions, political interference, non-performing assets, especially in lending to small-scale industries etc. also plays an important part in limiting the expansion of branch network in the rural areas. Further, the peculiar geographical topography having large hilly area with sparse population, scattered villages and poor and costly and sometimes ineffective transport also curtails possibilities of approaching a formal sector branch. Then, the poor services at bank branches also play an important part. Inconvenient timings, delay in services because of cumbersome documentation and procedures, unsuitable products, linguistic incomprehensibility, etc. are some of the important factors which make the poor and needy people take resort to the informal sources. And to all these, the indifferent approach of the individual service providers and insensitivity towards the needy add to
the low credibility of the banking sector in the eyes of the deprived class. Moreover, in
the hilly region, which comprises some parts of Assam, the penetration of bank credit is
also hindered by non-establishment of transferable property rights on land
(Chakravarty, 2006; Dev, 2006; RBI, 2006).

The poor people do have demand for financial services; in fact, they often bear the high
costs charged by the informal financial markets for various types of services, apart from
the risk involved in such products (RBI, 2006). The fact that the poor are capable of
weekly repayments shows that the poor are capable of savings, even if it is only in
small amounts. However, one of the reasons why the poor might not save in financial
form might be the lack of appropriate products.

According to Thingalaya et al (2010), appropriateness of the financial products/services
and how their availability is marketed are crucial in financial inclusion. Exclusion
occurs because the products are inconvenient, inflexible, not customized and are of low
quality (Arunachalam, 2008; Basu and Srivastava, 2005). Sinha and Subramanian
(2007) express the similar view that the consumer/clients don’t want to settle for cheap,
stripped-down versions of mainstream products. They want attractive offers. The poor
economics of serving this group, however, undercuts the formal sector’s ability to
develop products for them. Many offerings in the informal sector provide features like
suitability, timeliness, convenience, flexibility, adequacy and better understanding of
the demands of the needy, etc., whereas most offerings in formal sector are
comparatively rigid, unsuitable and inconvenient. This gives the informal sources an
edge over the formal sources.
Even if the products are appropriate, terms and conditions attached to products such as minimum balance requirements and conditions relating to the use of accounts, often dissuade people from using such products/services. In addition, many banks have not developed the capacity to evaluate loan applications of small borrowers and unorganized enterprises and hence, tend to deny such loan request (RBI, 2008).

Financial literacy and awareness are important factors which determine the extent of access and usage of available financial products/services. Exclusion occurs when clients are not aware about the products and services available, their use/relevance in meeting needs and their contribution to risk management strategies. Financial literacy of the poor is also very critical to building a vibrant and competitive low income financial services sector that facilitates affordable and need based access to financial services rather than mere access alone (Arunachalam, 2008; Sinha and Subramanian, 2007). High percentage of illiteracy and social exclusion play an important role in keeping the level of awareness regarding newer and better service plans and facilities low.

People and attitudes/alienation from banks also determine the level of inclusion. Exclusion could occur when staff delivering services is not well-suited to their role (Arunachalam, 2008). It is necessary for the proper functioning of the financial system that staff cares for the client’s welfare, they deal with clients in a timely, patient and concerned manner, and they are trained specially to deal with the poor. In the similar line, rural banking has to be friendly to small and marginal farmers and other vulnerable groups. It requires a specific type of organizational ethos, culture and attitude (Rangarajan, 2005).
Arunachalan (2008) while endorsing the UNDP’s country programme (2008-12), “Promoting social, economic and political inclusion for the most disadvantaged, especially women and girls” in seven states of India observed that there are several aspects of financial inclusion which must be taken care of to avoid the cycle of inclusion and exclusion, i.e., people who have been temporarily included would be excluded again. According to him, better delivery of products is one of the factor which can avoid the cycle of inclusion and exclusion. He says exclusion occurs when clients cannot be reached easily and at low transaction costs. It is, therefore, essential to have a simple and convenient process of delivery, accessibility in remote areas, lower transaction costs and minimal documentation and other requirements for clients to remain included in the formal system.

Literature also points out the possible impact of government policies on the access of financial services. According to Basu and Srivastava (2005), the Indian Government’s polices like persisting interest rate restrictions, government’s interference in rural banks, high fiscal deficits, etc. make things difficult from the banks’ perspective, creating a ‘financial climate’ that is not conducive to lending in general, and rural banking in particular.

Apart from the supply side factors, demand side factors also have significant bearing on the extent of financial inclusion. Despite the huge demand for financial services, there are many factors that act as barriers to the demand of financial inclusion, such as, low productivity and risk and vulnerability of small and marginal farmers, low level of commercialization, low income/assets, high level of grants per capita, poor and costly transport, low skill and poor market linkages for rural non-farm and urban workers,
vulnerability to risk for rural landless and urban poor and low financial literacy (Dev, 2006; RBI, 2006).

According to Sinha and Subramanian (2007), the leading reason for financial exclusion is the lack of a steady, substantial income, which means people have little incentive to open a savings account and are not likely to qualify for a loan. The percentage of population below the poverty line (BPL) also determines the level of financial exclusion. A higher share of BPL population results in lower demand for financial services as the poor may not have savings to deposit in savings banks. Similarly, at low levels of development, investment activity may be low, thereby low demand for credit from banks and other formal financial institutions. Thus, low income leads to low demand for financial services. However, with decline in the poverty level, households’ propensity to save increases as they move into higher income group, and it leads to higher demand for financial services both for saving and investment purposes (RBI, 2008).

Lack of formal employment throws up additional barriers to inclusion in the formal sectors. Households with sporadic incomes find it difficult to accumulate savings and tend to earn and spend their wages in cash, so their transactions circumvent banks. As a result, they never develop a verifiable transaction history, which is a common prerequisite for obtaining loans in the formal sector (Sinha and Subramanian, 2007).

Income inequality has received much importance in various writings as an important factor determining the extent of inclusion at all levels. According to Kempson (2006), countries with low levels of income inequality tend to have lower levels of financial
exclusion, with high levels of exclusion are associated with the least equal ones. At national level, it has been observed that the glaring disparity between rural and urban household income is responsible for vast difference in rates of financial inclusion in rural and urban areas (Sinha and Subramanian, 2007).

The level of consumption in any region also determines the need of financial services in that region. The NSSO’s consumption data reveals that the level of consumption in the region is above the national average while the level of income is markedly lower (RBI, 2006), thereby leading to low savings and low asset base with the banks, and hence, less demand for banking services.

According to Rangarajan (2008), the extent of inclusion/exclusion varies widely across social groups, occupational groups and regions. The NSS data shows that across social groups, indebtedness through formal sources is lower for scheduled tribes as compared to others. The poorer the group, the greater is the exclusion. Marginal and small farmers are more excluded than medium and large farmers. The NSS data also shows that the share of formal loan sources increases with the size of land holdings (Dev, 2006). This seems to be one significant reason for a very low level of indebtedness of the farm households to the formal sources in Assam since the average size of land holdings (1.17 hectares as per 1995-96 Census) in the state is very small. Similarly, access to land also determines access to other sources for the marginal farmers (Kelkar, 2008).

According to Arunachalam (2008), structural barriers also determine the level of exclusion. The vulnerabilities of the poor are not just linked to their extremely weak
asset base but also rooted in the social, economic and political barriers they face. This is particularly true for the socially excluded groups among the poor such as tribals, dalits, minorities and women who are more vulnerable. Therefore, inclusion is not just reaching out to the poor in a technical sense but also means removing the barriers and structural inequalities they face.

The level of financial inclusion also varies among the genders. Access to credit is often limited for women who do not have, or cannot hold title to assets such as land and property or must seek male guarantees to borrow. Moreover, lack of legal identities like identity cards, birth certificates or written records often exclude women, ethnic minorities, economic and political refugees and migrants workers from accessing financial services (RBI, 2008).

Age and geographical location/place of living have also been identified in literature as important factors in identifying those at risk of banking exclusion (Kempson, 2006). The very young and very old are more likely to be unbanked than the general population, just as the people living in rural areas are. According to RBI (2008), financial service providers usually target the middle of the economically active population, often overlooking to design appropriate products for older or younger potential customers. Similarly, factors like density of population, rural and remote areas, mobility of the population (i.e., highly mobile people with no fixed or formal address), insurgency in a location, etc. also affect access to financial services.

According to Agarwal (2008), cost, non-price and behavioural factors are very important in limiting the spread of financial inclusion. Transaction Cost which remains
high for both banks and clients is one of the important hindrances from demand and supply side perspective. Poor do not utilize the financial services as they find it costly and unaffordable. For many households in rural areas, the cost of visiting a branch is prohibitive as it includes not only transportation but also the loss of daily wages (Agarwal 2008; Basu and Srivastava, 2005; Sinha and Subramanian, 2007). Hence, even if financial services are available, the high costs deter the poor from accessing them (Arunachalam, 2008).

Agarwal (2008) has also emphasized on the non-price factors, like documentation, distance, infrastructure, etc. Access to formal financial services requires documents of proof regarding a person’s identity, income, etc., which the poor people many times do not have and hence are excluded from these services. Most of the time, even if they subscribe to these services initially, they may not use them actively as others because of high distance between the bank and residence, poor infrastructure etc.

Research in behavioural economics has highlighted the behavioural aspect as another important factor. Many people do not use formal financial services because they are not comfortable using it for various reasons, like difficulty in understanding languages, various documents and conditions associated with these services, etc. (Agarwal, 2008).

According to Mohan (2006), the factors which make it difficult to expand institutional credit in rural areas are risk perception, costs of its assessment and management, lack of rural infrastructure and vast geographical spread of the rural areas with more than half a million villages, some sparsely populated. He further emphasized that the slow deposit growth can also suffer financial inclusion. If deposit growth does not match credit
growth, excess demand would inevitably lead to increase in real interest rates leading to further possibility of financial exclusions. Similarly, Kelkar (2008) has also emphasized the importance of rural infrastructure and risk management measures in agriculture in promoting financial inclusion in rural areas.

Basu (2005, 2006) has identified collateral and bribes as two important roadblocks that rural households face when they attempt to take loan from a bank. Banks require collateral to give loans. Rural Finance Access Survey (RFAS 2003) conducted by NCAER and the World Bank found that a little less than 90% of those who borrowed from banks had taken loan against collateral. In rural areas, the most common form of collateral is land and lack of clear title in rural areas would clearly preclude a sizeable proportion of the poor (United Nations, 2006). The survey also indicates that bribes, ranging from 10% to 20% of the loan, are common in all formal financial institutions including banks, RRBs and credit cooperatives. Further, the average time taken to process a loan application is almost 33 weeks in a commercial bank. Such cumbersome and costly procedures make it unattractive for households to rely on formal finance (Ramji, 2007).

Kempson (2006) has also given importance to the psychological and cultural factor which deters people from using mainstream financial services. Rural people may feel intimidated by banks and develop a belief that there is little point applying for a financial product because they believe they would be refused. This self-exclusion by low-income households may be as important a cause for exclusion as direct exclusion by banks. The studies in North East India show that the traditional ethnic tribal
cultures, where need for savings and credit is limited, keep a significant part of the population of this region away from the formal banking system (RBI, 2006).

According to Trivedi (2008), the barriers to access in the formal banking sector have been identified as relating to culture, education (especially financial literacy), gender, income and assets, proof of identity and remoteness of residence. The evidence from around the world has also shown that cultural norms, age and gender are important determinants of access to finance (Ramji, 2007).

According to Sinha and Subramanian (2007), the impact of these disincentives and barriers varies widely among the consumers. For some consumers, just one major impediment prevents them from participating in the formal sector. For others, a combination of factors leads them to the informal sectors.

2.4 Nature of Demand for Financial Inclusion (Financial Services)

The poor people do have demand for financial services; in fact, they often bear the high costs charged by the informal financial markets for various types of services, apart from the risk involved in such products. A higher percentage of indebtedness to the informal sources not only indicates the failure of formal sources but also the demand for the financial services. Empirical research in Asian and African countries has demonstrated this fact (RBI, 2006). The informal sources have an edge over the formal sources to address these issues successfully with its basic features like suitability, timeliness,
convenience, flexibility, adequacy and better understanding of the demands of the needy, by virtue of being an insider (Goyal, 2008; Sinha and Subramanian, 2007).

According to Ray (1997), the demand for credit or capital can be divided into three parts. First, fixed capital that is required for new startups or a substantial expansion of existing production lines, i.e., for the purchase and organization of fixed inputs such as factories, production processes, machines or warehouses. Second, working capital that is required for ongoing production activities, which occurs because of the shortage of enough savings to fill up the substantial gap between the expenditure required for normal production and sales receipts. Finally, there is consumption credit, mainly demanded by poor individuals who are short of cash, either because of a sudden downturn in their production, or a sudden fall in the prices of what they sell, or perhaps because of an increase in their consumption need caused by illness, death, or festivities such as a wedding.

Highlighting the demand for credit, RBI (2008) mentioned that a significant portion of demand for credit by rural households arises in order to ease the financial burden of crop failures, illness or death, and health care. The evidence on the demand of credit in India suggests that medical and financial emergencies are the major reasons for household borrowings. Among the lowest income quartile, medical emergencies are particularly high. In the case of microenterprises, credit may be needed for upscaling business activities.

The study conducted by Ruthven in 2002 revealed that life-cycle purposes (birth, marriage, death) were the primary motivations for raising and spending lump sums of
money. Health spending and house construction were also found to be important reasons for saving or borrowing large sums of money. Several studies have found out that the frequently used source of borrowing for the poor are not moneylenders and pawnbrokers, but family and reciprocal contacts such as friends, relatives and shopkeepers (cited in Karmakar et al, 2011).

In addition to these staple demands, the changing structure of Indian agriculture is also increasing the demand for banking facilities. As the development activities in rural areas are increasing, greater is getting the demand for banking activity in these areas. Along with growth of rural infrastructure, there is also likely to be an increase in rural non-farm activities, such as repair activities, education, housing, restaurants and medical services. These activities, both traditional and emerging ventures, would be available for financing by the banking sector (Mohan, 2006).

However, apart from credit there are other financial services like savings, insurance, etc. which are also important. NSSO data shows that around 88 per cent of rural households in 2002 reported one or the other form of financial assets under deposits in various forms, but only 36 per cent of households are using banking services for having a deposit account in 2001 (Dev, 2006). The facility of deposits is one of the key elements of financial inclusion. This is particularly important for the people with low and irregular income. The fact that these are capable of weekly repayments shows that the poor are capable of savings, even if it is only in small amounts. Given a suitable product they might make use of it. Access to facility of safe deposits would not only enable these people to plan their expenditure with convenience but also promotes thrift and develop the culture of savings. Safe deposits ensure withdrawal of money from
accounts as and when required, whereas, the absence of such facility forces people to keep their savings in various informal forms such as cash at home or deposit with relatives/moneylenders and as such the possibility of losing money becomes very high (RBI, 2006).

According to Karmakar et al (2011), all poor households save to manage risk, reduce their vulnerability against natural disasters and other emergencies, smoothen consumption requirements during off-seasons and for investment and many other purposes. Success of informal saving scheme in mobilizing savings indicates that the poor have the capacity and willingness to save. Therefore, there is a demand for savings services for the poor that are safe, secure, convenient and liquid.

Moulick (2008) while analyzing the ‘Savings Behaviour of Poor People in the North East of India’ has reinforced that everyone, including low income people in remote areas, saves; and that too significant amount. However, much of their savings is lost to fraudulent operators in the absence of a secured and accessible savings services. The study reveals that savings in the North East Region including Assam is practiced through informal, semi-formal or formal mechanisms in the form of cash, in-kind or account based savings depending upon the economic status of the user. Each mechanism has certain advantages and disadvantages, which affect the choice of savings options by different economic category. Savings in cash at home has the advantage of liquidity and accessibility, but it is not the preferred mechanism because of its vulnerability to theft or being frittered away. Savings in-kind is more common because of its quicker and higher returns, and also because of traditional social
practices and the status attached to assets like land and jewellery. Nonetheless, savings in kind is highest amongst low income people.

Most people, despite preferring to save in a secure and accessible account in a formal institution, do not save through this mechanism because of the several formidable barriers, such as long distance of formal institutions, unsuitable products offered, insensitive/unfriendly staff members, lack of promotion of new initiatives like no-frills account, etc. In contrast, saving with Non Banking Financial Companies (NBFCs) and other informal sources are more common practices, due to their high outreach and simple processes.

According to Moullick (2008), formal institutions are used mostly by the rich and the least by the poor whereas semi-formal institutions such as Self Help Groups (SHGs) and Micro Finance Institutions (MFIs) cater more to the poor and reach out to the lower segment of not-so-poor category. The poor also often use the informal mechanisms, but the most commonly used option is simply to hold cash savings at home, which is mostly driven by lack of feasible alternatives.

In the region including Assam, lack of access to formal financial institutions has resulted in the emergence of a variety of informal systems based on socio-economic structures and needs, such as Namghars, Pujaghars, Samities (locally referred as Xonchois), etc.

According to Sharma and Mathew (2009) the villagers in Lower Assam are pioneers on the frontiers of informal finance and they use Xonchois extensively. Their survey of
two villages reveals that on an average, each household in the surveyed villages of lower Assam has five Xonchoi memberships and though average member balances appear small, average household balances is quite significant. As Xonchois also provide loan facility to its members and sometimes to non-members but at higher rate, its occurrence has reduced the number of moneylenders in the villages significantly. The study also reveals that despite having a close proximity to bank, individual villagers rarely use it because of its high deposit requirements and fees, combined with the villagers’ low levels of literacy and probably the confidence they have in Xonchois. The success of this system lies in its flexibility and wide range of services offered to accommodate all kinds of households and address the seasonality of rural cash flows.

According to Moulick (2008), for low income people, the attribute of security of savings ranks the highest, whereas distance from or accessibility to services is also considered quite important. However, leveraging savings for loans or getting high returns on savings is in demand, but less essential. Further, relative preference of individual/households for different delivery channels indicates that while banks are preferred for security, SHGs and Xonchois are preferred for accessibility. People prefer SHGs and Xonchois along with insurance companies for high returns for short term and long term savings plan respectively.

According to Karmakar et al (2011) the overwhelming need for rural clients of financial or microfinance institutions is safe deposits of very small and infrequent sums and the need for loans when essentials. They also outlined the required features of the financial products for the rural vulnerable clients, which is presented in Table 2.1.
The poor and vulnerable groups like small and marginal farmers also need some kind of insurance to cope with the risks they face in their day to day life, such as droughts, floods, cyclones, fires, theft, pest attacks, sudden and sharp fall in prices, health problems, accident, death of a family member, etc (Dev, 2006). Although the types of risks faced by the poor are no different from those faced by others, they are more vulnerable to such risks because of their economic circumstances. Citing the reference of a World Bank study which reported that about one-fourth of hospitalized Indian fall below the poverty line as a result of their stay in hospitals and that more than 40 per cent of hospitalized patients take loans or sell assets to pay hospitalization expenses, Karmakar et al (2011) highlighted the role of insurance, particularly micro-insurance. According to them, insurance is fast emerging as an important safety-net strategy even for low-income people who remain exposed to a variety of risks mainly because of the absence of cost-effective risk hedging instruments.

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<td>Timely</td>
<td>Life (Group)</td>
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<td>Safety</td>
<td>Adequate</td>
<td>Health (Group)</td>
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<tr>
<td>Return</td>
<td>Assurance of repeat loans</td>
<td>Non-life</td>
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<tr>
<td>Easy accessibility</td>
<td>Reasonable interest rates</td>
<td>Integrated cover</td>
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<td>Procedural simplicity</td>
<td>Collateral free</td>
<td>combining life and non-life insurance</td>
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<td>Repayment as per the cash low</td>
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Source: Adopted from Karmakar et al (2011), p.81
2.5 Costs and Consequences of Financial Exclusion

In India, the financially excluded sections comprise largely marginal farmers, landless labourers, oral lessees, self-employed and unorganized sector enterprises, urban slum dwellers, migrants, ethnic minorities and socially excluded groups, senior citizens and women (Mohan, 2006). The exclusion of these segments from the access of formal financial system has certain repercussions at various levels.

According to RBI (2008), the cost of financial exclusion may be conceived from two angles. First, the exclusion may have cost for individuals/entities in terms of loss of opportunities to grow in the absence of access to finance or credit. Second, from the societal or the national point of view, exclusion may lead to aggregate loss of output or welfare which may restrict its growth potential. Echoing similar views, Chanana (2007) pointed out that the consequences of financial exclusion are different for different levels. At the macro-level, exclusion limits growth prospects whereas at the individual, micro-level, it results in a susceptibility to cash flow disruptions, inability to benefit from interest rates, and lack of long-term financial security and planning through saving opportunities.

According to Dev (2006), exclusion of the large number of groups of people from the opportunities and services provided by the financial sectors leads to their marginalization and denial of opportunities to grow and prosper. Financial exclusion is a serious concern among low-income households, mainly located in rural areas. It imposes various costs. Lack of formal savings facility can be viewed as problematic in many respects. People who save by informal means rarely benefit the interest rate and tax advantages that people using formal methods of savings enjoy. Moreover, informal
saving channels are much less secure than formal saving facilities (Mohan, 2006). Financial exclusion also leads to higher charges for basic financial transactions like money transfer and expensive credit. It exposes the individuals to the inherent risks of holding and storing money and operating solely on a cash basis increases vulnerability to loss or theft. It could also lead to denial of access to better products and services that may require a bank account (RBI, 2008).

On the other hand, lack of formal credit leads to dependency on non-formal providers like money lenders, who charge exorbitant rates of interest apart from taking borrower’s property as collateral, resulting greater financial strain and unmanageable debt. In the rural areas, the increasing dependence on money lenders may force farmers to sell off their land or could lead to other socially undesirable practices such as bonded labour. At the wider level, financial exclusion leads to social exclusion, poverty and all other related economic and social problems (Kempson et al, 2000; RBI, 2008). According to Kempson et al (2000), financial exclusion forms an important component of a much wider social exclusion. The people who lack access to financial services are frequently also excluded in other ways, and financial exclusion often reinforces other aspects of social exclusion. Similarly, Agarwal (2008) relates it to poverty. According to him, financial exclusion leads to a vicious cycle. First, high cost of finance implies that first poor person has to earn much more than someone who has access to lower cost finance. Second, the major portion of the earnings is paid to the moneylender and the person can never come out of poverty. Thus, financial exclusion is often a symptom as well as a cause of poverty.
According to Kempson et al (2000), financial exclusion is not a new problem. However, the consequences of not having access to key financial products are much more serious now than they were in the past. The options of operating a household budget outside the mainstream financial services sector are far more costly and often unregulated. Lack of access to a bank account and banking facilities can make money management more complex and time consuming, more costly and less secure.

Consequences of financial exclusion will vary depending on the nature and extent of services denied. Some of the important consequences include increased travel requirement, higher incidence of crime, general decline in investment, difficulties in gaining access to credit or getting credit from informal sources at inflated rates and increased unemployment, etc. These may lead to social exclusion (Leeladhar, 2005).

It is not always the individual who have to bear the cost of financial exclusion. It also results in the loss of business opportunities for banks, particularly in the medium term. Banks often avoid extending their services to lower income groups because of initial cost which perceived to be higher than the revenue generated. However, with the stride of technology, the cost of delivering services to low income groups is becoming gradually redundant. Moreover, availability and usage of financial services by the otherwise excluded groups would have resulted in their increased income levels and savings, thereby, increasing their potential to savings deposits and credit demand and profitable business for banks in the medium term (RBI, 2008).

Hence, it can be said that financial exclusion can impose significant costs on individuals, families, society, banks and economy as a whole.
2.6 Rationale for Financial Inclusion

The role of financial development in the economic development of a country is well recognized both in theoretical and empirical literature. A developed financial system broadens access to funds; conversely, an underdeveloped financial system narrows access to funds which restricts the number of economic activities to be financed and hence, retards the growth process. Therefore, strengthening of the financial institutions and increasing their outreach covering the maximum possible population in a region can provide necessary impetus to growth (RBI, 2006). Financial inclusion will strengthen financial deepening and provide resources to the banks to expand credit delivery. Thus, financial inclusion will lead to financial development in our country which will help to accelerate economic growth (Mohan, 2006).

The recent trend in research shows that financial inclusion is as important factor as finance for growth and development (Agarwal, 2008). Patrick Honohan (2007) of Trinity College, Dublin, while developing an index to measure access to finance in 160 countries, showed that the economies which have the higher indices are those which are referred as developed/advance economies. Though this cannot confer that financial inclusion alone has led to the development, this certainly implies that it is an important factor.

According to Leeladhar (2005), unrestrained access to public goods and services is the *sine qua non* of an open and efficient society. As banking services are in the nature of public good, it is essential that availability of banking and payment services to the entire population without discrimination is the prime objective of the public policy. Expressing the similar views Kelkar (2008) said that, the degree of ‘publicness’ in
‘financial inclusion’ may be different from the standpoint of a typical public good like say ‘defense’, but there is no doubt that financial inclusion meets the two criteria of non-rivalness in consumption and non-excludability of public good to a large measure and to that extent it is a ‘quasi public good’. According to him, there are a number of positive externalities associated with financial inclusion. First, it brings the advantage of network externality as the value of the entire financial system increases and second, the consequent fuller participation of all in the financial system makes monetary policy more effective and thus, enhances the prospects of non-inflationary growth. This reflects the quasi-public good nature of financial inclusion.

According to Mohan (2006), financial inclusion is essential not only because of its implications for the welfare of citizens but also for the reason that it can be used as an explicit strategy for fostering faster economic growth in a more inclusive fashion. Access to a well-functioning financial system can economically and socially empower the poor and low income people and micro and small enterprises (by lifting the financial condition and standards of life), and can help them to better integrate into the economy of their country (ISED, 2006).

It is well recognized in the literature that finance performs the important functions of mobilizing savings, allocating capital and transforming risk by pooling and repackaging it. There is growing evidence that a well-functioning financial system fosters faster and more equitable growth. Access to financial services allows the poor to save money outside the house safely, prevents concentration of economic power with a few individuals and helps in mitigating the risks that poor face as a result of economic shocks. Providing access to financial services is, therefore, increasingly becoming an
area of concern for the policymakers for the obvious reason that it has far reaching
economic and social implications (Kelkar, 2008).

According to Mohan (2006), financial inclusion offers several benefits to the
consumers (regulator and the economy alike). Establishment of an account relationship
can pave the way for the customer to avail the benefits of a variety of financial
products, which are not only standard but also safe. The bank account can also be used
for multiple purposes, such as, accessing credit, making loan or premium payments,
transferring money within the country, making small value remittances at low cost, etc.
Thus, a bank account determines access to many other financial services (Littlefield et
al, 2006).

The focus on financial inclusion comes from the recognition that financial inclusion has
several externalities, which can be exploited to the mutual advantage of those excluded,
the banking system and the society at large. Banks need to understand the market and
develop products suited to the clientele. They need to develop data sets to evolve risk
assessment models for proper rating and pricing. Financial inclusion has to be viewed
as a business strategy for growth and banks need to position themselves, accordingly
(Kelkar, 2008).

According to Raj (2011), financial inclusion initiatives would provide banks with a
low-cost and stable source of funds, helping them improve their asset-liability
management (ALM). As the urban customers are interest rate sensitive because of their
higher financial literacy, the potential to tap the rural areas for raising low-cost and
stable deposits is high. Therefore, ensuring a good mix of rural and urban deposits
becomes strategically important for banks. Rural India can also help banks significantly increase their low-cost current account-savings account (CASA) deposits, thereby, helping protect margins and spreading the business risks. He also emphasized the role of opening savings accounts for rural Indians and how it can be a win-win proposition for banks, customers and governments. According to him, once the bank accounts are opened customers can receive payments in these accounts directly from governments towards subsidies through direct cash transfers, social security transfers and wages through ‘Electronic Benefit Transfer’. This will minimize both transaction costs and leakages and banks can gain from the float income in these accounts as several hundred million bank accounts are opened.

There are the distinction between the macro benefits and the individual micro benefits of financial inclusion. At the macro-level a well developed and widespread financial system improves productivity and accelerates growth through expansion of access to those who do not have adequate finance themselves. At the individual, micro-level, it smoothens consumption and safeguards assets from major disruptions like disease, natural disaster, etc. (Chanana, 2007). Hence, the argument for greater financial inclusion in a country like India, not only derives from reasons of social inclusion but also from economic grounds based on theoretical and empirical research (RBI, 2006).

However, all these ideas and approaches towards financial inclusion give one-sided picture of the phenomenon, but some thinkers have shown their apprehension towards overemphasizing the schemes of financial inclusion. For example, Reddy (2010) in one of his interviews, criticizing the profit-oriented approach of microfinance institutions (MFIs) pertinently said, “You may end up in a situation, where in the name of financial
inclusion, you may come across financial intermediaries who would exploit the situation, or in the name of technology virtual financial functions may be taken over by some other companies. I can see signs of this happening.” He related the recent approach towards financial inclusion with that of sub-prime lending. According to him, it can be a dangerous situation when like in sub-prime lending, some financial intermediaries in the name of financial inclusion start exploiting the situation. Sub-prime started with the good intentions of providing affordable housing. The construction industry wanted to build more houses and the financial sector wanted to lend more. So irresponsible lending and uncontrolled construction of houses led to money being lent to those who could not afford houses. Similar situation cannot be fully ruled out in the case of financial inclusion drives.

However, when seen closely, the apprehension of Reddy have more to do with the agencies involved in the process of financial inclusion, rather than its objective per se. In comparison to the large scale benefits what can emanate from financial inclusion, such little risks appear almost insignificant.

2.7 Role of Financial Inclusion in Rural Development
According to Todaro and Smith (2003), in an economy with vast majority of the people living in the rural areas, if development is to take place and become self-sustaining, it should start in the rural areas in general and the agricultural sector in particular. In India, more than 740 million people live in rural areas. Therefore, to accelerate the pace of economic development of the country focus has to be put on the development of the rural economy, which is mainly characterized by agriculture sector (Mohan, 2006). The
same logic applies to Assam where around 86 per cent of the population lives in the rural areas (Census, 2011).

In developing countries, promotion of sustainable development and employment generation for a vast majority of population especially in the rural areas is the main focus of financial inclusion (Bernanke, 2006). The importance of financial inclusion becomes significant, particularly in the context of doubling agriculture productivity, targeted for India’s 11th Five Year Plan (Chanana, 2007). The changing image of our agriculture from that of traditional simple rice and wheat to a more complex cash-intensive structure as well as the development activities in rural areas would necessitate increased banking facilities (Mohan, 2006). In view of the rising demand of finances in rural areas, there is also a need to make the supply chain more efficient to deliver credit at the lowest cost to the ultimate user in the rural areas. It would to benefit both the bank and the borrower. In this regard, bank credit is likely to play the role of key driver towards financing emerging activities.

According to Kelkar (2008), enhanced financial inclusion will drastically reduce the farmers’ indebtedness which has been one of the main causes for farmers’ suicides. The second important benefit is it will lead to more rapid modernization of Indian agriculture, which needs more working capital and is capital intensive. As enhanced financial inclusion means better risk management tools for the farmers, they will be encouraged to adopt new technologies at a faster rate. Yet another benefit would be increased growth, as well as more equitable growth both in rural and urban areas as it will mobilize the bottom of the Pyramid.
According to Mohan (2006), a developed financial system broadens access to funds, empowers the poor and low-income people both socially and economically by lifting the financial condition and standards of life and integrates them into the economy of their country in a better way (ISED, 2006). In this regard, the Approach Paper to the 11th Five Year Plan (GOI, 2006) has also asserted that access to financial resources enables the poor to exploit investment opportunities, reduces their vulnerability to shocks and promotes economic growth.

2.8 Relevance of Financial Inclusion in the Present Day Context

Financial inclusion is no longer an option but a compulsion (Rangarajan, 2008). While the thrust globally has been on ‘inclusive growth’, financial inclusion is a topic of equal significance and relevance in our times. In India, which has been moving on a healthy growth path during post-reforms period in general and the last decade in particular, there is a vast section of the society which has not been able to access the benefits of the so-called development oriented reform process. The Approach Paper to the 11th Five Year Plan (GOI, 2006) has, therefore, duly recognized the need for a development model, which is inclusive in nature with a view to bringing the deprived and less privileged section of the society into the development process as participants and beneficiaries. A major step towards ‘inclusive development’ is the attainment of a higher level of financial inclusion by minimizing the extent of financial exclusion in the years to come.

It has been found that countries with low levels of income inequality tend to have lower levels of financial exclusion, with high levels of exclusion are associated with the least equal ones. In Sweden only less than two per cent of adults did not have an account in
2000 and in Germany, the figure was around three per cent (Kempson, 2006). Again, less than four per cent of adults in Canada and five per cent in Belgium lacked a bank account (Buckland and Guenther, 2005). In contrast, countries like Portugal, where inequality is very high, about 17 per cent of adult population had no account of any kind in 2000 (Kempson, 2006). The same figure for India is as high as 41 per cent in 2004.

The focus of financial inclusion comes from the recognition that this can serve the interests of both the society and the banking system. The banking sector can play the most crucial role in attaining the economic objectives of the country by mobilizing domestic savings, particularly those from the households, which the Approach Paper to the 11th Five Year Plan (GOI, 2006) has recognized as an important tool to achieve a higher, sustainable and equitable growth for the country. However, this can be attained only by making banking more inclusive through expanding the coverage of banking services by reaching the vast ‘unbanked’ and ‘underbanked’ population of the country. Inclusive banking, thus, is not an end in itself but also a means to achieve balanced, sustainable and inclusive growth (Joseph, 2007).

It has been said that a country’s level of banking development is a good predictor of economic growth, capital accumulation and productivity growth. Therefore, according to Sinha and Subramanian (2007), a concerted effort to increase financial inclusion could have a profound multiplier effect on India’s broader society and economy. Moreover, because India’s population is relatively young, the benefits of greater inclusion will reverberate in the Indian economy loudly and for a long time.
2.9 Summing Up

Financial inclusion can be defined as a process that enhances availability, smoothens accessibility and ensures usage of the basic financial services for all sections of the society. In most of the cases, especially for statistical purpose, banking inclusion is used as analogous to financial inclusion. There are a number of factors that determine the nature and extent of financial inclusion/exclusion in a region which are broadly classified into supply and demand side factors. These are mainly geographical factors like location, economic factors like income level, consumption, employment, products, cost/price, bribes, collateral, size of holdings, rural infrastructure etc., non-price factors like documentation, distance, etc., demographical factors like age, gender, social groups, culture, etc., behavioural factors like attitude towards rural people, psychological factors, financial literacy and awareness and so on.

In the present scenario, financial inclusion is of utmost necessity as it has far reaching economic and social implications. There are several advantages associated with it. They include -- economic growth, sustainable development, improved productivity, enhancement of employment, more effective monetary policy, etc. Financial inclusion also has an important role in rural development.

Providing access to financial services is increasingly becoming an area of concern for the policymakers for the obvious reason that it has far reaching economic and social implications. Moreover, the renewed focus on inclusive growth by the government across the globe makes financial inclusion highly relevant in the present day context. Therefore, in the next chapter, an attempt has been made to trace some of the past and contemporary initiatives undertaken by the Government of India and RBI for financial
inclusion. Along with the initiatives, a brief outline of the various forms of financial service providers engaged in promoting the objective of financial inclusion has also been presented in Chapter Three.