CHAPTER 1
INTRODUCTION

Indian economy and banking services have made significant progress in past few years but a large part of the population, primarily the weak and poor remain excluded from the basic services provided by banks. There are varying views on the lack of financial inclusion, which interalia includes poverty and inequality. Both poverty and inequality have impact on individual and society respectively. While, poverty incapacitates the individual, inequality dampens the spirit of the society. Economist-philosopher and Nobel Laureate Amartya Sen (1999) has stated that “the poverty leads to intolerable waste of talent. Poverty is not just lack of money, it is not having the capability to realise one’s full potential as human being”. Reserve Bank of India (RBI) and the Government of India (GoI) recognize the problems associated with large unbanked population; hence, many programs are launched to ensure greater inclusive growth in the country. However, the impact of such programs including the ones that were specifically aimed at financial inclusion is limited.

In agrarian economies, large section of people dependent on primary activities, are the ones excluded from the financial system and hence not part of the growth story. The academicians, bureaucrats, policy makers and central bankers are uniformly in agreement that the non-availability of credit negatively affects economic growth and poverty alleviation. It is believed that, the poor cannot save, therefore are not able to create assets and invest in income generating activities. They fail in arranging decent food, clothing, shelter, healthcare and education for themselves and their dependants. Lack of credit is perceived as stumbling block in their entrepreneurial capabilities. It is universally accepted by economists’ that unless there is surplus income, there is no saving and thus no investment. Cummin (2014) highlighted “importance of access to finance so that entrepreneurs are encouraged to take risk, invest and contribute to growth”. Similarly, Pearce (2011) has stated that “the pursuit of financial inclusion aimed at drawing the ‘unbanked’ population into the banking system”. Since the onset of 21st century, several studies by scholars such as Patrick Honohan (2004), Demirguc-Kunt and Klapper (2012) have stated
that there is a strong correlation between access to banking services and economic development. The subject of financial inclusion has been recognized as one of the main fields of enquiry, both in development economics and social science research, world over. There have been several studies, mainly based on secondary data sources to assess financial inclusion in various parts of the globe and its impact on economic development. Van der Werff et al. (2013) have analysed “Global Financial Index” (Findex) data in respect of 31 Organisation for Economic Co-operation and Development (OECD) countries and concluded that though the higher reliance on the Government and Banks helps in “financial inclusion, however income inequality interrupts the use of financial institutions”. Allen et al. (2012), based on 1.24 lakh data points from 123 countries, have analysed and observed that “low cost and easy accessibility increases use of accounts” and promotes financial inclusion. Demirguc-Kunt and Klapper (2012) analysed Global Findex data from 148 countries and concluded that nearly fifty percent of adults have accounts with FFIs. Majority of those not having accounts with banks cited that the high cost, physical distance and tedious documentation are the reasons for exclusion. This establishes the fact that infrastructure bottlenecks and the issue of pricing is a major concern, globally and may be the reason for financial exclusion and poverty. The high cost of credit puts poor in cyclical loop / vicious cycle from which exit requires a big push.

Pierce (2011) observed that “policymakers are increasingly recognising that despite a significant growth in profitability and efficiency, banks have been unable to reach out to vast segments of population, especially the underprivileged sections of the society”. The studies by Chakravarty and Pal (2010), Desmond and Sprenger (2007), Dobbie, Gillespie, Lindsay, McHardy and Sinclair (2009), and Marshall (2004) have observed that reasons for being unbanked are lack of surplus cash, costs and fees of accounts and trust in banking institutions. Further, Neime and Gaysset (2017) have observed that empirical evidence indicates a distinct rise in income levels of the countries with higher number of bank branches and deposits. Their study essentially concludes that higher bank branch penetration in high income countries, while low branch network in low / middle income countries.
These studies suggest that access to banking services helps in improvement of per capita GDP. It is widely accepted view that “people with low income have no headroom to bear downside risk” and their livelihood may get severely disrupted by financial instability. The World Bank study concludes that large unbanked population may cause financial instability and therefore, suggests that financial stability, if not ensured may have devastating impact on “economic growth and social welfare”. For Banker’s, financial stability provides them with a stable source of funding, which enhances the resilience of banks. During the period of systemic crisis, deposit from low income clients, kept with banks as part of future planning, typically act as a continuous source of funds to Banks. Hence, financial inclusion is strategic as well as of critical importance to Banks and the economy.

The issue of financial inclusion is not a unique problem in India alone, but large sections of the world population, especially within the developing world, continue without banking services to them. It is believed that the low-income savers and borrowers tend to maintain stable financial behaviour in terms of deposit and borrowings. There is uniformity among scholars that financial inclusion helps in poverty alleviation and economic development, while financial exclusion is seen as one of the deterrents to development. Some of these studies have estimated that there was widespread exclusion in countries across the globe, although, there are regional / country specific variations. At times, it is observed that the variation existed with different regions of the same country also.

1.2 Institutional Linkage

Access to financial services and products is measured in terms of individuals and firms using financial services, i.e. savings, credit and insurance. The World Bank uses number of accounts held by individuals of 15 years old, with FFIs, loans from banks and electronic payments and debit card ownership as a measure for financial inclusion. The FINDEC data analysed by Andrew D. Van Der Werff, at al. have found that “more favourable macroeconomic conditions are expected to increase the financial inclusion of population”. Hogarth et al., (2005) have observed that
“a higher rate of employment within a population will result in a more banked population”. As the nation’s financial infrastructure improves and the transaction cost gets reduced, the cost of accessing financial services also reduces, which stimulates financial inclusion. Further, it is observed that educated people have greater trust in institutions and thus it helps avail banking facility.

Leeladhar (2006) has defined “financial inclusion as delivery of banking services at an affordable cost to vast section of disadvantaged and low-income groups”. For Thorat (2006), “financial inclusion is provision of affordable financial services, viz, access to payment and remittance facilities, savings, loans and insurance services by the formal system to those, who tend to be excluded”. To examine financial inclusion, the Government of India constituted a Committee on Financial Inclusion (CFI) under the Chairmanship of Dr. C. Rangarajan in 2008, which defines, “financial inclusion as a process of access to financial services and timely, adequate and affordable credit needed by vulnerable groups, such as weaker sections and low-income groups at an affordable cost”. As may be observed in the above definitions, adequacy and affordability of credit to vulnerable groups is recognized as the key, which is the main area of enquiry in the present study. Vulnerable group / weaker sections of people are defined as that section of society which has low capacity to anticipate, cope with, resist and recover from natural or man-made hazards, associated with poverty, occurring amongst people who are isolated, insecure and defenseless in the face of risk, shock or stress. Though, banking in general at affordable cost was key, it may be observed that committee has emphasized the availability of credit as important component of financial inclusion.

Therefore, there is little doubt that credit is of great importance in development and growth in the economy. However, sizable number of people earn only enough to survive and thus remain poor. They do not have resources to keep them employed gainfully nor engage in productive activity. In absence of surplus income, enterprising individuals seek public funding for their ventures. During the course of this study, it was observed that All India Financial Institutions (AIFIs) and Scheduled Commercial Banks
SCBs have not been keen to offer smaller loans, which they do not find cost-effective owing to transaction cost and are comfortable in lending large sums. Therefore, to reach out to large number of people, there is need for intermediation to ensure financial inclusion of the excluded. In last two decades, financial intermediaries have increased at a phenomenal rate, though many of them could not survive and have vanished from the financial markets, at times questioning the intent and effect of intermediation as a potent tool for financial inclusion. Under financial intermediation model resource deficient institutions depend on the resource surplus institutions for funds. Similarly, resource surplus institutions find it convenient to leverage the outreach of the resource deficient institutions, suggesting that, they complement each other, which is beneficial to both kinds of institutions. However, this is a complex relationship and has several layers into it, which forms compelling reason for understanding the linkage among various institutions, which has been shaped by the financial eco system of different phases, which could be broadly divided into following 4;

**Phase 1:** The period prior to 1980 [little or no linkage among various institutions] – This phase had Formal Institutions and Informal Institutions alongside and almost no Semi Formal Institutions. This phase is characterized with the emergence of social banking, which was marked with nationalization of banks in 1969 and 1980, setting up of Regional Rural Banks in 1976 and creation of grassroot level Primary Agricultural Credit Societies in 1976.

**Phase 2:** The period between 1980 & 2005 – emergence of SFIs with support from the formal financial sector. Slow but steady decline of the IFIs started during this phase. The idea of social banking gained further fillip with creation of National Bank for Agriculture and Rural Development (NABARD) in 1982, Small Industries Development Bank of India (SIDBI) in 1990 and scores of other initiatives.

**Phase 3:** The period between 2005 & 2010 – Focused attentions by RBI / Government of India directing the FFIs to hand hold the semi-formal sector to enable those help as a tool of financial inclusion. The important
developments of this phase were adoption of financial inclusion as one of the principal policy programs by RBI followed by recognition of the lending to the sector as priority sector lending. However, this phase was mired with many negatives as this phase witnessed Krishna crisis (2006), which later engulfed entire state of AP and Kolar, Karnataka crisis. The impact of this phase continues not only on Indian MFI sector, but has resulted in change of strategy world over.

**Phase 4:** Post 2010 – Andhra Pradesh Micro Finance Crisis - learning and emergence of a micro finance regulatory system, greater control on micro finance institutions through contracts, peer monitoring etc.

CFI observed that the vulnerable groups are vulnerable under any circumstances and their resource endowment is inadequate to provide enough income for decent life and include Women, Scheduled Castes and Tribes (SC / STs), Disabled and Poor migrants. CFI observed that 4.59 crore (51.4%) farmer households did not have access to credit, either from the institutional or non-institutional sources and that only 27 percent of the households had credit from Formal Financial Institutions (FFIs). The committee also observed that there were wide regional variations, i.e. north-east, east and central India had very low credit availment as only 4.09 percent, 18.74 percent and 22.41 percent respectively. The factors that has kept large section of population from the financial system are as follows;

(i) Low income, unemployment and low household assets.
(ii) Deficient physical (bank branches) infrastructure.
(iii) Higher interest rates and transaction cost.
(iv) Socio-economic inequality and lack of trust.

In addition to the above, the resources crunch of the grassroots institutions is also a problem, which acts against the institutions reaching out to larger section of people and thus keeping them outside the banking services. Thus, the role of inter-institutional linkage assumes importance, which is defined as a process, where, two or more entities forge an alliance to share the scarce resources in a manner that the resources are utilized to
the benefit of a large segment of targeted people. In last two decades, the linkages between formal and semi / informal institutions have grown.

There are few empirical studies concentrating on inter-institutional linkage and its impact on financial inclusion and financial deepening. Ojo (1996) in Nigeria, has stated that the linkage between the FFIs and Informal Financial Institutions (IFIs) are complimentary and not competitive. Verghese (2005) based on some studies, both on India and other developing countries stated that the assessment of the linkage between FFIs, Semi-formal Financial Institutions (SFIs) and IFIs and impact on pricing indicates that greater the IFIs depended on the FFIs for financing, lower was the cost to the end beneficiary. The higher dependence of SFIs and IFIs on the FFIs has led to greater compliance and better responsible finance from the former. During the initial days of micro finance in India, the lending rates were unregulated and built on the arguments that they are facilitating credit to people on the terms, which are unlike the moneylenders. They also argued that, for poor, it was more important to ensure liquidity and that cost really did not matter. Therefore, most of the MFIs were charging interest ranging between 30-40 percent p.a., and additional cost towards insurance and administrative expenses were also collected. During present study, it is observed that interest rates have not been influenced by competition, possibly, as most of the intermediaries were trying to fill up the void created by money lenders. These institutions compete to acquire client however appeared to be collaborative as mostly, they did not offer finer interest rates, vis-à-vis moneylenders. The interest rate reductions have been caused by RBI regulation in the matter, yet it took years to bring rates below 25 percent (all-inclusive cost to client) norm suggested by RBI. However, for higher interest rates, MFIs alone cannot be blamed as they had to depend on high interest-bearing resources from formal financial institution.

Stewart and Ghani (1991) stated that, linkage is a transaction between economic agents, through the market or outside it, fully or partially priced. When transaction between parties are frequent and significant, they may result in some form of cooperation such as investment sharing, technology transfer, training, and close supervision of parties with low
capacities. For Pagura and Kirsten (2006), “financial linkage was a mutually beneficial partnership between a formal and another less formal financial institution and that it results in expansion of financial services to rural areas”. The above understanding assumes the presence of mutual benefits without considering the distribution of these benefits to transacting parties. Kirsten identifies two categories of financial linkages - direct and indirect. Under direct financial linkage, the main objective is to help less formal institutions to diversify their resources and better manage the liquidity. Whereas, under indirect linkage, the formal institution hires the less formal as their agents. Kirsten’s classifications ignored the fact that formal institutions stand higher chances to benefit from linkages than the less formal, and the possibility for the latter to act as distribution channels.

The study of funding positions of indigenous bankers, micro finance institutions and cooperatives suggests that they suffered from limited financial resources, whereas, the AlFIs and SCBs possess huge liquidity, have better human capital, extensive system & processes and therefore, helps in portfolio diversification, which enables them to offer a wide range of services. However, they have limited capacity to offer micro-credits to rural clients as they generally operate away from the rural areas and limited branch network. This limits their accessibility to adequate and reliable information, which is considered important for enforcement of contracts. For those targeting micro clients directly tend to have lower repayment rates (Seibel, 2005) and incur high administrative costs.

In respect of both, direct and indirect institutional linkage, financial flow is the key, which provides stability to the monetary system. However, despite the role of credit and deposit, other services offered by banking system is now getting currency as institutions have begun offering those financial services as add-on to the main products. These services include – insurance (life, live-stock & assets), financial literacy, investment services etc. and offered with an intent to secure credit, educate about financial products, while investment services are generally a non-starter.

However, the nature, magnitude and impact of these institutional linkages have not been explored by many scholars in India. In this context,
a study of linkages among various institutions and their implications for financial inclusion is compelling.

1.3 Study Approach

The broad objective of the study is to investigate the state of financial inclusion and way inter-institutional linkages have shaped it. The specific objectives of the study are (1) to explore the nature and extent of inter institutional linkages among the financial institutions in India, (2) to assess the contractual arrangement among FFIs, SFIs and IFIs, and (3) to explore the impact of such linkages on financial inclusion. To achieve the objectives of the study, following key research questions were explored (i) Kind of linkage among formal, semi-formal and IFIs, (ii) Linkages other than credit and deposit, (iii) Key components of Bank - MFIs linkage, (iv) Complementarities in the activities of Bank and MFI, (v) Key features of the contractual arrangement, (vi) The major impact of the linkage on the financial market (vii) Impact on financial activities which can be attributed to linkage (viii) Effects of contracts on financial inclusion and (ix) Impact of availability, accessibility and utilization of credit on linkages.

To understand the subject, past works have been reviewed, which suggests that the issue of financial inclusion in India has not been investigated by many including the work by Bell (1991), who focused on state agencies, cooperatives and banks, which were established to reduce bad effects of money-lending and usury. He concluded that in case of intermediation, the cost of funds to the money lender will decline. This study is different from the above as it focuses on interinstitutional linkage and impact this may have on financial inclusion and is based on the inquiry into the state of financial inclusion in two districts of Eastern Uttar Pradesh (EUP), i.e. Sant Ravidas Nagar (SRN) and Varanasi. EUP is spread over 1/3rd of the area of the state and is home to about 40 percent of the state population with higher than the state density. Similarly, the region has lowest literacy rate, lowest per capita power consumption and lowest per capita income. The bank branch penetration is high in Varanasi but very low in SRN. Therefore, the region has 33651 bank correspondents to facilitate financial services to people of the region. Clearly, even RBI recognizes that
EUP is one of the regions, which has low bank branch penetration. Hence, over 17 per cent of all the bank correspondents in the country have been hired to ensure banking services in the region. There are 148 micro finance institutions, registered with Sa-Dhan, of which 19 operate from Uttar Pradesh. The two districts of SRN and Varanasi spanning an area of 2550 sq. km. (2.97 percent of the EUP) are selected based on the extent of financial inclusion. The selection is also guided by the geographic proximity, language spoken and socio-economic background, which was presumed to be important to minimise the travel time, understand the respondents and at the same time compare the findings from geographically and socio-economically diverse regions.

Field study suggests that the problem of financial inclusion could be addressed by grassroots level agencies and institutions supported by FFIs. Though, the financial inclusion comprises of “credit”, “deposit”, “insurance” and “other financial services”, it is perceived that credit assumes greater importance as it creates capacity to enable people to seek banking services such as deposit, insurance and other financial services. Therefore, this study focuses on the credit aspect of financial inclusion. Further, as SFIs have been growing in numbers and their impact has also been phenomenal, the study is restricted to FFIs and SFIs on the credit side.

1.4 Chapterisation

Findings of the study are reported in eight chapters in the thesis. These are: Chapter 1-Introduction, Chapter 2-Review of literature, Chapter 3-Research Methodology, Chapter 4-Present State of Financial Inclusion, Chapter 5- Analysis of Inter-Institutional Contracts, Chapter 6-Institutional Perspectives, Chapter 7-Findings of the Household Survey and Chapter 8-Summary and Conclusion.

In the chapter on the “Review of Literature”, a survey of the available literature has been carried out under five broad categories – financial dualism, theories of finance and financial inclusion, inter-institutional linkage and its impact on financial inclusion, inter-institutional linkage and contracts, inter-institutional linkage in Indian context to facilitate the
research work. The review of literature is not exhaustive, and the selection is guided by the curiosity to understand the reasons for fragmented nature of financial markets, theoretical premises for linkages and whether these premises are validated empirically, and the history of linkages in India and developing countries, which are characterized by coexistence of formal and non-formal financial institutions, commonly referred to as financial dualism.

In the chapter on “Research Methodology”, it may be observed that, due to exploratory nature of the study, it was decided to adopt mixed methodology, which has gained acceptance in last decade. A mixed method appeared as a logical way to approach the complex issue of financial inclusion, which comprises of a primary (both quantitative and qualitative) method that guides the research and a secondary and complementary (both qualitative and quantitative) one, which is embedded or nested within the main method. In this approach, the first method addresses the outcome / impact related to the research questions and the second method explores the experiences of people and groups, and seeks mainly to elaborate, illustrate and clarify. In the present study, we relied on embedded method and qualitative and quantitative data collection and analysis occurred concurrently.

In the chapter on “Present State of Financial Inclusion”, the attempt is made to understand importance of banking services, which comprises of (i) credit for business, livelihood, consumption, emergency and asset creation; (ii) access of banking facilities for contingency planning, and (iii) access for banking services for wealth creation. Despite concerted efforts, availability of credit to the poor and needy remains a major concern. It is observed that large section of population continues to be financially unserved. In addition, the various phases of financial inclusion have also been looked at and major initiatives to serve the large section of people have been surveyed.

In chapter on “Analysis of Inter-institutional Contracts”, an attempt is made to understand various components of a contracts and how they have shaped the lender-customer relationship over past years, especially pre and post Malegam Committee recommendations for regulatory
requirement in the micro finance sector and how the contract violations have been handled by stake holders.

The chapter on the “Institutional Perspective”, suggests that understanding of financial inclusion would be incomplete without considering the experience of the institutions especially about institution building, support or opposition they had to face from the society and formal financial system and from the local population and traditional money lenders etc.

For understanding the ground realities, “Findings of the Household Survey” are summarised in chapter 7, which is also used to validate the secondary data sources and the one collected from MFIs. For the purpose, household survey was conducted in two phases – May-June 2017 and October 2017. The respondent households are primarily small and marginal farmers, non-farm labourer, agricultural labourer, small traders, service providers and rural artisans, both banked and unbanked. The focus area offers an insight into the ways it has been impacted by interinstitutional linkages, as the region witnessed increased interest from MFIs in the past few years.

The final chapter of the study “Summary & Conclusion” comprises the findings of the field survey observations and an attempt is made to identify the gaps in the financial inclusion discourse. It is observed that MFIs started their operations with small capital base, which was later complemented by AIFIs, Banks, Multi-lateral agencies and Domestic and International Investors. The 4 identified MFIs around which the present study revolved have largely been dependent for funding on AIFIs, SCBs and Private Investors.