Inclusive finance India SUMMIT

Exclusive Interview
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with
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Approach to Financial Inclusion: PMJDY

Prof. Sriram: Thank you for agreeing to speak to us for the annual Inclusive Finance India Report.

The first issue that we would like to discuss the approach to financial inclusion. We have both Reserve Bank of India (RBI) and the Government of India (GoI) being interested in this agenda in a big way and the objectives of both RBI and GoI are converging. However, while the objectives may be converging, are the paths really converging? If they are not, then is how do we manage this. I ask this in the backdrop of the ambitious announcement that the GOI made about the Pradhan Mantri Jan Dhan Yojana (PMJDY) and the caution that RBI has tried to exercise on the scheme.

Dr. Rajan: Historically, if we outline the paths of the government and the RBI, we implicitly believe that a push is needed and given a sufficient push, it can become self-sustaining. Now, over time we have discovered that it hasn't become self-sustaining. So, either the push hasn't been enough or that the notion that sufficient push will create self-sustainability itself is wrong. There is something else that needs to be done and we unfortunately have not found what it is thus far.

With PMJDY the government is giving yet another push and saying let's cover everybody to the extent possible. There is some virtue in this approach. This is because some programs like Direct Benefit Transfers are intended to be linked to these accounts. These programs can work well if everybody is covered. If something like Aadhar is also universal and linked to these accounts it also helps in measuring the extent of indebtedness. If the coverage is partial it does not quite work. So, the thrust on universal accounts, Aadhaar and Direct Benefit Transfer (DBT) are good.

At the same time, I think we need to reconsider and examine if the gaps are in the institutional framework and the nature of institutions that are participating in this endeavour. So we are basically saying: We need local institutions that have lower costs and employ local labour that will not go the RRBs way and then demand the terms and pay scale that is national. For that we need to empower local institutions like Small Finance Banks (SFB). We should see whether we can get Cooperatives to be governed better (some of them already are), or move them into a joint stock structure where they will be regulated like the SFBs. We have set up a committee to see the possibilities for co-operative banks.

The other issue is whether we can tap into the last mile. So the SFBs would be for small credit, whether its retail credit or rural credit or rural industry or urban industry, but as far as bank accounts and financial services go, they can be created in a Payments bank. For example, just yesterday in a remote village in Sikkim, where there is no bank, I saw an outlet selling mobile airtime. That point can be used as a cash point operated by any mobile company. So that's where Payments bank comes in. Can we include everybody by including cash in-cash out points, which can be a Business Correspondent (BC) of a variety of banks? I am very hopeful that this way we can cover much more ground.

Approach to Inclusion: Institutional Innovation

Prof. Sriram On the institutional front, I have seen a shift in the approach taken by RBI. In case of Local Area Banks (LAB) and even when the draft guidelines for the SFBs were put up, it appeared that RBI had a geographic focus. But the final guidelines opened up the space for SFBs to have a nationwide foot-print…

Dr. Rajan Possibly, but not necessarily.

Prof. Sriram But that possibility is real. With LABs or SFBs with a restricted geography we would have been able to achieve a regional penetration much better. When it is open to a nationwide footprint, then it encourages functional penetration. Instead of targeting some regions, we target certain types of customers.

Dr. Rajan Yes you are absolutely right. My hope is that we will also get some local players. When we put up the draft guidelines the Microfinance Institutions (MFI) represented to us and said "look we are already national, we are able to make these small loans because we have a certain structure that decentralizes decisions locally. So why do you want to penalize us?" There is also a stability issue with these small local entities. I mean, one firm focused in say Andhra Pradesh may be subject to both the political environment as well as a hurricane and so on.

Prof. Sriram Yes, there is the geographical concentration risk. If we look at the growth of banking post-nationalisation when we had the 1:4 rule for rural branches, and later the rule of 25% branches being in rural and semi-urban areas. But these measures have not taken away the geographical mismatch. North East, East and Centre continue to be under-banked despite these efforts. So what do we do?

Dr. Rajan That leads us to the real question- what comes first, industry or finance? And I think that in these areas, typically the missing factor is not primarily finance, it's only partly finance. Primarily it is industry. Unless the real sector flourishes, which means fixing all the issues that are associated with the real sector, banking itself cannot be the prime mover. So people say credit-deposit ratio is low, it could be because there is no demand for credit. Of course you can always find somebody who says, "I wanted a loan, I didn't get it." That does not negate the basic point.

Prof. Sriram Though RRBs did equalize this balance a little bit, possibly at the cost of the viability of some of the RRBs themselves, but if you look at the 60's data when it was predominately south and west, north has caught up over these decades and largely when I was looking at the data, the deeper penetration of rural branches has been much more of RRBs than commercial banks.

Dr. Rajan This is why we are trying to foster these new institutions. Locally managed institutions have a great incentive to give local loans. We have to ensure that they are viable and are not unstable because of their local dependency. That's why, we are willing to see a variety of them, and also maybe look at strengthening the urban cooperatives as well as the RRBs, including changes in their mode of governance. But the other thing is that we also have to look at the financial infrastructure that supports these. Today we have credit information bureaus; can they penetrate more fully in the rural area? Can Aadhaar be used every time a loan is made so that everybody knows the extent of indebtedness. Today, somebody who wants a loan needs to get a no-objection certificate from everybody else.

Prof. Sriram: But MFIs are also part of the Credit Information Bureaus

Dr. Rajan Exactly! It's not linked with Aadhaar as yet, but it's linked to some address that seems to be working reasonably well. But can we do this in a more systematic way? The second is collateral registries for bigger players. Can we register collaterals with (some entity) and say you have borrowed once against this you cannot go re-hypothecate it somewhere else. If these kinds of structures are put down (credit information bureaus, collateral registries), as well as more rapid action by the small courts, I think credit will flow more easily.

Prof. Sriram This has always intrigued me, both on the LABs and the SFBs, you've always had a higher Capital to Risk-weighted Assets Ratio (CRAR) at 15%. But you know the issue is that the problem is on the assets side, because of either geographical concentration or functional concentration. With a high CRAR that risk doesn't go away. So how does a higher CRAR help, apart from the fact that it keeps the depositors a little safer? It does not attract capital because the Return on Equity (ROE) will not be great unless you have leveraged enough?

Dr. Rajan Presumably if you are taking on more risk, you'll have to charge a premium. This notion that somehow you're going to charge the riskier guys lower rates doesn't hold.

Prof. Sriram Is there any other way in which the assets side itself can be diversified by allowing them to do a lot more treasury and things like that.

Dr. Rajan You can do securitization of loans. The only problem is you need to have adequate skin in the game to collect because you cannot securitize loans and then not be around to collect.

Prof. Sriram With Basel III kicking in do you think all the banks including RRBs, SFBs and Cooperative banks be covered under the norms. How does that pan out?

Dr. Rajan Eventually some version of Basel will be there. I think apart from capital ratios, we have to have some notion of liquidity for all these entities, but the counter-cyclical capital buffers, this that, we'll have to see how to apply them across the board. But let us see.

Prof. Sriram Do you think RRBs should further consolidate?

Dr. Rajan I think there is a process by which this is taking place. There is some talk of one RRB per state rather than two.

Prof. Sriram That's right. That is what the ministry was pushing a couple of years ago.

Dr Rajan Yes, I would say we need to maintain the local character of these institutions, rather than make them so big that policies are made in Delhi or in Bombay, and not locally. I think when we get to that point we have created too big an RRB.

Prof. Sriram Let us look at the public sector banking architecture. Would it be a good idea to break them up functionally and say that you specialize and have a set of institutions, which penetrate into functional specialization, given that we are talking of tradable priority sector lending notes?

Dr. Rajan: I think that could emerge, could be a regional specialisation as well as functional. But I don't think we should force it from Delhi or Bombay. It should be something that's driven by the banks primarily.

Prof. Sriram: But you need to provide a framework which allows that to happen.

Dr. Rajan: We need to decentralize decision making to the banks themselves. Which means we need to create strong boards as the government has suggested. And let them be free, let them decide what the policy is. And as you free up independent boards they will say we cannot all be doing the same thing.

Prof. Sriram: Actually, if you go to a public sector bank and do a blind test you will not know which bank it is.

Dr. Rajan: Exactly! So let them differentiate themselves, but it can't be driven by the Ministry or the RBI. It has to be done by the bank itself.

Prof. Sriram: In the inclusion space we also have a lot of unregulated entities, registered but unregulated, like Trust, Societies and possibly section 8 companies. What is RBI's outlook on such entities?

Dr. Rajan: As far the unincorporated entities go, including your local money lender, I mean we do have a huge number of those but we cannot do much about it unless it gets to a size that it starts creating a systemic concern. So our current view is that we will help coordinate the regulation of these entities through State Level Coordination Committees (SLCCs). Many of them are more a law and order issue rather than a systemic stability issue.

Prof. Sriram: Therefore are you saying that RBI should not be too concerned?

Dr. Rajan: No, no, we should be concerned about them. When somebody loses money they are going to say that I was taken for a ride by this financial institution, where were the regulators? We have had enough adverse mentions by various judicial and investigative agencies. Clearly, even if it's not our baby the public will hold us responsible. So what we are doing is activating these State Level Coordination Committees in every state which has the Chief Secretary, the Criminal Investigation Department, the Director General of Police, etc. come together to exchange information about who these operators are or where there is a possibility of public harm.

Prof. Sriram: …..and also are of a size that could cause concern

Dr. Rajan: Yes, the size will cause concern. For the tiny guys we are trying to say that if you take deposits, or what are deemed deposits, without having the regulatory permission, then it will essentially be a cognisable offense. So before you default on a deposit, even the act of taking it without license should be seen as a cognisable offense. Otherwise you have these guys who are running Ponzi schemes and until they disappear they are fine, they are legal. So I think we need to make unlicensed deposit taking an offense. So those are two areas where we are pushing harder.

Microfinance

Prof. Sriram: The next thing I want to talk to you is about MFIs. Prior to 2010 they were growing at a very fast pace. Then the Andhra Pradesh episode happened and then RBI set up the Malegam committee. I think the RBI announcement came on the same day as the Andhra Pradesh ordinance. So, possibly RBI was anticipating a crisis because if you look at the dates it was the exact same dates as the Chandigarh board meeting. Based on the report of the committee, there are stringent norms laid out on MFIs. Some of these possibly are still necessary, but some of these are difficult to implement like income, asset size, number of loans. Number of loans is of course possible to monitor.

Dr. Rajan: That I have said that there has been some substantial improvement in monitoring the over indebtedness of the individual.

Prof. Sriram: That is true but there are couple of things- 85% of the qualifying assets (portfolio) has to be in a defined category of households with Rs.60,000 income in rural areas and Rs.120,000 income in urban areas. Such norms lead to a large amount of misreporting. It also becomes worthless data for their own data mining purposes.

Dr. Rajan: What we need to do is liberalize. We are trying to develop a norm for NBFCs as a whole. See, the problem comes when some NBFCs get regulatory preferences. So, for example, lending to NBFC-MFI counts as priority sector. So if we instead say that lending to any NBFC against MFI –type loans, MFI portfolio, should count as priority sector, then the entire privilege for NBFC-MFI vanishes. So that is probably something that we could examine. And that will alleviate this problem of having to micro-manage the structure of the MFIs.

Prof. Sriram: Yes because 85% is also a difficult ratio to maintain, given that some of these clients actually graduate and there is a fair mid-level market developed.

Dr. Rajan: Yes I know. We are trying to move away from creating these silos for NBFCs, to make it continuous. If you are 95% in equipment financing, you are treated as thus and such. But if you are 70% into MFI financing…. so you should get privileges based on what you do, rather than because of the institution you are categorised as. That's all. We shouldn't have 0/1 categories.

MUDRA

Prof. Sriram: On MUDRA, what is your view? Do you want to talk about it at all?

Dr. Rajan: I am happy to talk about it. Firstly, it is not going to regulate incorporated MFIs. That will stay with us. That has been established with the government.

We need to bridge the gap in credit, but it will take hard work, new frameworks and better systems. The MUDRA Bank will have to work on all these dimensions. We just had a bunch of people come to the RBI and represent that small guys aren't getting credit. Yes, tell me what's new? Small guys haven't been getting credit across the world since time immemorial. The real issue is you don't solve this problem by pushing more credit in their direction. You try and figure out what are the ways in which you can bridge the gap between the financier and the small guy. Often the gap is informational and enforcement.

Informational because if you are sitting in a nationalised bank you may not know much about villages and what's going on and who is what, etc. And for a variety of reasons it may be too costly to enforce anything. So you depend on the borrower being willing to pay back. If he isn't willing to pay you back, you have no willingness or ability to go and enforce.

MFIs overcome this with their various social collaterals. And because they are closer they know what's going on. So unless you create the institutions that get closer to the borrower, you're not going to bridge that gap. It's not a question of cost of finance.

Dr. Rajan: No, you can always offer subsidised finance to somebody. But, unless it is sustainable, it will never scale. Now a new institution, lending to the informal sector, is not a complete answer because what are you going to do, how are you going to monitor them? You take the local money lender, there is a belief that if you lend to him, he'll offer cheap loans to the people. Perhaps he will. Or perhaps he won't.

I think this is one of those things we'll have to think outside the box and experiment a little bit. Do it at a small scale so we don't do too much damage and see what happens. So refinancing, we've tried that. I don't think that's the complete answer. Securitization, maybe. If you can, you know, see some way of creating the necessary infrastructure, fine. If you can do some hand-holding, fine. Maybe the MUDRA Bank will do a little bit of all these. The diagnosis of the problem seems to be that nobody is lending to these informal MFIs so therefore let us create an institution to lend to them. But we have to be careful we put in place adequate frameworks and systems, else we could incur substantial losses.

Priority Sector Lending and Agriculture

Prof. Sriram: Would you like to talk about the priority sector lending norms and the changes that are on the anvil?

Dr. Rajan: Yes, we are increasing the small and marginal farmer support and the micro support. Our approach was, let us figure out who really needs access, because we have mixed up access and priority and national importance together. In some cases we don't know where it ends up. So these are the customers who desperately need access. Let us push here. For the rest, these are broadly national priorities, we'll put it broadly and you can choose between one and the other. Agriculture target is still 18% but 7% (going up to 8%) to small and marginal farmers is the harder target. Those are people who truly need credit. Once we achieve the marginal farmer and the micro enterprise category, the rest are probably going to be relatively easy to achieve. And therefore, it won't become that binding, but these two essentially become binding.

Prof. Sriram: That brings me to the agriculture portfolio. It's a wicked problem in a typical public policy sense. When you are talking of trading of priority sector lending notes, the report recommends trading of obligations without moving the portfolio and restricts this to banks. So there is no regulatory arbitrage. Does it make sense for us to think of actually encouraging a regulatory arbitrage? Say, NBFCs lend at a higher interest rate for agriculture and the banks achieve their targets by purchasing this portfolio? If that is possible then possibly there will be a specialised institution marked which actually caters to the needs, but banks also achieve their targets, in a lazy way.

Dr. Rajan: The problem with that is it makes it too easy and the banks themselves will back off lending to the priority sector. The NBFCs that have been doing this lending will come into the market and sell. You will not get incremental lending to the priority sector, and maybe even a decline. Basically NBFCs will crowd out the banks and sell priority sector loans to them. So unless we impose targets on the NBFCs also, it will not serve the purpose.

Prof. Sriram: With the recommendations of the internal working group on tradability of PSL obligations, do you think it may morph into a larger trading platform across structures in future or you want to keep it limited to the banking system?

Dr. Rajan: As of now banks. But let's see how it goes.

Prof. Sriram: Is there no other way, with which we can do anything about this subvention and make lending to agriculture inherently attractive?

Dr. Rajan: No. subvention doesn't necessarily imply that you have to lend at 9%. That's not so much the subvention than the fixed price. The subvention actually tries to make lending a little more attractive. We have said to the government that they should eliminate fixed price. Otherwise what happens is that you get an excessive focus on gold loans. We have this policy of saying do 'A' but you cannot either charge the appropriate interest rate or take collateral. In that case banks are basically saying "Why should I do 'A'?"

Prof. Sriram: That's right. Then they'll do the minimalist thing required.

Dr. Rajan: Or find somebody who looks like 'A' but is not really 'A'. I have pledged my gold, I get a gold loan. And that counts as agriculture.

Prof. Sriram: But the banks still don't get the return and that's the problem. Even if they look at the total adjusted cost of funds, agriculture has to become a loss-making portfolio because of the interest rate cap.

Dr. Rajan: It does not have to be that way. But we do worry about cases where the same guy who borrows from the bank goes back and re-deposits, because he is charged effectively 4% and earns 8% on fixed deposits

Post Bank

Prof. Sriram: Can we talk about the Post Bank. I am not sure what happened but they had applied for a license as a mainstream bank, the Finance Minister announced in the budget that they will be a Payments bank. Any reasons why they were not considered for a universal bank?

Dr. Rajan: At that time we did not proceed with the universal bank application because it had not been sent with government approval. With the Payments bank application announced in the budget, we are examining the proposal for a Payments bank.

Prof. Sriram: Do you think it would have been a good idea to grant a universal bank licence?

Dr. Rajan: I would say it would be appropriate for them to first start as a payments bank.

Prof. Sriram: But they are already a Payments bank in one sense.

Dr. Rajan: Yes, well they say that. But it would be nice to segregate all that properly into a structure, have a clear accounting, have a sense of who is in the structure, who is not. There is a need for transparency about the banking operations. What kind of a relationship do they have with the postal department? That needs to be clarified substantially. Once that is clear, the separation is clear.

Prof. Sriram: Postal department had a consultant's report which had a road map, basically saying that every post office will not have a bank branch but in 6-7 years every district head-quarter will have a banking outlet.

Dr. Rajan: See, our worry about credit to any untested organisation, especially if the organisation can in a span of a year or two generate 2 lakh crores in deposits, how will that be deployed? What kinds of loans will be made? Where is the credit evaluation capacity? We need to have a greater comfort with that.

Prof. Sriram: One of the arguments made was that they don't have credit experience. That is an oxymoronic argument. But you are saying size is the argument...

Dr. Rajan: Exactly, but let us first get the bank management, cash management, and the structure together. Once we have confidence that all those things are working well and there are no operational risks then we can start slowly seeing how we can move the Post Payments Bank towards more. In a number of countries the postal bank is just cash in-cash out, no lending. It doesn't make loans. Some advocates are basically saying the postman knows the local area and can make loans. But postman has no financial experience. He can only do KYC at best. He can't make the loans objectively, because his friends are there. So in what sense is he going to make loans and collect them?

Co-operatives

Prof. Sriram: You are moving towards converting co-operatives into mainstream banks. But the form of the organisation doesn't permit you to do that in one sense, because there is no residual claim on liquidation income as far as co-operatives are concerned. There is only residual claim on current income. With all these large banks, what route would you take?

Dr. Rajan: There are two options for co-operatives that we regulate. They could morph into the kind of structure that the Malegam committee has proposed, which gives us a little more regulatory confidence. The other is to transform into the joint stock bank. In the United States when it went through this, they did basically give the equity rights to the existing depositors. We'll have to worry about how the membership of the cooperative will get rights to the equity.

Prof. Sriram: Particularly since these banks are largely controlled by borrowers rather than depositors.

Dr. Rajan: Exactly!

Prof. Sriram: So that is a tougher problem and much more gradual issue.

Dr. Rajan: We'll have to figure out how to do it. So we'll have to make sure that members are involved in the proportion they share the cost of subscription. Maybe the appropriate proportion would be one member, one equity share. And so that way we don't get an excess concentration of the surplus value in a few hands.

Prof. Sriram: What do you do with the accumulated reserves and the surpluses?

Dr. Rajan: So it would be divided up equally across the membership. That would also accord with the cooperative nature. However, all this needs to be thought through in discussions with stakeholders.

Last Mile Delivery

Prof. Sriram: On the last mile delivery of financial services, the last big idea that we tried was BC and that has had mixed response and mixed results. Are there any other big ideas you have on this?

Dr. Rajan I think BC has to go together with connectivity and with mobile transfers. BC has to be perhaps cash in-cash out. But having agents who do other functions acting as a BC may also allow for recovery of cost.

Prof. Sriram- That's the State Bank of India (SBI) model, where they have put this Customer Service Points (CSP) very near the branch in most of the places so they divert small ticket traffic to the CSP. It's safe in the sense that the exposure of the CSP is backed up by a fixed deposit. As the point is near the branch, anytime CSP runs out of limits they can go top it up. They have given limited access to CBS. It's a very interesting model but not many banks have picked it up.

Dr. Rajan Well some have, but I was thinking more in terms of- he's doing another business, and the BC is on the side. So the other business which is not a banking business, like he's running a shop and he does BC also on the side.

Prof. Sriram Yes, these guys also do photocopying, selling insurance products and other small services.

Dr. Rajan In some states they are doing government business.

Prof. Sriram Yes the Sahaj is doing that, wherein you share the sunk costs across.

Dr. Rajan Exactly! The fixed costs are shared, so that I think would work. We are trying to figure out what we can do with white label BCs. So allow them to do business for multiple banks. Now there the problem right now is which bank controls them. Let them have one bank which they do primary business with, but let the bank not make it disadvantageous to work with other banks.

Concluding Questions

Prof. Sriram: One last personal question, you've been outside the system, you've been extensively writing, including your Hundred Small Steps and so on. Has your outlook, having occupied the office changed a little bit with the internal constraints kicking-in? In a way you have cautiously advocated the markets approach and deepening of the markets.

Dr. Rajan: I have broadly moved in the direction of that report in a number of dimensions. I just saw the currency markets, trading has increased substantially over the past few months, interest rate futures markets have increased so this notion that somehow we are against markets is wrong. Where I have become a little more cautious is that, post financial crisis, the notion that market participants are fully responsible is hard to hold. A variety of problems plague them.

Take for example External Commercial Borrowings (ECBs). Should we, as the Sahoo committee suggests, allow unbridled ECB, regardless of who you are, so long as you hedge. I am uncomfortable because I don't think the only problem is lack of hedging. I think there are number of players who basically are willing to take on dollar loans and remain unhedged because they pay one and a half per cent. They basically say that if the dollar appreciates substantially against the Rupee, I am in deep trouble. But then I go to the bank and say take a hit, so I am not really in trouble, my banker is in trouble. And if the dollar stays where it is, I make a ton of money.

Prof. Sriram: So there is an upside but there is no downside. Downside goes back to the public.

Dr. Rajan Exactly! That is the game the unhedged promoter could be playing. In that game if we don't have proper bankruptcy, the moral hazard involved is tremendous. So this notion, that we liberalise and just require hedging may be optimistic ….first they don't hedge, second I cannot monitor what they hedge. Banks tell us they cannot monitor, obviously because he hedges the first day he undoes it the second day. How do you know if he undid it? You have no idea. I think there is a value here to being reasonably conservative. Of course you don't want to be so conservative that you hold back necessary change. So I am open to change, but I, precisely your point, want it explained and I want to understand whether it's an ivory tower view of participants or a reasonable view.

The banks have a constraint because some bank managers also have a short horizon and are desperate to find every which way to off-load the problem to the future, so the next manager can take care of it. So in that kind of an environment, the kinds of outcomes can be quite different from what you get in a well-functioning capital market. Even in a well-functioning capital market we have the experience of 2008. So basically, I am cautious. I'd like to see markets work better, I'd like to bring more of them into the picture, but let's be a little more careful about how much we rely on them.

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