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Finance for the poor: Policy, not programmes

Enacting and enforcing the draft Indian Financial Code holds the key to financial inclusion

Recent evidence suggests that many bank accounts created under the Jan-Dhan Yojana are fake or inactive. This should not surprise us. Financial inclusion is not a simple matter of giving orders to public sector banks (PSBs). We have to look deeper at the incentives of financial firms and the needs of individuals. The solutions lie in policies and not in programmes.

The Indian financial system fails on growth, stability and inclusion. In the political system, inclusion has a ready salience. Jan-Dhan Yojana was the idea that we should force PSBs to open a lot of bank accounts. This was particularly convenient as it shifted financial inclusion from cerebral policy debates into the comfort zone of a field problem. It became a simple matter of arm-twisting employees of PSBs.

SNAKES & LADDERS

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High-powered incentives generally backfire. We worry that kids don't know physics, so we setup a physics examination. Kids and their teachers then focus on the examination and not on the knowledge of physics. High-powered incentives (either carrot or stick) around the wrong performance measures are particularly damaging. When we setup such incentives around opening accounts, the focus shifts to mechanically opening accounts, through means fair or foul.

It's useful to take three steps back, to our knowledge of financial inclusion of five years ago. Poor people face risks in their life that are vastly greater than the salaried middle class. The technology of risk shifting is of supreme value to them. But, this will require solving the problems of outreach, high transaction costs for low-value transactions, and business model innovation. These require a combination of competition policy in finance with innovation-friendly regulation.

Let's look at two examples. There was a time when we used to bemoan the lack of telephones in India. Public sector telecom firms spent decades trying to achieve the target of one phone per village. In the late 1990s, the power of DOT was disrupted, and we got the entry of new technology, new private energy, and new business models. Nobody in DOT or a PSU telecom firm would have come out with business model innovations like pre-paid SIM cards. We are perhaps a decade away from one phone per person.

There was a time when the BSE was a monopoly stock exchange. There were roughly 600 securities firms, with offices in south Bombay. Most of India was excluded. Then we got new technology, new private energy and new business models. The NSE came in as a second exchange, both NSE and BSE switched to electronic trading with a new governance model for stock exchanges, and roughly 1,000 new private securities firms came in. Members of the NSE and BSE today have roughly 200,000 offices all over India. This has greatly increased market participation.

Both these examples show us that stagnant PSU systems require fundamental policy reforms. We require new technology, new private energy and new business models. Whipping PSUs to do the government's bidding will not solve problems.

As with the bad old days of telecom and the stock market, Indian banking is a stagnant PSU landscape. Private and foreign competition has been shut out. For all practical purposes, there are only four private banks, and we seem to give out two bank licenses per decade. This needs to change, which requires a deeper questioning of administrative law at the Reserve Bank of India.

New technology holds immense potential. As an example, the key insight of the New Pension System was: To deal with small value pension contributions by poor people, we needed to push to the technological frontier. The world of "fintech" is particularly important for India from this point of view. The bottleneck is the rigidity of the present regulatory arrangement. India is the only country in the world that has banned Uber's cashless transaction. This calls for a deeper change in the regulatory processes at the financial agencies.

It is tempting for bureaucrats to write down business models — eg, RBI's notion of a "payments bank" or "small finance bank". However, no bureaucrat could have imagined pre-paid SIM cards. What is needed is the energy, dynamism, and pressure of private competition, not business model development by bureaucrats. New business models, such as micro finance institutions or peer-to-peerlending, are likely to lead the way for inclusion.

Poor people live under extreme levels of risk. For example, a farmer who does one Kharif crop a year has exactly one income source (the Kharif harvest) and is subject to the immense vagaries of the monsoon, yield and output price. This calls for insurance and derivatives markets, with business model and technological innovation to connect to the remote individual. At present, we lack the raw materials (i.e. insurance and derivatives that work in Mumbai) and we lack the connecting tissue (innovative private efforts to link this to the small farmer). This requires private energy, business and technological innovation, and restructuring of financial agencies.

Finally, Indian finance has a long tradition of abuse of customers. An extensive array of evidence shows how financial intermediaries obtain unfair profits by hurting the interests of consumers. You can't fool all the people all the time. Consumers are aware that they need to be very cautious. This requires a new framework of consumer protection to be put at the heart of financial agencies.

A key element of the abuse of customers is financial repression. When the Indian government runs deficits, it forces bonds down the throats of financial firms (banks, pension funds, insurance companies). The post-inflation rate of return in a savings bank account is generally negative. This hampers household participation in formal finance.

This requires the establishment of the Public Debt Management Agency.

Jan-Dhan Yojana was in the comfort zone for people who are more comfortable with field work. Financial inclusion, however, requires policy work. The key ideas – entry barriers, technological and business model innovation, consumer protection, financial repression – are woven into the draft Indian Financial Code. Enacting and enforcing this holds the answer for financial inclusion.

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