
Good afternoon. I want to speak today about financial sector reforms in India. Some of you must be asking – why financial sector reforms? Why now? Aren’t the record Sensex, or the gleaming towers in the Bandra Kurla area in Mumbai enough confirmation that India’s financial sector reforms have succeeded? I think not. I will try to convince you that a tremendous amount needs to be done in the financial sector, and it is critical to India’s economic growth and stability.

But let me start first with what we think our growth path should be. There is a school of thought that India should ape whatever China has done. So we should move next into labor intensive manufacturing growth, using an undervalued exchange rate. But there are many things different in India’s starting point. For example, Sanjay Gandhi failed in his family planning program, while China succeeded with its one child policy, so the Chinese are growing old before they grow wealthy, and are consuming little and saving tremendously for their old age.

The low consumption helps limit domestic demand, making it easier to maintain an undervalued exchange rate. Do we want to repress consumption to the extent they effectively have, in order to follow their exchange rate policy?

There is another big difference between India and China – unlike China, India starts out with China already occupying the commanding heights of low value-added manufacturing, with Vietnam close behind. Do we really want to go head to head with those countries?

While not ruling out labor intensive manufacturing, any sensible growth strategy for India should focus on what we do well. Indian capabilities in skilled manufacturing, ranging from pharmaceuticals to auto ancillaries, are undoubted. So is our ability in services ranging from IT and engineering services to healthcare. Our poor infrastructure and past excessive
spending on higher education may have forced these specializations on us, but we must not abandon them lightly in an attempt to ape China.

Two forces make these specializations particularly valuable at this time in history. First, the falling costs of international trade in goods and services, spurred by improvements in transportation and communications, gives us an unprecedented opportunity to leapfrog the traditional development process. Instead of working our way up from textiles to machinery to electronics to skilled services, we can move directly to providing medical services, legal opinions, financial analysis, or chip design to the world.

Second, much of the value in global production is moving to property that is human capital intensive, not physical capital intensive– for example, brands – think of Apple or Sony, entertainment – think of Steven Spielberg, or firms – think of McKinsey. Unlike capital intensive production where immense capital investment is needed before even producing the first steel rod, all we need for human capital intensive production is a good education, a creative environment, and a way to link up to markets.

This does not mean that we will not manufacture or grow things, but we have the opportunity of manufacturing or growing things where the bulk of value added is via human capital – for example, making fine wines instead of simply growing grapes. And these activities can provide both direct skilled jobs as well as generate unskilled jobs.

Equally important, though, is that we have a huge, and largely untapped domestic market. If we can create, and cater to, demand at the bottom of the pyramid, at the same time helping the poor become more productive, we can develop unique capabilities that we can sell to the rest of
the world, poor and rich. For instance, if we learn how to provide the financial services the poor need, at a cost they can afford, not only is there a market of hundreds of millions in our country, there is an equal sized market in China, Africa and Latin America. And these are the fastest growing areas in the world today, markets we can tap and capture.

At the same time, bringing the bottom of the pyramid into the productive mainstream can help address the very real concern that we are creating two countries – the India of the rich and the Bharat of the poor, and that those two countries will collide in the years to come to the detriment of all.

My talk will focus on how the financial sector can help draw Bharat and India together. To do this, however, we have to rid ourselves of a profoundly fallacious belief. It is that our financial sector needs to offer choice only to the elite and our large Indian multinationals, but not to the tiny farmer, the slum dweller, or the landless laborer. The latter, or so the belief goes, are better served through subsidies, targets, and government programs.

To illustrate the consequences of this belief, let us look at some data. After decades of attempting to channel credit to the poor through bank nationalization, priority sector lending, rural branching, and through subsidized or capped interest rates, who exactly do the poor borrow from?

[Figure 1] This is a chart from an excellent recent survey by IIMS showing the sources of borrowing for different income groups. Look at the lowest group, which consists of everyone at or below an income of Rs 50,000 per year, about 60 percent of the population. Approximately 75 percent of the borrowing by this group is from informal sources such as friends and family or moneylenders. Only about 14 percent of their borrowing is from banks. By contrast, 63 percent
of the borrowing of the richest group is from banks, while only 32 percent is from informal sources. Banks seem to be bypassing the majority of the population.

You may say so what, aren’t the poor borrowing a lot from friends, and what are friends for? [Figure 2] Well, what we have in the next chart is the distribution of interest rates charged by different sources of finance. Friends seem to be a very expensive form of finance with nearly half the loans from friends having interest rates above 36 percent per annum. Only moneylenders and chit funds seem to be more expensive.
Note that banks do charge low interest rates, but as we have seen, the poor get very little bank finance. But one could go further. Is there a connection between low interest rates and the lack of access for the poor? There probably is.

For loans of below Rs 2 lakhs to the poor, banks are not allowed to charge above their prime lending rate, though they have some leeway to set that rate. [Figure 3] The true cost of making a small loan is, however, about 25-30 percent, as these estimates from ICICI bank suggest. If a bank is allowed to charge only 10 or 12 percent, why would the bank lend to the poorest of the poor? The government could force the bank by mandating it meets priority sector targets, but banks would lend to the best credits that qualify for the target, for example, rich farmers in rural areas, not the poorer, higher risk, ones.

Bankers could react to mandatory targets in worse ways. Think of the loan officer sitting in a rural branch, and having to meet targets on how many subsidized loans he gives out. What would he do?

Source: ICICI Bank Staff Estimates
Given that there is so much demand for credit, and so little supply, he would charge a personal fee for approving a loan—in other words, a bribe. [Figure 4] We have some data on that. As you can see from this survey of loans conducted in Andhra Pradesh and Uttar Pradesh, the bribe as a fraction of the loan amount granted can go up to 40 percent of the loan. No matter what the actual interest rate charged on a loan, if 40 percent of it is swallowed by the lender, the effective interest rate is extremely high. That is, of course, if the borrower has any intent of repaying.

More likely, the bribe is an all in service fee, whereby the understanding between the loan officer and the borrower is that the loan is not meant to be repaid. My guess is that it is not the poorest of the poor who benefit from such arrangements, instead it is the richer borrowers who have the ability to pay in advance!

Note also that while the survey indicates banks are relatively honest, they take an average of 33 weeks to process a loan. In part, it may be that to control possible corruption in a remote branch, the head office has to tie the branch loan officer with bureaucratic controls and paperwork. This makes it impossible for him to react speedily to local needs. But the majority of the loans taken by people in the lowest income quartile are not for starting long-planned

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Bank</th>
<th>RRB</th>
<th>Coops</th>
<th>Schemes</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate (median) % p.a.</td>
<td>12.5</td>
<td>11</td>
<td>11</td>
<td>14</td>
<td>14</td>
</tr>
<tr>
<td>Loan amount received as % of amount applied</td>
<td>91.8</td>
<td>88.2</td>
<td>83.5</td>
<td>86.6</td>
<td>93.9</td>
</tr>
<tr>
<td>Percentage of households reporting bribes</td>
<td>26.8</td>
<td>27.0</td>
<td>9.7</td>
<td>27.27</td>
<td>23.21</td>
</tr>
<tr>
<td>Bribe as % of amount approved</td>
<td>10.1</td>
<td>18.2</td>
<td>19.9</td>
<td>42.3</td>
<td>8.3</td>
</tr>
<tr>
<td>Time taken to processes a loan application (weeks)</td>
<td>33</td>
<td>28.5</td>
<td>24</td>
<td>8.9</td>
<td>14.3</td>
</tr>
</tbody>
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*Source: RFAS 2003.*
businesses, but for financial and medical emergencies. If a poor landless laborer needs money to buy medicines because his daughter has fallen ill, he simply cannot wait 33 weeks for a bank to make its decision, even if it were willing to give him unsecured credit – a big if. He therefore goes to the local moneylender, who can make decisions on the spot, needs little paperwork, and needs no collateral.

I have focused on just one aspect of financial services for the poor, credit. Even though this is the aspect emphasized most by the government, the poor need far more than credit. For instance, they want a safe and easily accessible place to invest their savings. Here again the data suggest something very intriguing.

[Figure 5] This chart describes incomes and savings accounts for a variety of employment categories. Note first that the agricultural worker is least likely to have a savings account. But urban laborers or street vendors are also unlikely to have savings accounts. In fact, incomes seem a more important determinant of whether you have a savings account than...
location. The poor in urban areas, which are chock-a-block with bank branches are almost as unlikely to have access to financial services as the poor in rural areas with few branches, while the rich have good access in both areas. The implications are profound – the data suggest that simply opening branches in rural areas is unlikely to have much further effect in improving access – for it has not had much effect in urban areas where branch networks are plentiful.

Finally, before we leave savings accounts, note that this is the primary means by which the poor invest their meager savings, they invest virtually nothing in equity. I am sure most of you have only a small fraction of your money in savings accounts – largely as a convenience I presume.

What kind of returns have the poor got, net of inflation? [Figure 6] We see here the amount net of inflation from an investment of 10000 rupees in a savings account, in the stock market, in gold, and in an account that is 80 percent savings, 20 percent market. Clearly, the stock market soared over the last four years, but it was volatile before that. Both gold, and the mix of equities and debt, have provided more moderate returns, but with low volatility. But focus on the red line for savings account returns. It is steady but with a negative trend – it is a clearly inferior investment. Anyone invested in savings accounts was assured of a steady loss – a Rs
10000 investment was converted into Rs 8938 because the meager returns did not compensate for inflation. And the returns were meager because the government controlled interest rates on savings in order to improve bank profitability and stability.

You and I can escape the government’s financial repression by moving our money elsewhere. The poor have no easy way of escaping. Indeed, often, they are driven into informal savings schemes like chit funds, which could be riskier than mainstream investments. The immense boom in equity wealth in this country has largely bypassed them. Worse, the government has taxed their preferred mode of investing so as to confer profits on the banking system.

One can look at other services such as micro-insurance, which the poor desperately need, and a similar picture of exclusion emerges.

What does all this mean for reform? It suggests that the current formal system is simply not serving a majority of our citizens, despite the tremendous steps taken in the past to expand the rural banking network, the grand schemes targeting rural credit, and the considerable attempts to impose interest rate ceilings to protect the poor against predatory lending. As the data suggest, all these efforts may have reached diminishing returns. It is time for change.

What kind of change? One ray of hope is micro-finance institutions, who seem to offer the necessary financial services, provided they are allowed to charge reasonable interest rates or prices. Not all micro-finance institutions use the social lending model whereby peer-pressure from others in the group forces a borrower to repay.

But unlike the large national banks, they have cheaper local staff who understand the local environment and local needs. Decisions can be made on the spot, an immense benefit for the
poor who do not have the margin of safety to wait. And if a borrower defaults, he has nowhere else to go, so repayment rates, even with unsecured credit, are high.

1) Allow more small banks

One way to replicate their success is to allow more small local banks to start up. The minimum scale for entry right now is Rs 300 crores (of capital), and that immediately means only large players can enter. What matters, however, is not the quantity of capital but the quality of the promoters, their management, their capital adequacy (relative to the tasks they undertake) and their systems. Provided regulators apply stringent entry criteria to banks on these dimensions, the minimum capital requirement could be relaxed considerably, and the resultant entity nevertheless easy to supervise.

With the expansion of mobile and internet banking, off-the-shelf customer management packages, and of distribution structures that rely on business correspondents, such as local shops, it may well be possible for a transparent, well-managed, bank to be set up with little capital and this should be encouraged.

As an aside, one reason for the high capital requirement may be that it is an easy way for the regulator to deny entry rather than having to deal with myriad requests to open banks by the politically well connected. Regulatory backbone will be essential in any reform.

Small banks, while benefiting from local knowledge and the proximity of decision makers to the customer, do suffer where products have scale economies. For example, think of a deposit account that pays the poor a steady but low interest rate, but at the end of the year, also gives them half the positive return of the stock market (and none of the negative return). This might be attractive, at least relative to the choices the poor have. But such an equity linked
deposit will require innovation, and the risks will have to be managed by hedging in the index stock options market.

Small banks may neither have the specialized personnel to design and manage the product nor the market size to recuperate the costs. Moreover, small banks are heavily exposed to local economic conditions, and are thus riskier.

It would be useful, therefore, for small financial institutions to tie up with larger ones so that they can benefit from scale economies. For example, instead of devising all the products in-house, the small institution could simply be a distributor – a business correspondent for a larger bank -- for some products. We have regulations permitting business correspondents in place, we should make sure they work.

Second, associations of small banks, including loose mergers, could form so as to share back offices and costs. They could also exercise mutual monitoring to ensure no single member of the association runs amok.

Third, a market for securitizing confirming small loans would help small financial institutions get refinance, and a well-supervised securitization market could impose its own discipline on them.

No matter what precautions are taken, though, it should be recognized that small banks will have a higher propensity to fail than large banks, other things equal. While supervisors have to be more vigilant, we should also increase our tolerance of failures. Higher risk is the price we will have to pay for more growth and inclusion. Excessive risk aversion imposed on the regulatory system will only hold us all back.
2) Competition and costs

There is nobody who pays more for the services they actually get, adjusted for quantity and quality, than the poor – whether it be water, medicine, or finance. This means that even if the poor pay fairly high prices, they are better off compared to the alternative. By capping prices or interest rates at low levels, though, the government does not ensure the poor get low prices. Instead, it ensures they get no service and have to resort to very highly priced unsavory alternatives.

We should allow the market to set interest rates, so long as the rates are transparently set and contracts willingly entered into. We do need better consumer protection, especially of the weaker sections, but protection focused on eliminating unsavory practices, not on constraining market interest rates. Interest rates should be brought down by more competition and a better infrastructure for delivering financial services. And we should avoid politically motivated campaigns to forgive debt on a blanket basis – that only ensures the repayment culture is vitiated. Instead, we need ways to selectively and quickly renegotiate debt in case the debtor is in trouble.

The government can do its bit by bringing down the extremely high costs of servicing the poor. For instance, social lending is very costly – you need to create the self help groups, then have a bank employee in constant contact with the group so as to create the group solidarity and peer-pressure that encourages repayment. What if instead everyone had a national ID that allowed their transactions to be tracked? Furthermore, what if financial institutions, landlords, and even cell phone companies pooled information about an individual’s financial transactions in a credit rating agency? By mining the data, an enterprising finance company could find a poor driver who paid his cell-phone bill regularly, and take a chance on giving him a loan. And he
would have an incentive to repay the loan because his impeccable credit history would be an asset worth protecting.

What role does the government have to play here? First, to roll out a unique national ID, perhaps with biometric identification – we have talked about this for long, but there is too little movement. Second, allow more entry into the credit rating business, a move that is in the works. Third, allow for collection and dissemination of information from, and to, more sources, with appropriate safeguards for privacy. For instance, cell phone companies probably have more widespread information on payment behavior than anyone else in the country. Fourth, force everyone to share the information they collect, not just on defaults, but also positive information.

Another place where costs can be reduced considerably is savings and payments. Our whole delivery system for banking services is predicated on delivery through branches. But technology offers far cheaper ways to provide simple banking services – through cell phones for example. I can deposit cash at my local kirana shop, which can then transmit a signal to my bank which can then send a signal back with my new balance. Indeed, it may be efficient for cell phone companies to offer rudimentary payment services through their cell phone accounts, without going through banks. The time for that will come, and it may be the cheapest way to make small payments.

3) **Better thought out interventions.**

As you may have noted, I believe we can create more access by creating more competition to provide services the poor want, and by reducing the costs through technological and organizational change. But what about direct government intervention? There may be some
benefits from the government intervening, but it should do so in a way that will encourage efficiency.

For instance, banks currently have to meet priority sector norms – 40 percent of all lending has to be to the priority sector. But while some banks have the capacity to make these loans profitably, not all do. In an attempt to ensure that priority sector lending does not automatically generate NPAs, the eligible categories for priority status now include software and housing below 20 lakhs in value. It is indeed a stretch to call someone who can afford a Rs 20 lakh house poor.

Rather than stretch the definition of the priority sector, it is better to have lower overall requirements but restrict eligible categories to the truly needy. This requires politicians to recognize that a lower norm restricted to the truly needy may be more effective in expanding access. A more important change would be to allow some lenders to specialize in priority sector lending, and for them to make additional money off it. Here is how: Allow any financial institution, such as a micro lender, to obtain certificates for loans that it makes to eligible categories. A bank that exceeds its lending requirement would also obtain certificates for the excess. Both could then sell the certificates (not the loans but only the certificates) to banks that have not met their priority sector quota.

Purchasing banks could use the certificate towards fulfillment of their quota. If priority sector lending is truly difficult, the certificates would command a high price, and this would attract more lenders to the priority sector. If the government wants more priority sector lending, it could buy up certificates, increasing their price, and thus offering more of a subsidy to such lending. Over time, the priority sector requirement could be brought down for banks and the
government could replace banks by buying certificates in the market, thus converting an implicit subsidy to an explicit one.

The point is that instead of having reluctant banks make priority sector loans they may not be suited to make, let more efficient lenders emerge to take over the lending. Note that even if the market for priority sector certificates looks complicated, it is not – in principle it involves no more new ideas than the market for bank reserves, which is well-functioning.

I can go on and on. But let me summarize, leaving time for questions. I have deliberately picked the issue of access because it embodies all that the Indian financial system needs including more entry, more competition, more innovation, and more use of technology. It is also the issue where the popular consensus is that competition does not matter, where instead we need more targets, subsidies, and government intervention. I think this is consensus is terribly wrong. But it is what allows the government to intervene extensively in the financial sector.

Indeed, I see little evidence that state ownership helps significantly in achieving public aims such as greater inclusion. It makes sense to rethink the state presence in the financial sector. It should be reduced at a pace consistent with the private sector’s ability to absorb it. Meanwhile, we should improve the public sector’s ability to compete, and protect the legitimate interests of public sector employees.

That brings me to my last concern. Despite nearly two decades of reform, protection of producer interests, at the expense of consumers, is still rife in the Indian financial sector today. The entrenched public sector institutions are not the only culprit. Why, one should ask, with all the global integration that India is undergoing, has the share of banking system assets owned by foreign banks remained constant or even declined? Are we protecting domestic banks overly? Is
that helpful for our global ambitions? Similarly, should we protect banks from competition from non-banks such as cell-phone companies? What is best for our people? These kind of questions have to be asked loudly and often.

Let me conclude. India’s financial system has many successes – the rapidity of settlement at the NSE or the mobile phone banking being implemented around the country indicate that much of our system is at the Internet age and beyond. We should feel proud of this. Yet some parts are still in the Stone Age, and unfortunately, this is the part that our poor typically face. There is an opportunity here. For the road to making Mumbai an international financial center runs through every village and slum in India -- it is in the process of gaining the productivity and innovativeness to serve the masses that we will get the unique edge and scale to be competitive internationally. It is also the moral and just path for us to take. I sincerely hope we will take it.

Thank you.