The role of financial services sectors in intensifying economy for development pathways & achieving financial inclusion

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Abstract: Financial services are fundamental to economic growth and development. Banking, savings and investment, insurance, and debt and equity financing help private citizens save money, guard against uncertainty, and build credit, while enabling businesses to start up, expand, increase efficiency, and compete in local and international markets. In many developing countries, access to formal financial services is very limited, particularly for poorer households and SMEs, and it is likely that this lack of access to finance significantly constrains economic growth and reduces the ability of the poor to participate in markets, to increase their income and to themselves contribute to economic growth. This paper sets out the crucial role the financial sector plays in the economy, facilitating public & private sector development, stimulating investment and growth and contributing directly to poverty reduction. Thus, successfully implementing financial sector services promotes better access to economic facilities. This paper highlighted that financial opening promotes better access to financial services, by stimulating competition and hence reducing excess profits made by the banks and thus reducing the cost of credit, and by incentivising financial service providers to expand their client base as they compete for market share. Paper shows that there is a need for the financial inclusion initiative to have a special focus on respective States in North India to make it more meaningful.

Keywords: Financial Services, Economic Growth, Developing Countries, Stimulating Efficiency, Development Challenges, Financial System, Financial Inclusion

1 Introduction

It is widely recognized that the development pathway requires access for families and firms to appropriate financial products, including savings, credit, insurance, and investment instruments. Although much of the debate around poverty reduction focuses on meeting basic needs, such as food and health care, sustained long-term economic progress at both household and economy-wide levels depends on access to financial products and services that allow individuals and firms to move away from short-term decision-making to an intertemporal allocation of resources. Access to financial services is a fundamental driver of increased household income and resilience in an increasingly shock-prone global economy. Designing financial products that respond to the needs of the poor and middle class and creating the policy environment in which financial institutions can flourish present core development challenges. Although the evidence on the role of the financial system in shaping economic development is substantial and varied, there are serious shortcomings associated with
measuring the central concept under consideration: the functioning of the financial system. Researchers do not have good cross-country, cross-time measures of the degree to which financial systems (1) enhance the quality of information about firms and hence the efficiency of resource allocation, (2) exert sound corporate governance over the firms to which they funnel those resources, (3) provide effective mechanisms for managing, pooling, and diversifying risk, (4) mobilize savings from disparate savers so these resources can be allocated to the most promising projects in the economy, and (5) facilitate trade. Instead, researchers have largely—though not exclusively—relied on measures of the size of the banking industry as a proxy. But, banking sector size is not a measure of quality, or efficiency, or stability. And, the banking sector is only one component of financial systems. There has been a considerable debate among economists on the role of financial development in economic growth and poverty reduction, but the balance of theoretical reasoning and empirical evidence suggests that finance has a central role in socio-economic development. Economies with higher levels of financial development grow faster and experience faster reductions in poverty levels. This section introduces the concept of financial development and provides a brief review of the literature on the linkages between financial development, economic growth, and poverty reduction. Moreover, research sheds light on the mechanisms through which finance affects growth—the financial system influences growth primarily by affecting the allocation of society’s savings, not by affecting the aggregate savings rate. Thus, when financial systems do a good job of identifying and funding those firms with the best prospects, not those firms simply with the strongest political connections, this improves the capital allocation and fosters economic growth. Such financial systems promote the entry of new, promising firms and force the exit of less efficient enterprises. Such financial systems also expand economic opportunities, so that the allocation of credit—and hence opportunity—is less closely tied to accumulated wealth and more closely connected to the social value of the project. Furthermore, by improving the governance of firms, well-functioning financial markets and institutions reduce waste and fraud, boosting the efficient use of scarce resources. By facilitating risk management, financial systems can ease the financing of higher return endeavours with positive reverberations on living standards. And, by pooling society’s savings, financial systems make it possible to exploit economies of scale—getting the biggest development bang for available resources.

2 Literature Review
Defining financial development in terms of the degree to which the financial system eases market imperfections, however, is too narrow and does not provide much information on the actual functions provided by the financial system to the overall economy. Thus, Merton (1992), Levine (1997, 2005), Merton and Bodie (2004), and others have developed broader definitions that focus on what the financial system actually does. Economies with higher levels of financial development grow faster and experience faster reductions in poverty levels [Levine (1997, 2005)]. Economists have long debated the role of the financial sector in economic growth. Lucas (1988), for example, dismissed finance as an over-stressed determinant of economic growth. Robinson (1952, p. 86) quipped that "where enterprise leads finance follows." From this perspective, finance responds to demands from the non-financial sector; it does not cause economic growth. For financial markets, earlier work by Levine and Zervos (1998) indicates that the trading of ownership claims on firms in an economy is closely tied to the rate of economic development. In the database, financial market depth is

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approximated using a combination of data on stock markets and bond markets. Financial depth, approximated by private credit to GDP, has a strong statistical link to long-term economic growth; it is also closely linked to poverty reduction [see, for example, Demirgüç-Kunt and Levine (2008)].

3 Policy Principles for Expanding Financial Access

The principles are directed not only to policymakers and other actors whose main focus is to provide financial access, but also to those whose policy actions can influence access. These include the prudential and market-conduct regulators of financial markets and of banks and other financial intermediaries; competition and licensing authorities; and the ministries concerned with legislation governing interest-rate ceilings, and anti–money laundering and combating the financing of terrorism policies. At a time of increased focus on financial-sector policy and of regulatory tightening, it is important not to lose sight of the goal of increasing the access to appropriate financial services essential to the escape from poverty and the achievement of firm growth. It is in this spirit that we propose 7 basic principles for financial-sector policymakers—including national authorities, donors, private-sector participants, international financial institutions, and others on the facilitation, regulation, and direct provision of financial services.

Principle 1: Promoting entry of and competition among financial firms
Policy should encourage competitive provision of financial services to customers such as low- and middle-income households and small firms. Policy should favour entry of qualified suppliers that are likely to improve the quality and price of services to such customers (in a manner consistent with financial stability and consumer protection). Competition policy should empower the active investigation of anticompetitive behaviour.

Principle 2: Building legal and information institutions and hard infrastructure
Policymakers should work with market participants to eliminate barriers and identify gaps in the institutional infrastructure relevant to small-scale supply. This includes ensuring that payments and collateral systems and hard infrastructure elements for retail transactions are available and have a Low unit cost. In particular, collateral and information infrastructures need modern supportive legislation and regulations. The state has a central role in ensuring the availability and maintenance of much of this infrastructure.

Principle 3: Stimulating informed demand
As a complement to other consumer protection activities, policymakers should facilitate education and confidence-building measures among those currently excluded by coordinating, setting standards and curricula, and possibly cofounding private efforts. Financial-service providers play a crucial role in fostering informed consumers, among others, by making information available in a manner suitable to small-scale clients.

Principle 4: Ensuring the safety and soundness of financial-service providers
The rules and procedures for prudential regulation of financial-service providers should be carefully designed for consistency with financial-service provision at a small scale. In particular, regulation

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should be assessed for its impact on access and should reflect the risks faced by low-income households and small firms. Prudential regulation need not be restricted to deposit takers. To avoid regulatory arbitrage undermining sustainable access, consistent protection should drive cross-agency regulatory harmonization.

**Principle 5:Balancing government’s role with market financial-service provision**
The design of any direct government interventions should seek to respect the commercial market logic as much as possible—especially in regard to cost effectiveness—and avoid damaging distortions to market functioning. To facilitate maximum scale through leverage of private capital and initiative, the design of policies and interventions to increase access should avoid stifling private provision. Some forms of direct government involvement in financial-service provision may be justifiable—for example, when it is otherwise difficult to overcome market failures or to deal with incompleteness of private market provision. Generally such problems require only temporary and catalytic interventions, and they should be explicitly time-bound. There need to be safeguards at state firms against political interference, especially where credit is being extended. Governance of such firms should be transparent to the public, modelled on best practices for non-government owned firms. Any non-commercial objectives of such firms should be publicly known, quantified, and costed.

**Principle 6: Using subsidies and taxes effectively and efficiently**
While some permanent element of subsidy can in some cases be necessary to foster access, the design of subsidies should, where possible, be time-bound and aimed at making institutions and access self-financing and sustainable. All forms of subsidies and policy costs should as far as possible be accounted for and be itemized clearly in the national budget. Any government-provided or directed credit or other (implicit or explicit) subsidy should be free of political influence, particularly in the credit underwriting process. The taxation of financial services should be access-friendly.

**Principle 7: Protecting low-income and small customers against abuses by FSPs**
Low-income and small customers need regulatory protection against abuses by service providers. FSPs should be subject to legislation designed to ensure that they do not sell customers products that are unsuitable for their needs. Market conduct and other regulations in this area (AML/CFT) need to minimize compliance costs while retaining effectiveness. Consumer protection and market-conduct regulation should aim to ensure that the design, pricing, and marketing of products offered to low-income households and small firms is not exploitative of market power and of these consumers’ limited ability to verify in advance the appropriateness, risks, and value for money of financial products. Consumer protection is of special importance for this segment, especially for credit and insurance products. Unregulated credit providers have been documented to offer credit products that impose heavy individual penalties for delinquency to vulnerable customers with low, fluctuating incomes. Indeed, unscrupulous FSPs may design their pricing and charging structures with the deliberate intention of exploiting such users’ innocence.

These principles are directed primarily to policymakers charged with improving financial access and to the multilateral organizations and donors that play a central role in the creation of relevant policy initiatives.
4 Indian Financial Sector – The way forward

As we have seen, financial services help the poor to reduce vulnerability and manage the assets available to them in ways that generate income and options. Perhaps the most significant way banks can contribute to expanding economic opportunity is therefore to find ways of making financial services available to low-income individuals, entrepreneurs, and small business owner-operators – ideally through inclusive business models that are financially viable, and thus offer the potential for sustainability and scale. In addition to inclusive business model innovation, large commercial financial institutions are engaging in efforts to develop human capital, build institutional capacity, and help shape supportive regulatory and policy frameworks in the geographies in which they operate.

The far-reaching changes in the Indian economy since liberalization have had a deep impact on the Indian financial services sector. Financial sector reforms that were initiated by the government since the early ‘90s have been to meet the challenges of a complex financial architecture. This has ensured that the new emerging face of the Indian financial sector will culminate in a strong, transparent and resilient system. Broadly, financial sector reforms can be categorized in two phases. The first phase of economic reforms that started in 1985 focused on increasing productivity, new technology import and effective use of human resources. These efforts were in line with the changes in international markets, organisations and production areas. In the second phase, beginning in 1991-92, the government aimed at reducing fiscal deficit by opening the economy to foreign investments. Financial sector reforms during this period focused on modification of the policy framework, improvement in financial health of the entities and creation of a competitive environment. These reforms targeted three interrelated issues viz. (i) strengthening the foundations of the banking system; (ii) streamlining procedures, upgrading technology and human resource development; and (iii) structural changes in the system.

4.1 Understanding Northern Region: Diversities and Opportunities

North India is the biggest region in terms of population and area. North India (includes the States of Punjab, Himachal Pradesh, Uttar Pradesh, Uttarakhand, Rajasthan, Haryana, Jammu & Kashmir, Delhi and Union Territory (UT) Chandigarh) accounts for 30.5% of the country’s population and ~31% of its geographic area. North India historically has been political centre of our Country. Delhi, today’s capital of our country has always played centre stage to political actions while the adjoining State of Uttar Pradesh is considered to be the most influential political State as it sends highest number of MPs to our parliament and has provided India with eight prime ministers so far. In terms of economic growth, North India has exhibited marginally better than average GDP growth in past 5 years with CAGR of 9% (FY06-FY11) vis-à-vis 8% of the country’s GDP growth and together they contributed 25% to India’s GDP in FY 2010-11 (measured at constant prices 2004-05). Strong GDP growth has resulted into emergence of big cities such as Delhi, Chandigarh, Jaipur, Lucknow etc. within the region. Each State in North India has a different vibrancy and unique characteristics in terms of its demographics, economic growth, financial literacy, competitiveness, etc. While some of the States such as Haryana and Delhi are developing at rapid pace, other States such as Uttar Pradesh and Rajasthan are lagging behind. GDP of Uttar Pradesh and Rajasthan which together constitute ~72.8% population of the North region have grown only at CAGR of 7.5% dragging growth of the
North Region. Uttar Pradesh has one of the highest percentages of population living in rural areas (~77.7% of the total population) in contrast to, say Punjab, where ~62.5% of the population lives in rural areas.

4.2 Economic Growth of North India

North India accounts for 30.5% of population and ~25% of the country’s GDP indicating a below par economic base as well as per capita. Within the Northern Region itself, there are pockets of high and low growth States (most likely due to legacy issues as well as natural advantages). The GDP growth of the select States in the Northern Region has outgrown the Indian average, indicating inherent potential as well as positive growth outlook.

Table 1: GDP Growth - Individual States (Source: Data book for DCH, Planning Commission, November 2011)

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<tr>
<td>Chandigarh</td>
<td>9.4</td>
<td>10.8</td>
<td>11.6</td>
<td>12.5</td>
<td>13.7</td>
<td>15.8</td>
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<tr>
<td>Delhi</td>
<td>110.4</td>
<td>124.1</td>
<td>138</td>
<td>150.3</td>
<td>165.8</td>
<td>183.3</td>
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<td>Haryana</td>
<td>103.7</td>
<td>115.7</td>
<td>127</td>
<td>137.9</td>
<td>151.7</td>
<td>165.4</td>
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<td>Himachal Pradesh</td>
<td>26.1</td>
<td>28.5</td>
<td>30.9</td>
<td>33.2</td>
<td>35.9</td>
<td>39.1</td>
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<td>J&amp;K</td>
<td>28.0</td>
<td>29.7</td>
<td>31.5</td>
<td>33.4</td>
<td>35.6</td>
<td>37.9</td>
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<tr>
<td>Punjab</td>
<td>102.2</td>
<td>112.5</td>
<td>122.5</td>
<td>130.3</td>
<td>140.1</td>
<td>150.3</td>
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<tr>
<td>Rajasthan</td>
<td>136.3</td>
<td>152.2</td>
<td>160.0</td>
<td>171.4</td>
<td>178.7</td>
<td>196.0</td>
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<td>300.1</td>
<td>322.0</td>
<td>343.8</td>
<td>367.8</td>
<td>397.5</td>
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<tr>
<td>Uttarakhand</td>
<td>28.3</td>
<td>32.3</td>
<td>38.0</td>
<td>42.8</td>
<td>47.8</td>
<td>52.1</td>
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<td>North Region</td>
<td>822.1</td>
<td>905.7</td>
<td>981.5</td>
<td>1,055.7</td>
<td>1,137.1</td>
<td>1,237.3</td>
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| India Total               | 3,254.2 | 3,566.0 | 3,899   | 4,162.5 | 4,493.7 | 4,877.8 |

Figure 1: Comparison of India’s GDP with Northern region (Source: Data book for DCH, Planning Commission, November 2011)

4.3 Financial Services in North India

Unique characteristics such as demographics, economic growth, geographic and cultural diversity has resulted into different degrees of financial services penetration within the States of North India. A few States in North India rank very low in terms of financial inclusion indicating that the economic potential of these regions has not been explored by the financial services players to the maximum

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extent. As provided the average population per bank office is relatively low in Delhi, Punjab, Himachal Pradesh etc. indicating better penetration while in more populous states such as Uttar Pradesh and Rajasthan it is higher than the national average (13,000 per bank office). This suggests that financial services players can pick their geographies within North India and leverage the underutilization of these potential pockets.

Northern region has been an underperformer from a GDP contribution perspective with ~30.5% of population contributing to ~25% of the country’s GDP. However, the region has exhibited better than average GDP growth over last five years. The ‘trickle-down effect’ as well as investments made in the region have created a positive spiral for the growth of the region. The growth within North Indian Region is however uneven. States such as Uttarakhand, Haryana and Delhi have grown at CAGR of more than 10% over past five years while Uttar Pradesh has grown at CAGR of 7%. The uneven growth and diversities have resulted in regional imbalances that need to be managed at the State level. There is a need for several State level initiatives – to propel economic growth as well as achieve the financial inclusion objective. Moreover, partnership among the stakeholders such as Financial Services Institutions, State Governments, State Level Government Bodies, and Regulators etc. shall be critical to achieve this objective. Some of the existing partnership initiatives undertaken by financial services players are indicative of the progress being made in the Northern region to achieve financial inclusion.

4 Financially Inclusive Ecosystems: Roles of Government

Financial inclusion is measured in three dimensions: (i) access to financial services; (ii) usage of financial services; and (iii) the quality of the products and the service delivery. The Basic Set, which addressed some of the key access and usage indicators, is hereby extended into the G20 Financial Inclusion Indicators, covering the three dimensions and providing further insight into access and usage aspects, including indicators on the emerging mobile financial services space. Both supply-side and demand-side data is included to form a comprehensive view. The realisation that financial inclusion is a key enabling element, both in the fight against poverty and in reaching the goal of inclusive economic development, is leading to an increasing focus on financial inclusion policies and initiatives. Financial inclusion today is about financial markets that serve more people with more products at lower cost. The term “microfinance,” once associated almost exclusively with small-value loans to the poor, is now increasingly used to refer to a broad array of products (including payments,
savings, and insurance) tailored to meet the particular needs of low-income individuals. Two separate but related developments have spurred this more holistic approach to financial inclusion. First, a growing body of research is demonstrating that poor people use and need a wide array of financial products, not just credit. Second, innovative lower cost business models—especially electronic and agent banking models—hold the promise of reaching unbanked populations with a fuller range of products better suited to their needs.

As governments become more actively involved in the financial inclusion agenda, a key challenge is defining roles for government in creating the broader and interconnected ecosystem of market actors needed for safe and efficient product delivery to the poor. This Focus Note explores three roles that have the potential for significant impact: (i) promoter of front-end and back-end infrastructure, (ii) rules maker with respect to that infrastructure and its contribution to responsible market development, and (iii) driver of transaction volume. While each of these roles can have significant impact, the application of these roles in any given jurisdiction will depend on country specific factors, such as customer demand, market structure and maturity, government philosophy toward the market, and supervisory and other governmental capacity.

Figure 3: Roles of Government in Financially Inclusive Ecosystems

With emergence of new technologies, new products, cost efficient business models and new participants in the eco-system there is compelling case to redefine the existing approach for financial inclusion. The new approach shall be built on competition among the financial service providers, collaboration with other participants and regulators, product innovation, superior cost efficiency, organizational flexibility with active support and participation from the government. For the financial services industry, to create an eco-system with the new approach would require active participation from all the stakeholders which include:

• Central and State Government
• Regulators including RBI, IRDA, SEBI, PFRDA, NHB etc.
Financial services providers such as Banks, Insurance companies, Mutual Fund companies etc.
- Other financial institutions, intermediaries and service providers such as NBFCs, IT Service providers and Telecommunication service providers
- Industry associations, NGOs and Consumer organizations

Figure 4: Evolving eco-system for financial inclusion

6 Role of Financial Services and Institutions as catalysts for inclusive growth

While it is understood that financial services players will be the key catalysts driving inclusive growth, it is important to understand and appreciate the key challenges and hindrances that have prevented us. From achieving full-financial inclusion in the past, Inclusive growth has been on the agenda of the Indian government for a long time now, however, it still remains a distant dream for our country. Various public and private interventions have been undertaken in the past five decades to expand reach of financial services. However, these have met with limited success. Exhibit above describes time linked interventions undertaken by various stakeholders. Despite the efforts made so far, a sizeable majority of the population, particularly vulnerable groups, continue to remain excluded from the opportunities and services provided by the financial sector. Some of the key facts of the ‘Financial Exclusion’ are given below:

- For the banking services, penetration remains abysmally low with only 55% of the population having deposit accounts and only 9% of the population having credit accounts with the banks
- As per RBI, India still has highest number of households (145 million) completely excluded from

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In order to counter challenge the traditional methods of financial inclusion, a new approach is being adopted that entails development of viable business model, development of innovative products and services, partnerships among broader stakeholders and more participative role from government. Financial services players need to adapt their operating and tactical strategies according to their strategic positioning. Players will have to determine their sweet spots and align their business and operating models that best positions them to service customers.

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The staggering numbers of financial exclusion call for system wide efforts to tackle the issue. We will be able to achieve the desired outcomes only if we create vibrant ecosystem for financial inclusion to ensure that the organizational architecture supports and creates institutions that can reach the low income and vulnerable groups of the society.

Exposure to global practices has made the Indian customer more discerning and demanding. There has been a clear shift towards those entities that are able to offer products and services in the most innovative and cost efficient manner. The financial services sector will need to adopt a better customer-centric business focus. It will also have to create value for its shareholders as well as its customers, competing for the capital necessary to fund growth as well as for customer market share. Engage in multi-pronged strategies for expanding economic opportunity. A firm’s primary focus should be to develop inclusive business models that make those services widely accessible. Constraints in the system however mean that inclusive business models often require complementary strategies to be viable.

7 Conclusion:
In the financial services sector, engagement with microfinance institutions, international financial institutions, and multilateral and bilateral donors is common, particularly around microfinance. Large commercial banks have the potential to serve as lynchpins in the dynamic transformation of financial inclusion.
markets to offer expanding economic opportunity to the poor. While individual firms must naturally choose the strategies most appropriate for them, strong collaboration capabilities will almost certainly be essential – both within the financial sector and beyond. Financial inclusion and inclusive growth are no longer just policy choices, but are policy imperatives, which would determine the long-term financial stability and sustainability of the economic and social order, going forward. We need to ensure that all of us are collectively willing to walk that extra mile to ensure that our fellow countrymen get easy access to the financial system and are able to leverage this access to improve their economic and social well-being. Please remember that the rich would not be able to sleep peacefully if the economic and social divide is allowed to grow any bigger. Financial services in India still remain largely under-penetrated and there lies the opportunity for high growth. Foreign banks are likely to be allowed to acquire local banks when the next stage of banking reforms is proposed and increased FDI limit in insurance will offer good opportunities in the insurance sector. Low penetration in the pension market makes it a lucrative business segment. India also offers a once in a lifetime opportunity for PE funds to invest in the infrastructure asset class across the board ranging from core sectors such as power, roads, transport to social asset classes such as healthcare, education, environment. Other service economy infrastructure sectors like telecom, ISPs, financial payment gateways also offer massive opportunities. As I mentioned at the beginning, in view of their reach and coverage, electronic and print media has an important role in not only supporting our financial inclusion mission but in leading the initiative by spreading our message far and wide. Today's event is a glowing testimony to the support being extended by the media to the cause of Financial Inclusion and I firmly believe that this support would act as a catalyst and further invigorate the efforts being made by the governmental and non-governmental agencies.

8 Future Work: Impact evaluation needs go beyond these data. Ideally the quantitative base for policy should be analysed at the design stage with rigorous methodologies, using pilots, baseline surveys, and control groups. Different types of data are needed for this: benchmarking, micro-impact studies, and financial literacy studies. This should determine the size and distribution of the policy’s costs and benefits. Studies should be published, so that their findings can be accessed internationally. Any government costs, direct (for example, subsidies for access) or indirect (for example, tax waivers) should be accounted for, in order to help ensure a proper discourse on the cost and benefits of specific government interventions. Regulatory impact assessments (RIAs) are increasingly being employed for financial and other regulatory policies; these, too, should be access-proofed. Explicit mandatory attention to the impact on access would become part of such RIAs where they are used.

9 References

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