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Subir Gokarn: The inclusion triangle

The right combination of product, delivery and awareness is critical to the Jan Dhan Yojana's success

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A triangle is symbolically important because it is the smallest number of lines needed to bound a space. Inclusion essentially means expanding the bounded space, so that those who were earlier outside can now come inside. The recently launched Jan Dhan Yojana (JDY), the government's big push towards financial inclusion, aims to rapidly expand that space. Let me use a triangular approach to assess its prospects. The three sides of my inclusion triangle are product, delivery and awareness.

On the product side of the triangle, the JDY could potentially make a quantum leap. The first stage of the inclusion strategy was focussed on opening bank accounts, logically seen as creating the last-mile channels for financial access. But, the fact that the channel existed was no guarantee that anything meaningful would flow through it. Consequently, the policy rhetoric moved to something referred to as "meaningful financial inclusion". This meant that the channels created were actually being used to deliver financial products - savings, credit, insurance and pensions. In November 2012, the Ernakulam district in Kerala was recognised as being the first to achieve meaningful inclusion, which essentially meant that virtually all households had at least one account and a non-negligible number of them were consuming one or more of these four categories of products.

What the JDY does is to compress the two-stage process into one. By offering an overdraft facility as well as both life and accident insurance with every account, it significantly increases the appeal of plugging into the financial system. I think that the most important aspect of this packaging, at least in the short term, is the overdraft facility. It can compete directly with the credit services that the informal sector currently provides people with relatively small requirements of capital.

However, in order to do this effectively, two factors need to be considered. The first is pricing. The general perception about informal credit is that it is extremely expensive. But, a correct assessment of its effectiveness cannot be made on the absolute level of the interest rate charged. It must be based on the return on capital (in textbook terms, the marginal product of capital) that the borrower is able to generate. At very low levels of capital employed, returns tend to be very high, therefore justifying the interest rates charged. The organised sector may be able to deliver credit to this constituency of borrowers at a price lower than the informal sector, but commercial viability will require a price much higher than that charged to traditional borrowers.

The second, which also relates to the next side of the triangle, i.e. delivery, is the issue of who bears the risk. Banks may provide the conduit and can presumably bear the credit risk intrinsic to the product, but the insurance risks will clearly have to be borne by insurance companies. An additional dimension to this issue is that the programme will inevitably have to use non-banking channels for delivery, for reasons that I will come to later. The ability of such channels to bear risks will vary, for both structural and regulatory reasons. Therefore, there must be mechanisms in place that allow for transparent and smooth risk transfers across institutions. Securitisation became a dirty word in the wake of the financial crisis of 2008, but its virtues in enabling such transfers should not be forgotten.

Coming to the delivery side of the triangle, a critical lesson that needs to be learnt from the informal sector is doorstep delivery. For the constituency being targeted by JDY, the opportunity cost of time is extremely high; visiting a bank or any other location to transact may just not be worth the price. The business correspondent (BC) model was supposed to solve this problem. The BC is in essence a home delivery banker. The only problem is that s/he, with the exception of cash transactions, has not really had a product to deliver! The challenge for JDY is to create a viable last-mile capacity to both distribute the product package and, very importantly, ensure payments and repayments.

Banks were supposed to do this, but, couldn't or didn't. In the meantime, several alternative channels of delivery have emerged. In the financial space, these include non-bank financial companies, particularly microfinance institutions, business correspondent networks and pre-paid instrument providers. Going a step beyond, telecom companies and consumer goods companies also have extensive networks, the former with the added benefit of know-your-customer regulatory requirements. At this stage in the process, there is no - or certainly not enough - evidence to suggest that any one of these channels is superior to the other.

In addition to all of these, there's the new kid on the block - the payment bank. The guidelines for these indicate that they will not be able to provide credit. However, they could presumably act as last-mile agents for banks and insurance companies, identifying and servicing customers of credit and insurance products.

Essentially, an effective delivery model requires a combination of significant last-mile capacity - all existing players and whichever new ones enter the fray - and a back end - banks and insurance companies - with efficient risk transfer and contract enforcement mechanisms linking the two. This is, of course, a classic wholesale-retail model, which works extremely well in so many sectors. With the right arrangements in place, there is no reason why it can't work here as well. Whether the right arrangements allow for broad-based commercial viability or not, only experience can tell us, but it is certainly an experiment worth trying.

Finally, on the awareness side of the triangle, there is an unquestionable need to support the rollout of the programme with clear messages relating to the potential benefits of various products and answers to questions about appropriateness and affordability. But, the key element in an awareness strategy for JDY should be an emphasis on the consequences of not living up to commitments. Sops like loan waivers must be completely abjured and the consequences of default must be visible and significant.

A number of observers have voiced the concern that the JDY runs the risk of becoming yet another resource-sapping burden on the banking system. There is always that risk, of course. But, an effective combination of product, delivery and awareness should help to minimise it.

The writer is director of research, Brookings India, and former deputy governor, Reserve Bank of India. The views are his own