Chapter – 12

Demand side causes and solutions for Financial Inclusion

12.01 The Committee's report has so far concentrated on supply side issues of financial inclusion and what can be done to enhance supply of financial services, through increased outreach by existing institutions, enhancing their incentives to serve the excluded and adding new distribution channels. The Committee is of the view, however, that financial exclusion is also caused by demand side issues – the fact that nearly 22% of the population is below the poverty line, and could not fully participate in the mainstream economy. Unless some steps are taken on the demand side, or in the "real sectors", mere supply side solutions from the financial sector will not work.

Resource Endowment Issues

12.02 It is widely recognized in economic literature that there are at least five different types of capital – physical (roads, buildings, plant and machinery, infrastructure), natural (land, water, forests, livestock, weather), human (nutrition, health, education, skills, competencies), social (kinship groups, associations, trust, norms, institutions) and financial. One of the causes as well as consequences of poverty and backwardness is inadequate access to all these forms of capital. Thus to look at financial inclusion in an isolated way is problematic.

12.03 Merely pumping a backward region with financial capital is not going to be enough in the absence of improvements on the side of human, social and physical capital. The people in the first place have to be healthy and educated to be productive, so that they can use finance effectively. There has to be a substantial degree of trust and functioning institutions, in other words social capital, for economic transactions to take place in an atmosphere of confidence. Finally, there has to be adequate access to physical capital in terms of roads, bridges, canals, warehouses and market yards, in addition to electric power and telecommunication, for financial capital to be useful. In the absence of all this, merely insisting on financial inclusion will not work. This explains why the credit deposit ratio in some of the eastern States, remains low over several decades. Let us examine the adequacy of various other forms of capital.

Inadequate Human Capital

12.04 Health and education are both essential pre-requisites for financial inclusion. Moreover, access to these services is enabled by access to financial services. Important health indices like life expectancy at birth, infant and under-five mortality levels show that a lot remains to be done.

12.05 On the education front also, quality of education imparted in the mainstream system of education, poor attainment level of children and high drop out rates at all levels need to be tackled urgently. The educationally excluded groups mainly belong to socially disadvantaged groups like the STs, SCs, OBCs and girls from poor households. In such a situation, financial inclusion has to be preceded by effective investments by the government to ensure near universal access to primary health and education.

Inadequate Access to Natural Capital

12.06 Land is the most important form of natural capital, followed by water. In most of the districts and states where financial inclusion is low, a vast majority of the rural population is either landless or have less than 1 hectare of land. In rainfed areas land ownership is higher, but the percentage that is irrigated is small. For example in Jharkhand, less than 10% of the cultivable land is irrigated. In Vidarbha, the extent of irrigation is only 7% of the gross cropped area. For small farmers the access to land and water resources is a key precondition for using credit. It is in this context that programmes for enhancing access to land and water become relevant. For tribal communities, access to natural capital in terms of forest lands is severely restricted and this adversely affects their livelihoods and the ability to use credit.

Inadequate Physical Capital

12.07 A vast majority of financially excluded regions and districts also suffer from low level of investment in roads, bridges, canals, power supply, market yards and warehousing. The absence of this leads to a general malaise in the local economy and a disincentive for private investments in directly productive sectors.

Underdeveloped Social Capital

12.08 There is a general correlation between financial exclusion and under-developed institutions. Gram Panchayats, commodity cooperatives, local administration and even local markets in the financially excluded regions are not well developed. Making these work is again both a pre-condition for financial inclusion, and will be assisted by it.

Productivity Issues

Low Productivity

12.09 The Committee noted that most of the regions which have a low degree of financial exclusion, also exhibit a low level of agricultural productivity. While the Committee was not able to commission any detailed studies on this topic, a cursory review of data indicates a high degree of correlation between low financial inclusion and low agricultural productivity. The Committee is aware of the aphorism that "correlation is not causation". That is why instead of saying that pumping more credit will enhance agricultural productivity in such regions, it is felt that there is a need for "real sector" interventions to enhance agricultural productivity which would then generate demand for additional finance.

No local value addition

12.10 One of the primary uses of finance is when value is added locally to primary produce. Regions such as Western Maharashtra and Western Uttar Pradesh have become prosperous by not only growing sugar cane but by adding value to it by local processing and marketing. This may be at the traditional level of "gur" or intermediate level of khandsari units, or modern sugar mills. The value chain can be further enhanced by producing by-products from molasses, such as alcohol and co-generated power.

Poor Market Linkages

12.11 The Committee was informed of the weak market linkages that exist both on the input and the output side, in most of the areas characterized by low financial inclusion. The North-Eastern States are a prime example of this - pineapples in Mizoram, ginger in Sikkim and orchids in Arunachal Pradesh - considerable quantity goes waste because they cannot be marketed. The same is true when crops like tomatoes or potatoes are grown and there is a glut. Farmers are unable to sell them to distant markets due to lack of information / communication and transport linkages. Effective increase in demand for credit in such areas without prior improvement in physical infrastructure will be difficult.

Risk Issues

12.12 Even where rural producers have access to land and water they may suffer from a high variance in yield and productivity levels caused by factors such as rainfall, seed quality, pest attacks and agronomic practices. This leads to higher financial risk. As several studies on the spate of recent farmer suicides show, the primary problem seems to be high risk in agriculture, due to yield as well as price variations. That is why even medium-sized farmers have been committing suicides.

Unorganised Nature of the Excluded

12.13 Apart from suffering from poor resource endowments in terms of low levels of natural, physical, human and social capital the financially excluded segments and regions are characterised by a very low level of social organisation. Due to prevailing levels of distress and uncertainty, people are often reluctant to collaborate or contribute to any common cause. This leads to a situation where collective action institutions such as cooperatives and SHGs thrive in the western and southern regions but not elsewhere.

12.14 People not only do not come together for savings and credit, they also do not come together for input purchase or output marketing or sharing a common production facility or managing a collective resource such as an irrigation canal. In such an atmosphere, mere availability of additional credit to individual producers is not very helpful. Once again, financial inclusion needs to be preceded by social inclusion.

Recommendations

Human Development

12.15 The Committee is of the view that regions, segments and sectors which are financially excluded require substantial investments in human development. In particular, primary health, nutrition, primary education and vocational training need attention. The Twelfth Finance Commission had already taken a lead in this direction by earmarking additional funds for health and education in backward States. The Committee endorses this and is of the view that this will lead to enhanced economic efficiency and consequent demand for financial inclusion, within a few years.

Access to Land and Titling

12.16 The Committee is supportive of various Government programmes under which surplus land is distributed to landless and marginal farmers. The Committee has also noted that the Government has enacted recently The Forest Dwellers and Tribal Land Rights Act, 2006, which will ensure that those who had been cultivating a piece of land for decades in the middle of forests, will now get security of tenure. This will open up the possibility of their accessing credit from banks.

12.17 The Committee has noted and endorses the recent move by NABARD to provide refinance for credit extended by banks and co-operatives to oral lessees and tenant farmers. This category of farmers has long been financially excluded due to lack of land titling or recorded tenures. Procedural changes in banks must be brought about to extend credit outreach to all such productive farmers.

12.18 Banks hesitate to finance tenant farmers / oral lessees as they do not have documentary proof of their right to till the land for raising crops or for investment purposes. Recording of tenancy and ownership rights on land is an important measure to enable access to credit.

12.19 Certificates by revenue officers or a system of land cultivation certificate by the Village Panchayats or local bodies may be made acceptable as documentary proof for cultivating the land.

12.20 Computerisation of land records will lead to systematization of land records and overall availability of required information to banks facilitating their loan appraisal process. It will also facilitate online search and eventual registration of charges on land. It is observed that 12 States have already initiated the process and GoI may advise all States to give priority for completing this process within a year. This will reduce cost to farmers in obtaining various documents and recording encumbrance.

Access to Work – NREGA

12.21 Given the fact that nearly 80% of farmer households in the country are small and marginal farmers, who rarely have work on their own farms for more than 100 days a year, the availability of wage employment in the vicinity of their villages is critical. In this context the Committee noted the nation-wide roll-out plans supported by the National Rural Employment Guarantee Programme (NREGP) which ensures that every household in need can ask for paid wage work for upto 100 days per year.

12.22 The Committee was given to understand that in certain States, such as Andhra Pradesh, all payments under the NREGP will be made to the beneficiaries through their bank accounts, most of which will be specially opened for this purpose. In Andhra Pradesh, the beneficiaries / depositors will be issued smart cards to enable transactions at several locations besides the bank branch. The Committee endorses this type of creative use of the NREGP payments to enhance financial inclusion.

Infrastructure Support

12.23 The Committee noted significant progress made for rural connectivity through the Pradhan Mantri Gram Sadak Yojana and the attempt to extend electric power to unconnected villages through the Rajiv Gandhi Gram Vidyutikaran Yojana. In several states the RIDF managed by NABARD has enabled the creation of much needed roads, bridges, irrigation canals, water harvesting structures and other useful infrastructure. The Committee endorses this and recommends a further impetus in the area.

12.24 The National Development Council (NDC) has recommended that the normative allocation of RIDF funds among States should be decided by factoring in, *inter alia*, the CD Ratio as a relevant criterion. This should be attempted by NABARD to improve equitable distribution of RIDF resources.

Enhancing Productivity and Incomes

Productivity Enhancement

12.25 The Committee is of the view that banks cannot be mute spectators in regions where agricultural productivity is low. In their own interest, to generate future credit business and attendant deposits, banks need to support the enhancement of agricultural productivity. The whole concept of SBI running agricultural development branches in 1970s was based on this premise. The Committee notes that in the last decade the efforts by banks to provide extension services have reduced. This is not in the long run interest of the banks themselves.

12.26 In this connection, the Committee has already recommended the establishment of Nodal Branches in each block to undertake intensive efforts for agricultural and business development services to farm and non-farm sector borrowers respectively. The Committee also recommends that banks explore tie-ups with government extension agencies, Krishi Vigyan Kendras, reputed NGOs working in this field, agri-business clinics and corporates engaged in agricultural activities, to provide inputs, extension services and market linkages to the bank's borrowers so as to offer credit plus services and enhance the efficacy of credit.

Local Value Addition

12.27 The Committee recommends that efforts should be made to ensure that all agricultural produce is subjected to primary and if possible secondary value addition locally. This means that post-harvest drying, sorting, grading and packing, can be done at the village level, preferably by women SHGs. Farmers groups can come together to establish secondary value addition facilities such as groundnut shelling, cotton ginning, dal milling, rice hulling, fruit pulping, milk chilling, etc.

Alternate Market Linkages

12.28 Roads, transport, power and water provide critical linkages in support of production-based activities. Social services like health, education, etc. contribute to improvements in the quality of rural life. State Governments should prioritise infrastructure planning, use of funds of the National Rural Employment Guarantee Programme (NREGP) for building critical infrastructure and encourage community participation in creation and maintenance of assets.

Reducing Vulnerability

Risk Mitigation through Non-financial Channels

12.29 A vast majority of poorer households in India are exposed to high levels of risk and considered as not insurable at reasonable levels of premium. For example, if a dry land farmer loses most of his crop every two years out of five then the insurance premium for him has to be 40%, even if administrative charges are waived. The Committee is of the view that before providing insurance to such house holds, their risk levels need to be mitigated. This can be done through a variety of measures such as soil and water conservation, watershed development, installing protective irrigation and by using appropriate agronomic practices all the way from ploughing techniques to seed selection and timely farm operations. In the case of livestock rearers, risks can be reduced by proper herd management practices and mass vaccination for example against foot and mouth disease. It is only after this type of investments have reduced the risks in farming that the private expense in buying insurance can be affordable.

Calamity Relief Fund

12.30 Repeated natural calamities and consequent rescheduling of bank loans take the debt burden beyond the repaying capacity of farmers. There is a need for the creation of a National Calamity Fund to address the problems of farmers in distress districts. Further, the subsidy on crop insurance may be directed more effectively towards the disadvantaged sectors.

Managing Price Risks through Warehouse Receipts and Commodity Derivatives

12.31 Apart from the physical risks which impact crop yields, farmers also suffer from price risks. In bumper years, their harvest fetches low prices. In order to hedge against such price risks the right instrument is commodity derivatives, particularly options in which a farmer can be assured of selling his produce at a certain price in future.

12.32 The Committee also noted that the Indian farmer is highly attuned to dealing in spot markets, traditionally known as Mandis, where the commodity is exchanged for cash. The Committee therefore supports any initiatives towards improving the transactional efficiency of spot markets.

12.33 The Committee noted that several multi-commodity exchanges have come up in the last few years and that they are registering a large turn over. This enables farmers to discover the future price and take decisions related to crop selection. The Committee is supportive of such initiatives.

12.34 However, the Committee noted the fact that a vast majority of financially excluded farmers have only small marketable surplus of any commodity and thus cannot benefit from the vibrant commodity exchanges, where the minimum traded lot is much larger than what the individual farmer has to offer. In order to extend the benefits of derivative exchanges to excluded farmers, aggregation mechanism such as cooperatives need to come up.

12.35 In the interim, financial instruments such as warehouse receipts and post-harvest credit can be offered so that farmers can avoid distress sales. The passage of the Warehousing (Development and Regulation) Bill, 2005 by Parliament is likely to open up a number of avenues for farmers to mitigate their price risks by encashing stock pledged in a warehouse to meet their cash needs, while waiting for the right price. The Committee is supportive of efforts to establish a chain of authorized warehouses throughout rural India, to provide such services, particularly when such warehouses are linked to PACS.

Organising the Unorganised producers

12.36 The Committee noted that financial services are in the nature of public goods. In order for it to be sustainable, banks need to aggregate the credit demand from the small borrowers. The celebrated mechanism for this is the SHG of which there are now more than 2.9 million in India linked with banks.

12.37 Another well known mechanism for collective action is commodity cooperatives. There is no better example than the dairy producers cooperative societies established by the NDDB.

12.38 The Committee recommends the establishment of similar commodity cooperatives to cover a large number small and marginal producers all over the country. The effort for bringing the producers together can be undertaken by specialized agencies like NDDB and suitable NGOs, while the cost for this should be defrayed by either the Government or by the banks, or a combination thereof.

12.39 The Financial Inclusion Fund cannot be used for a better purpose than supporting a competent and committed agency to organise commodity producer cooperatives in areas such as large cardamom in Sikkim, lac in tribal areas of Eastern Madhya Pradesh, Tasar in Northern Jharkand and seaweed in coastal Andhra Pradesh.

12.40 Commodity production is still a relatively private good. But protection of forests, regeneration of degraded communal pastures or harvesting of rainwater, are pure public goods. The Committee notes that there are several schemes such as joint forest management and the national watershed development programme, under which such activities can be encouraged. Even management of irrigation through canal cooperatives is possible as has been done in several parts of Gujarat and Bihar.

12.41 The Committee endorses Government programmes such as the *Velugu* programme which promote organizing the unorganized producers and recognizes that this cannot happen without the social intermediate of competent and committed NGOs. The legitimate expenses of such intermediaries need to be met. Initially, banks can lend to groups based on considerations of viability; but this will eventually lead to individual lending as individual producers grow. This is the slow and steady process that the Committee recommends to build true financial inclusion.