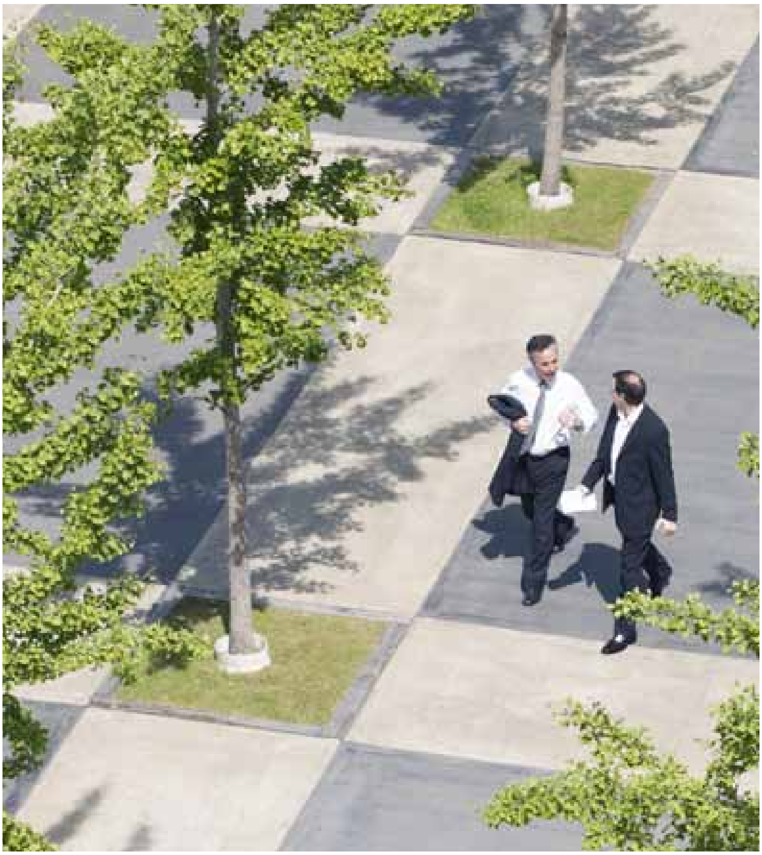
*"The future lies with those companies who see the poor as their customers."*

C K Prahalad

# Executive summary

**Today is the 'future' that CK Prahalad referred to, as organisations innovate and try to make available goods and services to the inclusive markets, defined as the middle to lower economic market segment. Providing a bouquet of financial services to these markets is a profitable business opportunity waiting to be realised.**



## *Background*

The 'global emerging middle' already accounts for 2.3 billion people globally and is expected to represent a combined annual market in excess of 6 trillion USD by 2021. Presently, 470 million people in India belong to the 'emerging middle income' group, earning 1 to 5 USD per day[16], and about 40% of the households are financially excluded[1]. In India, this market is expected to cross 1 trillion USD by 2021[16]. Organisations which build capabilities in this segment can go beyond their country's borders and compete in other such markets.

## *The way forward*

For India to be 100% financial included, all the constituents need to play their part. The government, through policies must protect customers' interest along with helping financial institutions build profitable business models. Banks need to move from looking at inclusive markets as a 'cost to business' to 'growth opportunity'. New and innovative small enterprises addressing inclusive financial markets must be supported and those with a strong distribution network need to partner with banks to help deliver financial services.

### *Government policies for inclusive financial markets*

The government has the keys to unlock the inclusive financial market through policies, mandates, regulatory requirements, subsidies and taxes. Joseph E Stiglitz, Nobel laureate said, "Even though market forces help shape the degree of inequality, government policies shape those market forces." Governments cannot achieve their objective of financial inclusion only through diktats. They need to help financial institutions create viable business models, whilst protecting the interests of the poor. They have to foster innovation by allowing small and new players to participate, be flexible in allowing more banks to operate in this segment, incentivise banks to create a different operating model for this segment and allow market forces to operate.

The Indian government has taken many positive initiatives recently, through its various departments – the Ministry of Finance, the RBI, the UIDAI, the Department of IT and the state governments. Transfer of welfare subsidies (overall estimated at 3000 billion INR of which 1500 billion INR is presently cash based), called 'cash transfers' to bank accounts through 'Aadhaar' will provide the much-needed impetus for banks to open accounts and treat this customer base seriously. While this is expected to happen over the next few months, it will impact only 43 districts out of the 600 in the country. The reality is that there are no established last-mile delivery channels at the ground level. It is estimated that more than 40% of the 120,000 outlets are inactive and 10 to 40% of 140 million 'no-frills' account are inactive. Only organisations which have an already established network have the capability to deliver the last mile for financial services, in a sustainable way. The government needs to foster collaboration between banks and organisations that have the distribution network, through a tiered partnership model- telecom and consumer companies for villages of larger population, and postal departments, microfinance companies and co-operatives for villages with lesser population.

Merely opening accounts and facilitating welfare benefits electronically are not enough. The usage of accounts and other financial services needs to be ensured. One way of doing this is by providing incentives for a short period for the usage of 'no frills accounts'. On new policies issued by the government, clarity needs to replace ambiguity. Innovative programmes like the pilot of the UIDAI's e-KYC and the RBI's 'meaningful financial inclusion' in Ernakulum district in Kerala are good, but not enough. The government needs to encourage innovation through smaller enterprises, i.e. regional banks like Krishna Bhima Samruddhi Local Area Bank, Business Correspondents (BCs), enterprises with technologies for low-cost Core Banking Solutions (CBS) and last-mile innovations.

Some of this will be possible with the passing of the Banking Laws Amendment Bill 2011.

The 'priority sector' lending target of 32 to 40% for agriculture, SMEs, education and housing, while good on intention needs to be reviewed to be in line with the contribution of the agriculture sector and infrastructure required. The needs of the agricultural community are more than just financial credit, and these needs have to be addressed concurrently. Support is required more for creating producer groups, sorting, grading and cold storage facilities near the farm-gate. The large Kisan Credit Card portfolio that banks are holding needs to be closely reviewed for non-performing assets (NPA). Affordable insurance and pension financial products through reduced distribution cost are required by the community.

### *Banks -shift in DNA required for profitable business in inclusive financial markets*

Banks, till recently, did not focus on the inclusive market segment, as there was no incentive to do so. Growth objectives could be achieved by servicing the urban, economically advantaged segment. Today, with some segments of this market showing signs of saturation, and stringent regulatory requirements, banks need to be more strategic in the inclusive markets business and move from 'cost to business' to 'growth opportunity'.

To build a profitable business serving the underserved requires banks to make a paradigm shift in their DNA.

Different DNA

New org. structure & products

Align new partners

### D: Different DNA

Low-cost airlines and Walmart were created with a different DNA, and similarly banks need a different DNA to address the lower economic segment. New ways of doing things will drive the 'low cost high volume' business. This may mean carving out a completely new subsidiary as changing the DNA is not a small task. The profile of people has to be different, and customer needs have to be satisfied in completely new ways. Products have to be designed for high volume and each element of cost has to be brought down to a fraction of the original. The main elements of costs are as follows:

- Nearly, 40- 60% of costs for a rural branch and indirect cost of a customer service provider (CSP) impacted by high attrition rates of 25 to 45%.
- Present CBS costs which range from 80 to 200 INR per account per annum is too high for such large numbers of 'no frills' accounts. There are few technology providers who offer a low-cost CBS for this segment of the market. Innovative enterprises can explore this unmet need for low-cost CBS at 8 to 12 INR per account per annum.
- The cost of rent which can be reduced through shared services and a hub-and-spoke model with Business Correspondent (BC) outlets
- The cost of customer acquisition is 50 to 150 INR per customer and can be brought down to a fraction, if the CSP is already servicing the customer through re-selling pre-paid airtime or similar services.

### N: New organisation structures and new products

Private sector banks have different units taking care of the liability and asset segment of the business i.e. loans to microfinance companies through the 'financial institutions' unit, gold loans and smaller value loans through different units, and no-frills account through a different unit of the bank. Public sector banks have a financial inclusion unit in the head office and the 'circles' or rural branches are not accountable to them for business. These disaggregated organisation structures do not serve the needs of the bank for the inclusive market segment. New organisation structures to get operational leverage will help banks address this segment.

For financial products to be a success, it is important to understand the needs of the customer. Is it the need to have money to send their children to college, or to take care of them in their old age? What are the cash cycles that the sugar farmer goes through versus the cotton farmer? For the purchase of financial products, there is a 'price-trust inversion'. In the beginning, trust is critical for adoption, demonstrated by customers who are prepared to pay prohibitive prices to the 'hawala' to transfer money, primarily because they trust him. Initially, banks, BCs and CSPs must focus on building trust, as price is not a consideration. Once there is trust in a new product and CSP, usage will increase and over a period the product gets commoditised. This is when price sensitivity starts coming into play.

Insights on the middle to lower income market segment and designing innovative products to meet their needs is critical for success. Learnings from successful traditional financial products like 'chit funds' and gold loans are valuable. International examples of innovation are the 'Jipange Kusuve' of M-Pesa which is a 'lend to save' model.

### *A: Align new partners for this market*

Banks find it difficult to reach the last mile due to staff constraints and expenses. They have been partnering with many BCs. In fact, some banks have 5 to 25 BC partners. Managing a large number of partnerships is a challenge and banks will have to optimise to manage better. A scientific basis for growth in Tier V and Tier VI villages (population of less than 10000) must be based on a tiered partnership model. Partnerships have to be made with BCs who have a viable business model themselves. E.g. re-seller of pre-paid airtime can add financial services to their bouquet of products, and make the business model more viable. Organisations with a strong distribution network and the skills to manage this network can deliver financial inclusion. Banks must also partner with telecom and consumer companies for villages with a higher population, and postal departments and microfinance and co-operatives for villages with lesser population.

Telecom operators seem to have a natural advantage as partners with banks for mobile financial services, as they have the technology and access to customers and data. We believe that mobile financial services will take off more in developing economies rather than developed economies, as M-Pesa has proven. In the developed economies, internet banking using computers is already ubiquitous and there is no real motivation to change this to mobile banking unless there is a completely new way of managing money. In developing economies on the other hand, internet banking is not an option and mobile banking will give customers what mobile phones gave people who could not get a fixed telephone line.

Telecom operators must seize this second opportunity to drive innovation by providing mobile finance, leveraging on their vast network and proven strengths to manage this network. Telecom operators can make a profitable business of financial services for inclusive markets by adopting the following:

- Use their experience and access to data to drive innovative financial products
- Represent the bank for not just remittances and savings products but the entire bouquet of banking products
- Sell the concept of financial services, to educate the retailer and customer
- Manage the distribution channel aggressively for financial services, just the way the telecom channel was managed by marketing schemes for customers and trade promotions

This is a time to for the government, financial services organisations, telecom companies, and grass-root organisations to make history by providing financial services in a sustainable way to the inclusive market segment in India.

### *Examples for inclusive financial services markets*

1 The Central Bank of Philippines - Bangko Sentral ng Pilipinas - has set up a dedicated unit that specialises in new technologies. “While we allow the market to lead, we cannot afford as regulators, to get left behind, we have to stay very close to the innovators just to make sure things don’t go out of hand. The target market are people who may not have had extensive experience of use of financial services and are also in that regard potentially vulnerable,” said the Deputy Governor[30].

2 The percentage of population who have bank account (for the bottom 40%) in some of the Asian countries is comparatively high, i.e. ranges from 50 to 60% for Malaysia, Sri Lanka and Thailand, whereas it is only 27% for India.

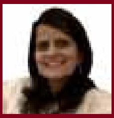
3 Banks such as the SBI, Yes Bank and BCs such as Eko and Suvidhaa have proved that domestic remittances are a profitable business. At Yes Bank , total value of remittance between August and December 2011 is 800.0 million INR approximately and fee income is 8.0 million INR approximately[27].

4 New products must take learnings from the successes of traditional products such as chit funds, postal savings and newer innovations like the lend-to-save model in Kenya of ‘Jipange Kusave’ (M-Pesa)’.

5 Non-bank financial institutions (NBFCs) with gold loans, vehicle loans and now low-income housing loans has shown the way to build profitable and low risk assets for the inclusive markets.

6 The ‘Sarva Shakti Suraksha’ of Bajaj Allianz Life Insurance, is a customised insurance cum savings product for members of co-operatives.

# *Contacts*



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