Confederation of Indian Industry

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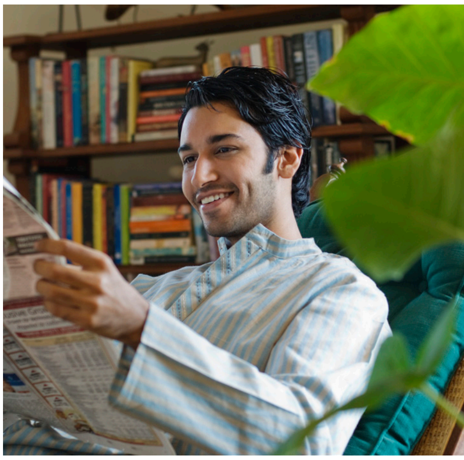

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Chairman's message

The history of our times will be remembered as one of the most challenging phases for the financial services industry. Given the constantly changing business environment, with frequent changes in regulations, the industry is struggling to build sustainable models.

Penetration of financial products and services has remained concentrated in the metros and Tier 1 and Tier 2 cities, without percolating down to the smaller towns and cities and the rural belt. The good news is that while there is a huge need for services in these segments, it is just that these customers are not aware of the right products and the right channel to leverage for the products. It has been observed that in most cases, it is the product which is the success factor for building up a resilient business model in these areas.

A well-acknowledged fact is that technology is needed to scale up operations in these rural markets. Market players need to capitalise on the benefits that technology has to offer, making investments in the right pockets of opportunity. The cost-benefit analysis of using technology as a facilitator and enabler needs to be pushed out to customers and market players alike.

It is also important for this industry to invest in the right partnerships or alliances to move forward with long strides. Partnering with industries such as telecom or FMCG should be a well-thought out strategic decision to penetrate un-banked areas.

All stakeholders, the banks, insurance companies, NBFCs, mutual fund companies, regulator, government, last mile agents need to work in tandem to build a sustainable distribution chain.

There are significant learnings from other countries that can be replicated in the Indian market. These need to be critically assessed and built upon to take the growth of the financial services industry to the next level.

Mr C Jayaram
Chairman - CII 2nd Financial Distribution Summit 2013
and Joint Managing Director, Kotak Mahindra Bank Ltd.

Setting the context

The 2011 Census data for India states 'unacknowledged urbanisation' as one of its major findings. It threw interesting results, forcing policymakers and industry experts to take notice of shifting urban patterns.

'Census towns', a term coined to explain hitherto ignored urbanisation trends accounts for almost 30% of the urban growth in the last decade, with large inter-state variations. A 'census town' is categorised so because farming has been entirely replaced with other formal or informal sources of livelihood with 75% or more of the male population depending on non-agricultural sources of livelihood. Interestingly, between 2001 and 2011, India added about 2,500 such towns, earlier classified as large villages, to the urban growth story. The validity of such ground-breaking data forces us to re-examine the stark demarcations of 'rural' and 'urban', accepting the prominently present 'rurban' regions. This acknowledgement of previously ignored spurious urban growth promises major policy implications.

The growth experienced by such towns and the 'rurban' region of India has been rapid and haphazard, unevenly spread across the country's topography. In fact, two-thirds of this region is concentrated in just six states--West Bengal, Kerala, Tamil Nadu, Maharashtra, Uttar Pradesh and Andhra Pradesh, in that order.

If the geographical spread intrigues, the characteristics associated with such spurious growth are astounding. Rural income grew at a much faster pace between 2010 and 2012 than in previous years, according to the provisional results of the 68th round of the consumption expenditure survey by the National Sample Survey Office (NSSO). While the average annual growth in monthly per capita consumption expenditure (MPCE) between 2005 and 2010 in real terms stood at 1.4% as per the 66th round of the survey, it grew by around 9% between 2010 and 2012. In value terms, the rural MPCE picked up from 927.7 INR in the 66th round to 1,281.45 INR in the 68th round. The income gap between rural and urban India is declining. While the 66th round survey carried out in 2009-10 showed that the MPCE in urban India was double (100.3%) than that in rural areas, it came down to 92.3% in the 68th round survey.

Rising income levels coupled with a surge in consumer awareness translate to higher spending levels and disposable incomes. Massive urbanisation will result in the increase in disposable income from about 40,000 INR in 2010 to 78,000 INR by 2016. This is likely to result in higher consumption and needs for financial products in order to enhance savings and investments. Non-agricultural sources of livelihood translate to a steady flow of funds leading to increased savings. These need to be channelised and hence the demand for varied financial products beyond the metros.

The increased consumption of lifestyle products and the ability to ape 'urban' lifestyle has led to shifting demand patterns. A variety of goods ranging from smartphones to automobiles and various electronic gadgets are now commonplace in rural India.

'Is India's manufacturing sector moving away from cities'?, a study conducted by Ejaz Ghani for Harvard Business School details the urbanisation of India's manufacturing sector. He observed that while small informal industries were moving from rural areas to cities, formal industrial sector units were shifting to the rural areas. Examples include Nokia and Hyundai.

What do these phenomena have in store for the financial sector?

The good news is that a considerable amount of unchannelised savings exists beyond the metros in semi-urban and rural areas. Financial institutions are yet to explore these markets and translate the savings of these people into strong wallet share for themselves.

Penetration in rural and semi-urban markets has till now been largely driven by the regulator and the government. Though, never before has financial percolation seemed more economically viable, multiple roadblocks exist in these regions in terms of inadequate infrastructure, low levels of financial literacy and lack of strong distribution channels. Financial providers do not seem to identify any viable opportunities from tapping these markets, given the cost of reaching the rural areas. To address this, a change in mindset that perceives financial inclusion as a profitable business model and not just as a social obligation is required.

Rural and semi-urban financial services is the fastest growing financial services sector with a potential of approximately 78,000 crore INR in revenues by 2015. This could potentially mean banking 700 million people by developing innovative and profitable operating models to fuel further growth. In addition, products need to be tailored to suit the needs of these groups and their associated peculiarities.

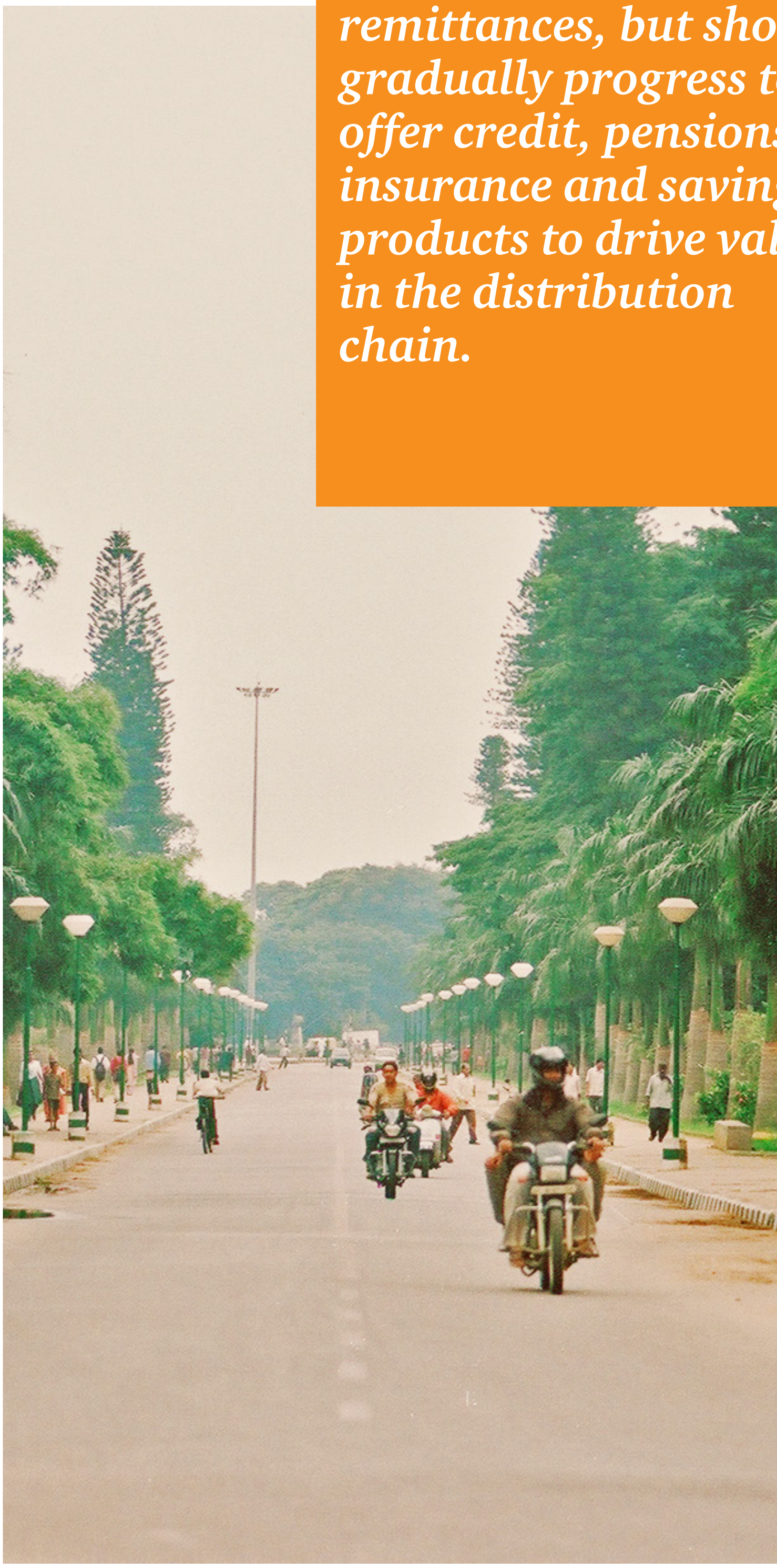
Products sold in the urban markets cannot be replicated in these markets. A considerable amount of investment is also required in choosing the correct agent or agent network to access these markets and then training them.

The curve ahead

While the financial sector needs to gauge the existing opportunity appropriately, the onus also lies with the regulator and government policies to clear roadblocks associated with infrastructure and various other restrictions that often lead to a lukewarm response. The industry today needs to take a step back and think how it can make inroads into the rural market and make its distribution model sustainable in the long-term.

Financial inclusion is a huge project and cannot be undertaken by a single provider working on its own. Partnerships and alliances are necessary in order to collaborate and seek answers to reach the unbanked. Banks and other financial providers will need to partner with technology service providers, mobile operators, FMCG companies, postal department, or will need to identify other alliances which could work out a viable revenue-sharing model. In fact, a series of such models can be modified on a continual basis to tweak peculiar topographical or socio-economic constraints.

This partnership channel should be used not only to provide remittances, but should gradually progress to offer credit, pensions, insurance and savings products to drive value in the distribution chain.



Financial percolation to the 'rurban'

Country name	% of adults having an account at a formal financial institution	% of adults using mobile money in the last year	% of adults who have taken a loan from a formal financial institution in the past year	% of adults who have taken a loan from family or friends in the past year	% of adults with a credit card	% of adults paying personally for health insurance
Brazil	56	1	6	16	29	8
China	64	2	7	25	8	47
India	35	4	8	20	2	7
Indonesia	20	1	9	42	0	1
Japan	96	-	6	5	64	-
Kenya	42	68	10	58	6	5
Mexico	27	6	8	15	13	8
South Africa	54	11	9	34	8	7
UK	97	-	12	14	52	-
US	88	-	20	17	62	-

Global Findex Database, 2011

The term 'financial inclusion' propels ambiguity and measuring the depth and coverage of percolation might be a hurdle. It is apparent that the financially excluded constitute a significant share of the population especially among low-income groups. The All India Rural Credit Survey (AIDIS) 2002 survey, showed that 111.5 million households had no access to formal credit and 17 million households were indebted to moneylenders. The recent Arjun Sengupta Report on financing enterprises in the unorganised sector has pointed out that only 2.4 million out of 58 million units in this sector (with an investment of less than 25,000 INR) have received credit from commercial banks. The 2002 survey also showed that lower the asset class, income and place of residence, higher the degree of exclusion. The Invest India Incomes and Savings Survey (2007) survey showed that 32.8% of households had borrowed from institutional sources and 67.2 % had borrowed from non-institutional sources.

There is hence clearly a section of the population that lacks access to finance and is crowded out of the credit markets. The regulator, government and the industry players need to reinforce their efforts to improve financial access, especially for small businesses and individual households. As the first three years of the Financial Inclusion Plan (April 2010 to March 2013) come to an end, here's a snapshot of the progress made:

- Banking outlets in villages have increased to nearly 2,68,000 from 67,694 outlets in March 2010.
- About 7,400 rural branches have been opened during this three-year period compared to a reduction of about 1,300 rural branches in the last two decades.
- Nearly 109 million basic savings bank deposit accounts (BSBDAs) have been added, taking the total number of BSBDA to 182 million. The share of ICT-based accounts has increased substantially. The percentage of ICT accounts to total BSBDAs increasing from 25% in March 2010 to 45% in March 2013.
- With the addition of nearly 9.48 million farm sector households during this period, 33.8 million households have been provided with small entrepreneurial credit as at the end of March 2013.
- With the addition of nearly 2.24 million non-farm sector households during this period, 3.6 million households have been provided with small entrepreneurial credit as at the end of March 2013.

However, future financial inclusion plans need to address major issues, financially viable regulations that attract private investors promoting percolation beyond the mandatory limits and seamless functioning of the regulators and the stakeholders.

- *In India, only 55% of the population have deposit accounts*
- *Nine per cent have credit accounts with banks*
- *145 million households are excluded from banking*
- *Only 18% have debit cards*
- *Less than 2% have credit cards*
- *Less than 20% of the population has any kind of life insurance and 9.6% of the population has non-life insurance coverage*

The Insurance Bill, AADHAR, cash transfers: 2013, the year that was

Although 320 million AADHAR cards have been issued, less than 10 million accounts have been linked. This has far outstripped the bank accounts. Such banking glitches would mean a huge roadblock to the success of the Unique Identity Programme and resultantly Direct Cash Transfers. State-Level Bankers' Committee (SLBC) Convenor Banks were advised to co-ordinate with government functionaries for the implementation of Aadhaar-enabled payments.

Banks need to expedite the process of opening bank accounts in camp mode and seeding of accounts with Aadhaar numbers. The status of the roll-out of Aadhaar-enabled payments is a regular agenda item for discussion in SLBC meetings as part of financial inclusion and Electronic Benefit Transfer (EBT) implementation. The Direct Benefit Transfer was rolled-out in 43 districts in the first phase from 1 January 2013, and has been extended to 78 districts from 1 July 2013.

However, the pace at which such benefits are being extended indicate the need to pace the process of financial percolation. The 2006 Annual Policy witnessed the term 'financial inclusion' for the first time ever, asking banks to open 'no-frills accounts' for all those wanting access to a bank account. Along with rural credit and equitable access to it, we also need to consider the insurance sector.

Increasing the FDI limit of 49% in domestic insurance companies from the earlier 26% will boost employment opportunities, sends a positive signal to overseas investors and will help India rein in the current account deficit in the short-run. The insurance sector needs a capital infusion of up to 51,500 crore INR over the next five years, with the life insurance industry requiring 41,000 crore INR and general insurance companies 10,500 crore INR.

Such infusion will help the industry benefit from the variations in scale and increase the insurance cover beyond the metros. What we need from the regulator is a mid-way approach that addresses customer concerns while keeping a tab on profit margins. Squeezing the sector of its profit share will lead the percolation process to collapse, doing more harm than good to consumers.

Initiatives taken by the government and the regulator

The Indian financial system has been characterised by a dual formal-informal structure giving rise to a gap that promotes 'the grey'. Nominal interest rates have been tightly regulated for decades leading to arbitrage profits through trading these in the informal system. How for instance, are microfinance institutions which charge interest rates of around 26% per annum any better than moneylenders? Several such concerns translate to only 35% of Indians above 15 years of age having an account at a formal financial institution. The rural-urban distribution is quite skewed with 33% of rural Indians and 40% of urban residents having an account with a formal institute. To achieve universal coverage and reach the maximum unbanked adults, the government and the regulator have taken a few initiatives.

- The first FIP has seen about 24,701 rural branches, 1,20,355 BC outlets, 2,478 other modes, 103.21 million total of 'no-frill accounts' registering an increase of 39.6% in NFAs. (2011-2012). Other figures that point towards increased penetration on the rurban include 932.89 billion INR of outstanding balance, 3.39 billion INR of overdrafts, 119.77 million transactions through ICT-based BC outlets, 2.15 million INR in KCC credit and 0.22 million GCC INR in credit as recorded on 31 March 2012.
- According to the World Bank's Global Financial Inclusion Index (Global Findex) database, only 26% of women in India admit to having a bank account. Per capita credit in the case of women is 80% lower than in the case of men. The Bharatiya Mahila Bank is thus a welcome initiative that predominantly serves women and hopes to achieve a more equitable form of financial distribution.
- The government has made financial percolation to the rurban and universal financial coverage a development policy priority. The RBI has on 23 September 2013 announced a 13-member committee to develop a comprehensive monitoring framework to track the progress of financial inclusion and deepening efforts on a nationwide basis. The Committee on Comprehensive Financial Services for Small Businesses and Low-Income Households includes representatives from leading industry players, RBI directors and government representatives. It will review existing strategies and develop new ones that address specific barriers to progress and encourage participants to work swiftly towards achieving full inclusion and financial deepening, consistent with design principles while developing viable business models for executing these strategies.

Rural credit across states

Commercial banks and institutions need to treat the process of financial inclusion as a viable and (potentially) profit-generating business model. Currently, Indian banks are required to give 40% of their loans to weaker sections of society and farmers, among others. To achieve these twin goals, it is crucial to dissect the diverse nature of rural credit dispersion across states.

RBI data on rural credit outstanding for each district in the country is astounding. Although for Bihar as a whole, rural credit outstanding per capita is 833 INR, it's as low as 371 INR per person in Madhubani district, 433 INR per capita in Darbhanga district and 443 INR in Sitamarhi. In other words, rural credit outstanding per person in Madhubani district is less than half the average in Bihar and one-tenth of the average in Andhra Pradesh. Another example is Nagaland's Mon district where rural credit outstanding per head is as low as 225 INR. In Manipur's Ukhrul district, 140,000 people in the rural areas share the princely credit outstanding of 8 lakh INR.

There is wide variation within states. For example, while Saharanpur district in Uttar Pradesh has per capita rural credit outstanding of 3,387 INR that for Ghazipur, on its eastern border, is less than one-third of that, at 971 INR. In Maharashtra, while the figure for Pune district is 3,031 INR that for extremist-hit Gadchiroli is 1,101 INR. In Chhattisgarh, extremist-haunted Dantewada district has a per capita outstanding of 824 INR in rural credit. The country's east gets far less rural credit. The data shows extensive inequality in the distribution of rural credit within the country pointing towards topography as a major factor. Accessing finance in the north east is more difficult that in mainland India.

Analysing the reasons for existing wide variations, addressing related concerns and tailoring products and models that ably adapt to the peculiar characteristics will help conserve profit margins leading to sustainable financial percolation.

Roadblocks: How do we overcome them?

The NPS and the RSBY: Is the industry listening?

A National Advisory Council (NAC) working group had recommended a social healthcare enterprise model for the delivery of universal health coverage (UHC) named the Rashtriya Swasthya Bima Yojna (RSBY). One of the significant recommendations is the formal integration of insurance schemes within the public health sector, a move experts maintain will further skew the healthcare landscape in favour of private providers. States have been asked to try at least one and up to three comparative models of district-level pilot projects to arrive at the most relevant and cost-effective one.

The Pension Fund and Regulatory Development Authority (PFRDA) received the status of a statutory authority with the PFRDA Bill 2011 being cleared. The National Pension System (NPS) was designed to bring the informal workforce predominant in the semi-urban areas under the pension umbrella making it a well regulated product spanning the length and breadth of the country. Low surplus incomes underline the need for liquid money especially given the seasonal nature of on-farm activities. Hence subsequent amendments to the bill ensure timely withdrawals. Such tailored initiatives by the government that work in partnership with private players fasten the speed at which access to capital and structured savings percolate to those who exist in relative isolation.

Regulator

Lack of collateral is a concern of the creditors catering to the rural and semi-rural areas, alongside the lack of capacity to fulfil all KYC norms. The RBI has notified the paperless electronic authentication, or electronic know-your-customer (eKYC) process provided by the Unique Identification Authority of India (UIDAI) to be valid. The customer can now authorise the bank to access user demographic records registered and stored in the UIDAI's Central Identity Data Repository. The bank will then receive details from it after matching the customer's biometrics scan with the Aadhaar number provided.

Government

Financial Inclusion Plan: 2013- 2016

Financial literacy and product awareness is indispensable to financial inclusion. It should make people better informed, better educated and more confident, able to take greater responsibility for their financial affairs and enable them to play a more active role in the market for financial services. A facilitating environment (physical and social infrastructure) for inclusion needs to be created. This involves improving connectivity through roads, bridges, power and information as well as communication networks.

Industry

Branch and branchless services

To ensure the reach of DBTs, there exists a need for outlets, either through brick-and-mortar branches or the branchless mode, in all villages across the country. For this to succeed, it is important that quality services are provided through the new ICT-based BC outlets. Therefore, an intermediary low-cost brick-and-mortar structure is required between the base branches and BC locations. This will provide timely support to BC outlets, ensure close supervision of BC operations and give them credibility and increase people's confidence in BC services. Hence, banks have been advised to plan for an increase in the proportion of branches that cover unbanked areas. The industry has been advised to consider setting up financial inclusion centres, to act as centres exclusively focussing on customers serviced through BCs.

Further, to assist banks achieve the 25% mandate, banks have been advised to open small intermediary brick-and-mortar structures between the base branch and the unbanked villages. The industry needs to concentrate on creating an eco-system to ensure efficient delivery of services, efficiency in cash management, redressal of customer grievances and closer supervision of BC operations. To further encourage banks and various other industries they have been advised to consider frontloading (prioritising) the opening of branches in unbanked rural centres over a three-year cycle co-terminus with their FIPs. This is expected to facilitate quicker branch expansion in unbanked rural centres.

Industry players also need to come up with innovative solutions such as BC outlets, other modes such as kiosks, off-site rural ATMs, mobile vans, etc. so as to resolve last-mile connectivity issues. Understanding the psyche of the rurban consumer and creating mass yet customised products is crucial to success. E.g. there is a mismatch of the lending products offered by financial institutions which are largely aimed at agricultural or other productive purposes, whereas the actual need of the consumer is to meet family emergencies.

Obviously, administrative costs are a huge contributor to the high interest rates, currently standing at 11.4% of outstanding loans. The high rate of non-performing assets (NPAs) emerging from this section is also a dampener commercially. Re-engineering the cost to serve by leveraging onto technology will reap the benefit of large-scale variations.

Other industries such as FMCGs and telecom have managed to make considerable in-roads in the rurban. Forging the right partnerships with the government and regulators and adopting best practices from these industries will assist the financial services industry delve deeper into the evading rurban market profitably.

Exploring various business models

The regulatory institutions and the policy designs in the country still revolve around physical capital driving growth. The services sector contributes 55% (excluding construction) of the gross domestic product compared with 16% of manufacturing, resultantly large investments are being made in intangible assets.

Financial institutions are still driven by the physical asset-based lending. This despite the fact that the biggest assets of enterprises today are their economic competence, including brand equity, region-specific human capital, networks joining people and institutions and organisational know-how that increases enterprise efficiency.

While the RBI is about to issue the list of provisional banking licences, the 26 applicants can be classified into five categories: private companies, non-banking financial companies (NBFCs), broking houses, government entities and others. Clearly, one part of the licensing policy has to be to help, facilitate and allow firms to evolve. Transforming an NBFC into a bank is a natural process of evolution, of a firm from one stage of existence to the other. This process cannot be a standalone process and needs policy aid. The fact is accentuated with 15 NBFCs among the 26 entities who have applied for banking licences. To meet the objective of financial inclusion, policies need to work in tandem with the regulators and the industry to develop a sustainable model that effortlessly achieves last-man-connectivity profitably. While issuing guidelines for the grant of new banking licences, the RBI stated that financial inclusion will be an important criterion of assessment. New banks will be required to establish at least 25%, a quarter, of their branches in places with less than a population of 10,000. The business model provided by the applicants for achieving financial inclusion will be a crucial parameter of the assessment matrix.

As for their part, industry players need to be come up with innovative business models that are capable of continually evolving and adapting the challenges that the 'rurban' poses. To fulfill the extremely crucial criteria of financial inclusion, operating models need to be different in nature. MFIs such as Bandhan Financial Services and Janalakshmi Financial that have a considerable presence have applied for bank licences. These institutions will have the added advantage of door-to-door connectivity and customer trust in place.

Where do the banks stand?

This September, ICICI Bank launched its Branch on Wheels programme as a part of its financial inclusion plan. The programme is a mobile branch with an ATM that offers basic banking products and services such as savings accounts, loans, cash deposits, withdrawal, account balance enquiries, statement printing and funds transfer collections, among others.

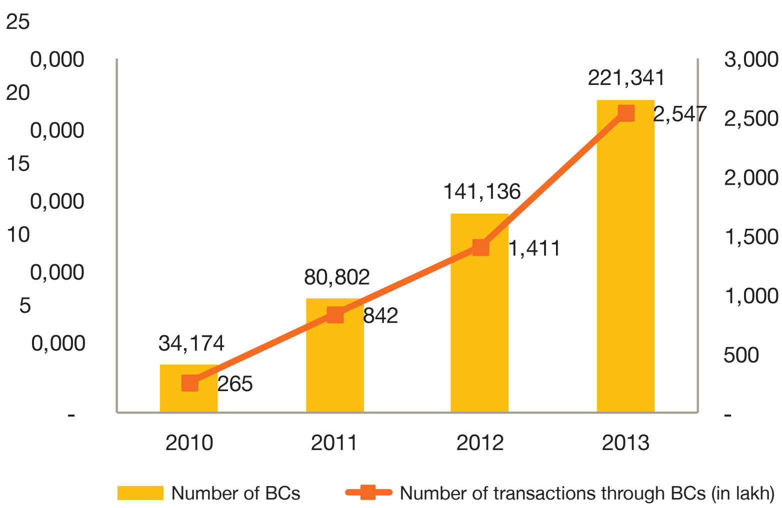
The mobile branch with an ATM will be operated at specific timings of the day in pre-identified, unbanked villages through a van that will be stationed at specified locations. It is equipped with a GPS tracking system, laptops with 3G connections, LED TV, a safe, a printer, a public announcement system, a UV lamp that detects forged cheques, a note counting-cum-authentication machine that identifies fake currency notes and a unique low-weight ATM. Two ICICI Bank officials and a guard will manage the mobile branch with ATM. The nearest branch of the bank will act as the parent branch of the 'branch on wheels', routing all the cash and transactions for it.

Such industry best practices suggest two things. One, the distribution model in place in urban markets cannot be replicated in rural markets, because this segment of the population has been structured differently with needs and requirements which differ from the urban segment with a different set of challenges. Two, innovative solutions tweaked to address area-specific concerns are a win-win situation for both, FS institutions as well as consumers.

Branch banking: Banks are probably the only financial institutions which have a significant brick-and-mortar presence in the rural and semi-urban areas as compared to other financial institutions such as insurance companies and asset management companies. The network of public sector banks is quite well established in these areas and can be effectively used to sell financial products and services to the under-banked.

Branch correspondent or the branch facilitator model (BC or BF model): Since 2006, the RBI has permitted banks to employ business correspondents in order to expand their reach and provide financial products and services in rural and under-penetrated areas. The number of BCs has steadily grown in number over time, with a significant increase in the number of transactions undertaken by them.

Growth of BCs



Source: RBI, 2013

With banks steadily appointing an increasing number of BCs over time, the number of villages that have come under the banking net has risen from 67,000 villages in 2010 to around 211,000 villages as of December 2012. Banks are free to leverage post offices, NGOs, self-help groups, MFIs, farmers clubs, *panchayats*, community based organisations, co-operative societies, etc to act as their BCs.

The people residing in the rural areas fall into the low-income category and need small savings products to meet their needs of security, easy access and minimum documentation. They also need micro credit facilities in the form of term loans and overdrafts which will help them meet their working capital requirements. Banks extend these facilities to the BCs so that they can further connect to these customers at the grass-root level by opening accounts, collecting loan applications, doing KYC, etc.

Typically, in rural areas the biggest obstacle lies in terms of geographical locations which are not connected by proper infrastructure. There is a huge cost involved in travelling long distances and waiting in long queues to avail banking facilities. Hence, these BCs need to be provided with a technology platform to facilitate these transactions and tide over operational hassles.

Serving as a trusted interface between the bank and the customer, the BC has the ability to facilitate transaction of small amounts and encourage healthy savings behaviour in these customers. Moreover, the BC garners the trust of these people easily as someone from their own community. This model has however met with its fair share of challenges.

The BC model in Brazil

Background: *The financial inclusion initiative in Brazil has been fostered by the BC model, the credit-co-operatives and bank service outposts, out of which the BC model has been observed to be the most successful. In Brazil, the number of bank branches per 100,000 adults rose from 13.7 to 14.7 between 2006 and 2011, complemented with a rise in the number of BCs from 55.4 establishments per 100,000 adults in 2006 to 113 establishments per 100,000 adults in 2011. The popular correspondents in Brazil are post offices, lottery outlets and supermarkets.*

Success factors: *Favourable regulatory reforms in the financial services sector have acted as catalyst for the growth of the industry. What seem to have driven the success of the BC model in Brazil are specific regulations concerning space and equipment for bank branches and agreements related to payroll of bank employees. The regulatory framework also ensures repayment favouring access to credit for workers. Regulations have been directed solely to increase transparency in prices, services and to standardise operations.*

Correspondents are required to have a mandatory certification in financial inclusion, and are subject to anti-money laundering rules and due diligence.

Also, Brazil allows considerable leeway in handling cash by non-financial firms as compared to other countries.

A significant move by the government entails a decision to route all payments of social benefits through the state owned bank Caixa Economica Federal, leveraging the fact that this bank has the largest network of correspondents in the country through its partnership with lottery houses and retail stores.

There has also been strong political support towards increasing financial reach. Overall, we can comment saying that differential regulation for correspondent banking has been significantly responsible for the success of this model in Brazil and has been instrumental in tailoring suitable products for lower income ***groups.***

What can be done better: *The array of products and services offered by correspondents can be increased with an inclusion of insurance and pension products. This network can also be used optimally to provide a basic level of financial education to the rural customers.*

> **Leading insurance player**
>
> *"Lack of a tied-agency concept, does not incentivise financial service providers to invest in their agents."*

Challenges

Low volume of transactions: The success of the BC model is heavily dependent on the transaction volume, which as compared to urban areas, has failed to pick up momentum. Another challenge faced by the BCs is that they are not incentivised enough to remain in this business. It has been estimated that most of these BCs earn less than 3,000 INR per month. As per the current commission structure, the agents are entitled to a percentage of the amount transferred. This naturally implies that the BCs would want to gain high-value transactions and ignore customers who make low-value transactions, defeating the purpose of the BC model.

Dormant accounts: Close to 100 million no-frills accounts have been opened by the BCs in operation, out of which only around 20% have been found to be currently operational. Reason for this has been a mass opening of these accounts by banks in order to meet their financial inclusion targets, and subsequently very little promotion by the BC or the bank to use these accounts frequently. The account holders need to be made aware of the transaction process, limits on volumes, etc.

Insufficient cash: Rural areas receive a large amount of remittances from urban areas and are known to be remittance heavy. It often happens that BCs end up in a situation of liquidity crunch and are unable to provide funds to the beneficiary at the required time. This puts the reputation of the BC at considerable risk.

Operational issues: Multiple inefficiencies exist with the integration of BC technology platforms into the bank's platform. Software glitches, unavailability of power back-ups and server downtimes are some of the daily issues that the BCs need to deal with.

Sub optimal operating model between banks and BCs: For instance, government payments (DBTs) are being leveraged to create viability in the system. There is inequitable distribution of revenue. While the banks make money on the float income, the BCs who take on the 'on the ground' execution are not adequately compensated. The success of the BC model is also dependent on the support provided by the base branch services especially for cash management, documentation and redressal of consumer grievances.

Insuring rural India: Best practices

The Life Insurance Corporation (LIC) in a first-of-its-kind initiative has launched the *bima gram* or an insurance village under the LIC brand. For a village to be branded, at least 75% of the households in it must have at least one LIC policy and 100 new policies should come in from the village in a financial year in which the village is to be declared a *bima gram.* Once it gets the branding, the insurance company will plough back part of the premium earned from the village to build infrastructure, both physical and soft-social, in the form of hand-pumps, solar power supply house schools, etc.

The cost of such will however not be more than 25% of the premium income received during the year from policies issued, subject to a ceiling of 25,000 INR in a financial year. To be a *bima gram*, the village should be a rural centre as per the definition of the IRDA with a minimum population of 1,000. The number lapsed policies issued prior to the current financial year should not be more than 20% at that time when the village is to be declared as a *bima gram.*

LIC believes that rural insurance has always been big business and having a branded concept for it should work well. With private players flocking to the urban areas, the rural market is vibrant and the logistics of revenue will be in favour of the LIC. The affordability of purchasing a policy in a rural area and the premium payable will depend on the individual's paying capacity for different policies.

However, insuring rural India comes with its own set of challenges which are similar to the ones faced by banks.

Product design: One of the biggest challenges is deployment of the right product to these customers in line with their requirements.

Trust of intermediaries: Another factor which is important for selling policies to these low-income groups is credibility. Intermediaries need to gain the trust of these customers to convince them to purchase insurance cover.

Private sector insurance players have tried to bring in some amount of innovation in products and operating mechanisms, within regulatory requirements. This has been done by introducing co-payment models, health screening, tele-medicine, mobile enrolments, internet kiosks, weather based insurance, rainfall index insurance, etc.

A study has found that there is inconsistency among insurance players in defining micro-insurance. Some insurance players categorise their products as 'rural products' while some term them as micro insurance. In general, insurance players find it difficult to position their products within the IRDA guidelines. Making a sum assured of 30,000 INR on health insurance cover viable for the low-income group does not make much business sense.

How a private insurance player works

Background: Market research undertaken by the company indicated that low-income groups were not really averse to purchasing insurance. They were just apprehensive about tedious documentation, payment of regular instalments and need of money during exigencies. If a product allows the flexibility to pay instalments as and when they have money, with no or minimal penalty, and the freedom to withdraw money when they require it in any emergency, these customers will be more attracted towards buying insurance policies. Hence, the first step in selling to the rural segment is designing a product tailored to their needs.

Approach to distribution: This insurance player put in place a local sales force to cater to the needs of these customers. The model is such that while advisors work on a commission basis, sales managers work with a variable component linked to the number of policies sold.

A simple product was designed to be sold to this market, which does not require the customer to make monthly, quarterly or annual premium like other insurance players. The other aspect was convenience with this product being sold over the counter at small local retail stores.

It adopted a multi-pronged distribution channel engaging as many partners as possible at the grassroot level.

Add-on insurance increases deposits

In 2011, Microensure launched a savings-linked product with a bank in Ghana that had been experiencing low account balances and limited transactions. Although the bank had over 100,000 depositors, more than 85% held a balance of less than 60 USD. Each of these customers actually cost the bank about 0.24 USD per month in administrative costs. The bank wanted to provide an incentive to customers to increase their savings balance.

Microensure and its partner StarLife Assurance launched an insurance product tied to the savings accounts. Depositors who held a minimum balance of 60 USD each month were entitled to free life insurance with benefits of up to 180 USD. Clients with a balance of 120 USD were entitled to life insurance for their spouse and children as well.

In the first five months after product launch, the bank's deposits increased by 19%. Deposits from clients with balances below 60 USD increased by 207% in five months as clients saved more to access the free insurance. This increase, along with anecdotal evidence from interviews with depositors, suggests that many customers saved more as a result of the insurance cover.

Micro-insurance in Indonesia

Background: *Payung Keluarga (PK), which means Family Umbrella in Bhasa, is a credit life product that Allianz Life Indonesia specifically designed to meet the needs of micro borrowers who take loans from microfinance institutions. In October 2012, six years after its launch as a pilot product in Indonesia, Payung Keluarga successfully reached the mark of one million active insured.*

There are more than 50,000 MFIs, serving 52 million small entrepreneurs in a population of 250 million. Allianz spells out a considerable amount of business potential to market not only credit life products but also other micro-insurance products in these areas.

Success factors: *The product itself acts as a key differentiator which in addition to providing life insurance cover, offers over 50 combinations of possible benefits, dependant on a single product and system platform. The interesting thing to note is that it is the MFIs who get to decide on the benefit package from these multiple options, which they are allowed to further customise by customer group.*

Another factor is an attractive compensation scheme. To distribute PK to MFIs, Allianz Indonesia uses two approaches–direct selling by staff and secondly, through tied agents and brokers. The commission is as high as 7% of gross written premium for tied agents for the first five years of the policy, free of any training, collection or servicing obligation on the agent. Another aspect to this compensation scheme is that once a particular MFI has been secured as a distribution channel, PK provides the MFI benefits in the form of a mark-up premium as well as profit-sharing. This concept of profit-sharing is new in the donesian market and is perceived favourably by the MFIs as it instills a sense of ownership and contributes to sustainable servicing of the product.

Operations are fairly simple and efficient, with 99% of loans not requiring any kind of underwriting. No complex documentation process and the use of a single monthly report accessed by all parties streamlines administrative hassles. Claims payment process takes around three to five days, with a rejection rate of below 1%.

Lessons learnt: *The first thing that needs to be kept in mind is that credit life is just an entry point. The rural population has the need for small business insurance, health insurance, savings related insurance, etc and these products need to be pushed into the market to grow this base of customers.*

Products need to be designed keeping customers in mind. They need to be flexible enough to attract customers in the first place. After introducing a modular version of the product PK in 2008, gross premium picked up from 70,000 to 865,000 GBP in 2012.

Another critical factor here is business relationship management between Allianz and MFIs, to secure a long-term relationship with partner MFIs. Statistics show that after the introduction of a dedicated BRM function in 2011, partner persistency picked up from 69 to 90% in 2012.

Also, the correct MFI needs to be identified for the product at the very onset. Once the scheme starts selling, many MFIs are hesitant to make changes in the structure of the product and benefits provided.

Source: Micro insurance innovation facility, ILO (2013)

CEO of a leading NBFC

"Focus has been on protection plans with a small ticket size, affordability and high demand. Most industry players were of the view that in the current scenario, the insurance product is the most viable, with higher margins as compared to other products like mutual funds."

NBFCs teach some lessons

Relative to various industry stakeholders, NBFCs have been the most successful in reaching and capturing a share of the rural markets in India. They have managed profitable operations through a different cost- to-serve model. This combines a deep understanding of the local consumer with proximity to them and the use of technology (handheld POS to facilitate transactions and enable productivity). NBFCs in India such as Shriram Transport Finance Mahindra and Mahindra Financial Services have been successful in catering to the needs of the rural economy. They provide a low-cost business model and last-mile connectivity, two crucial parameters to succeed in the rurban. Also, leveraging on their customer reach network helps them compensate for costs that are higher than banks. Utilising these financial intermediaries along with banks to achieve financial inclusion needs to be the plan.

Franchisee model: Large players have adopted the franchisee model to extend their geographical reach and have appointed small franchisees to sell these products. A share of profit is provided to the franchisee.

BC and MFIs: Some NBFCs appoint business associates which help in enhancing reach without opening physical branches. The advantage in this case is that the appointed intermediary is well-versed with the local market and needs of the customer.

Recruiting local talent: NBFCs have been successful in penetrating remote areas at the grassroot level by hiring and training from the local pool. This serves as a huge cost advantage as well as helps understand local market requirements.

NBFC viewpoint

"The gold loan business has been a pathbreaking innovation in the rural markets and yielded multiple benefits to financial institutions."

Challenges faced by NBFCs

Heavy dependence on banks for funding: NBFCs rely on banks for most of their funding, especially true in the case of smaller NBFCs. Out of every 100 INR that banks in India lend, 6 INR goes to the NBFCs. Shortage of funds and entry of banks in the retail lending segment have adversely affected profitability. In businesses where both banks and NBFCs have a presence, there are limited business opportunities for NBFCs to flourish. They have a high cost of funds in comparison to banks primarily due to the fact that NBFCs do not have access to refinance like banks. Banks have access to multiple organisations for refinance needs, e.g. RBI, NABARD, EXIM, SIDBI, etc while NBFCs stand at a disadvantage as they can rely on banks or the capital market for raising capital.

Securitisation of loans: **This** is also one of the major concerns that NBFCs in India face.

CEO viewpoint

"Interestingly, it has been observed if one branch opens in a particular under-penetrated area, other players immediately establish their own branches in that area, leading that market to saturation point."

Bank on the 'mobile': Other alternatives for the industry to consider

Another channel being exploited by banks to reach the under-banked population of India is capitalising on the mobile boom. Mobile network operators have been able to successfully penetrate remote areas and gain significant volume in their usage in places where there is no bank branch or ATM. Hence, it makes sense for banks to partner with telecom operators in order to reach this segment of the population.

There are 929.37 million mobile subscribers in India 50% of which belong to rural areas, signifying that there is immense opportunity to leverage this channel and increase reach of financial products.

The Indian Post

1. *In association with the Bharat Sanchar Nigam Limited (BSNL), the Indian Post launched the 'Mobile money transfer' service wherein money can be transferred from one post office to the other. This service is available in 7,000 post offices spanning 13 states, percolating down to the village level as well.*
2. *Agent based models have succeeded in making some amount of progress with companies like FINO, EKO, A Little World, etc.*

MNOs sell through a multi-layered distribution umbrella which consists of the main distributor, stockists and retailers who stock other goods apart from mobile top-ups. The MNO model has been successful in countries such as Africa, but its take-off in India remains to be assessed. The use of this network in India has been limited to remittances and the benefit has not managed to extend to other financial products.

This model has the capacity to create awareness among customers and increase levels of financial literacy while effectively utilising mobile banking services.

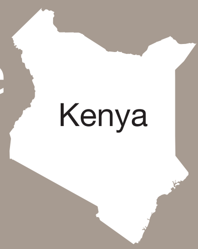
Currently, Kenya leads in offering financial services via the mobile with M-Pesa, attributing two-thirds of the adult population use this channel.

The enabling regulatory approach by the Central Bank of Kenya, has resulted in mobile financial services being used by

23 million people

via a network of more than

90,000 agents



while in Tanzania,

45% of the adult population is using mobile financial services through

138,000 agents.

Mobile banking in Bangladesh

Background: *Prior to the mobile banking initiative kicking off in Bangladesh, only 13% of the 160 million people in Bangladesh had bank accounts. However, 50% of this population was estimated to possess mobile phones. Bangladesh has performed favourably in terms of growing the banking system and reaching out to the unbanked population.*

Statistics indicate that 23.3% of the adult population have access to credit. Bangladesh has a large micro-finance market with the number of agents (9,093) exceeding the number of branches (7,961) and ATMs (3,000). The mobile financial services market is at a stage where providers are trying to leverage technology and achieve scale of operations, improve the strength of agent networks and acquire new customers. Currently, mobile banking clients have reached 7.21 million as of September 2013.

Success factors: *The model for the structured guidelines for the mobile financial services market released by Bangladesh Bank in 2011 was agent centric. The critical factor in this model was building trust as mobile banking with the tag of a bank attached to it added more credibility.*

What seemed to have worked in this market are the partnerships between banks and mobile network operators to take financial products to the under-penetrated areas. As the mobile market in Bangladesh reaches a mature stage in the development cycle, it becomes critical for banks to forge the right alliance or partnership. For example, a subsidiary of an SME based local bank, signed up with an MNO for access through the USSD. The distribution model was similar to that of an MNO but proved to be more effective by way of establishment of their brand and tying up with various telcos to ensure availability of their services across networks.

Another factor was upgrading the payment system with online automated interbank settlement of paper based and electronic fund transfers.

Regulatory guidelines have been found to be flexible and more consultative in approach avoiding being prescriptive by nature.

There is constant dialogue between the telecom regulator and Bangladesh Bank, the understanding being that the telecom regulator will oversee operations of telcos network services in the bank telco partnership while Bangladesh Bank will regulate the financial side of the mobile phone based financial services in the bank-telco partnerships.

The chosen path

Cohesion of the government, regulators and industry players

The government, regulators and industry players

The regulator plays a critical role in encouraging and facilitating distribution in under-banked areas. The IRDA regulations set rural insurance targets for each company. These require that 7% of all life insurance business should be generated from the rural social sector in the first financial year. This should increase annually to reach 18% by the sixth financial year. For general insurance, 2% of insured premium in the first financial year should be from rural social business, increasing annually to 5% in the sixth year. The RBI has relaxed branch authorisation to the extent that banks do not require prior permission to open branches in centres with a population of less than 1 lakh, which is subject to reporting. To further step up the opening of branches in rural areas, banks have been mandated to open at least 25% of their new branches in unbanked rural centres.

DMAT of insurance policies announced recently by the IRDA, will prove to be a revolutionary step in favour of pushing products out to the rural markets.

However, given the multiple variables at play, it is crucial that the government and its policy design, regulators and industry benchmarks work in tandem to generate a sustainable model beneficial to consumers and the industry. Creating such a viable model cannot be achieved by initiatives that function in isolation.

Rather, incorporating various requirements and developing a sustainable solution is the route to capture the rural market.

Industry viewpoint

"The regulator should give a proper turnaround time for the market, and be less restrictive in nature to promote better distribution."

Industry players need adequate incentives to facilitate financial inclusion beyond the mandatory. Both, the government and the regulator need to create an enabling ecosystem to facilitate the industry body to be successful. It cannot just be a mandate to the industry or a functioning that often takes place in isolation. The three stakeholders need to work in perfect rhythm with each other, understanding various constraints to achieve the goal of financial percolation for the rurban.

At the end of the tunnel?

The need for the regulator and the government to work in tandem with industry cannot be emphasised enough. The policy framework and execution should weave in considerable incentives for the industry, prompting them to pro-actively bear the torch of financial inclusion. For instance, the government needs to create an enabling infrastructure that holistically encompasses the NPS, RSBY, NREGA and DBT under one umbrella. Coupled with this, physical infrastructure that accentuates last-mile connectivity needs to be in place to save administrative costs. To enhance the percentage of insurance in rural India, passage of the Insurance Bill is crucial.

Industry players need understanding of the nuances relating consumer behaviour in these regions to align their needs and preferences (income, consumption and risk patterns) with product development. Innovative use of technology is allowing players worldwide to reach low-income groups. The SMAC (social, mobile, analytics and cloud) concept comes to play to look at device enabled sales forces, STP and paperless branches, using new collaboration techniques to co-create products with customers and better insights to individual customer risk profiling. All this will lead to enhanced productivity with lower costs.

Forge the right partnerships: No single player is the key-element of the value chain. Therefore it is imperative for financial institutions to get into partnerships to enhance reach and capability to serve this section of the society. Partnerships can be leveraged at various levels, with RRBs to leverage their infrastructure, with FMCG companies to leverage on their rural initiatives. E.g. the *Shakti Aamma* initiative by HUL with central and state governments in their FI initiatives and the distribution of welfare scheme payments to rural households and with telecom players to piggyback on their penetration levels.

Recent numbers estimate that 75% of the new branches of the total branches have been opened in semi-urban and rural areas. This showcases that banking services are reaching these areas at much faster pace than it used to a few years ago. Deposits and other saving schemes are the stars and the starting points in the rural markets. However, these markets not only face a technology challenge but also the business model challenge. All stakeholders need to address the specific nuances and then leverage existing demand. Existing banks are not able to fulfill the demand because it is difficult to create a new business model within the existing business model. The new banks about to receive their licences might be able to address this in a far more optimal manner through innovative operating models.

Bad loans from the agriculture sector have grown by 47% in the fiscal year 2011-12, higher than the 40% growth in such loans from non-agricultural sectors. Traditionally, loans to agriculture have always shown higher NPAs than non-farm loans. This trend is evident since 2004 with exceptions during the fiscal years 2009 and 2010. The union government had waived 76,000 crore INR worth of farm loans in 2008. Dissected from any angle, these numbers weaken the confidence of private players in the rural market widening the gap between the formal and informal. Policy initiatives designed to weave these into the existing welfare structure need to be in place.

The banking sector has not really addressed partnership models with telecom firms especially in terms of low-cost channels such as unstructured supplementary service data (USSD) and revenue sharing. However, the new RBI Governor has promised to work out a way for telecom companies and banks to forge partnerships. This may open up the mobile banking space on a wider scale than before. Interface related innovation is also key with respect to transactions. Understanding consumer behaviour and inculcating those in delivering the product and the way it is delivered is crucial to the success of any model.

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Contacts

Confederation of Indian Industry
Western Region
105 Kakad Chambers,
132 Dr Annie Besant Road
Worli, Mumbai - 400018
Maharashtra, India
Phone: +91 22 24931790
Fax: +91 22 24939463 / 2494 5831
Email: ciiwr@cii.in
Website: www.cii.in

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Contacts

Manoj K Kashyap
Leader, Financial Services
Direct: +91 (022) 6669 1888
Email: manoj.k.kashyap@in.pwc.com

Gaurav Dev Burman
Associate Director, Financial Services
Direct: +91 22 6669 1276
Email: gaurav.burman@in.pwc.com

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