First Annual GPFI Conference on Standard-Setting Bodies and Financial Inclusion: Promoting Financial Inclusion through Proportionate Standards and Guidance

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Good morning ladies and gentlemen,

Thank you Jaime and Anuradha for your welcome and thanks to the BIS and FSI and DFID for organising this first ever conference the GPFI.

I am honoured to follow Juan Manuel Valle as the second keynote speaker at this first GPFI Conference on Standard-Setting Bodies and Financial Inclusion. Having frequented meetings here at the BIS over many years including representing India at the BCBS, and in some of the sub committees of the CPSS and having participated in several IADI meetings, I can well appreciate the uniqueness of this event, an opportunity to bring together standard setting bodies based here and in Paris, G20 countries members of the SSBs, notably those active in the Global Partnership for Financial Inclusion, and developing and emerging market countries pursuing financial inclusion agendas while working to meet the international standards recognised globally as critically important for building sound financial systems.

Today, we all understand that financial inclusion is not merely access to a bank account or to credit - it is access to a bank account, insured deposits, insurance and pension products, loan products and access to mainstream payments and remittances. This is why it is so significant that we have here the SSBs relevant to all these services to subserve the interests of stability, integrity and consumer protection while promoting economic welfare for all. The issues that we will be discussing and debating today here at Basel are central to the mandate of my current organisation, the Centre for Advanced Financial Research and Learning, an organisation promoted by the Reserve Bank of India. Our focus is on the financial sector, in particular regulation and supervision, risk management, financial markets, financial stability and financial inclusion.

Financial inclusion vs. financial stability?

In 2010, I participated in an International Seminar on Policy Challenges for the Financial Sector co-hosted by the Board of Governors of the Federal Reserve System, the International Monetary Fund, and the World Bank at Washington, where one of the sessions was on “Financial inclusion and regulation – working together or at cross purposes?" At the very beginning of that session, the moderator asked the very senior central bankers and regulators present to raise their hands if they felt that financial inclusion worked at cross purposes with financial regulation and most of those present raised their hands!

In my comments at that session, I tried to establish that there was no conflict between financial inclusion and financial regulation – in fact that there was significant synergy between the two. I argued that good regulation was indeed required to further financial inclusion since it aimed at protecting depositor and consumer interest and those at the bottom of the pyramid needed such protection more than others. Sound and reliable deposit taking entities, backed by deposit insurance for small deposits, are an essential element of financial inclusion as only strong and sound institutions can deliver financial inclusion. It is not possible to have sound and reliable deposit taking entities and a deposit insurance system without sound regulation and effective supervision.

Another reason why there is convergence between financial regulation and financial inclusion is that if financial intermediaries have to deliver affordable services they need to take advantage of technology and economies of scale – this requires them to grow to some optimal size. Such growth is not possible without capital. Investors and lenders are comfortable with providing more funds only if such entities are regulated.

I would go a step further and say that unless there is sufficient penetration of well regulated and effectively supervised financial institutions, the needs of the excluded are most likely to be met by the informal sector, which could be unscrupulous and detrimental to the interest of the users of such financial services. Unregulated entities or shadow banks in this category, if prevalent on a large scale, can threaten political and social stability apart from financial stability. Hence I would argue that financial inclusion should be emphasised as a separate objective of financial regulation just as much as financial stability.

In my talk today, i would like to share with you the lessons that can be universally applied from the Indian experience of pursuing the objective of financial inclusion while ensuring that the principles and objectives of regulation are not compromised. I would like to highlight that we have not only adopted the principle of proportionality in evolving regulation but also used affirmative action through regulatory incentives and directions to promote financial inclusion.

Applying the proportionality principle in Indian regulation

1. In the 90s, RBI allowed banks to open savings accounts for informal Self-help groups (SHGs) despite their not having a legal status. This provided significant access to banking products to those excluded from the formal financial system. As these were locally sponsored groups and nurtured applying principles evolved by the National Bank for Rural development, the risk to financial integrity on account of such account opening was minimised. Relying on group cohesion and solidarity as social capital, the lending to SHGs did not compromise on safety and soundness. It was one of the first applications of the proportionality principle.

2. Relaxing KYC norms for opening basic banking accounts or no frills accounts is another example of tweaking regulation based on the proportionality criterion. This was done by us in 2006 and I find many countries have also adopted the same proportionality principle in KYC norms. Technology has made it possible to monitor small frequent transactions and as incorporated in FATF guidance in Feb 2012, there is merit in authorities adopting communications and policies to disincentivise cash and bring all financial consciously into the traceable banking channel to serve both the objective of inclusion as also integrity***.***

3. Branchless banking in India was adopted in India in 2006 by permitting banks to use business correspondents for delivering simple basic banking and insurance services - the benefits were clearly the lower cost and enhanced outreach, while the risks to consumer protection and to the bank were sought to be mitigated through technology solutions, and restricting the products offered to the most simple ones. Branchless banking through use of agents is still evolving and this could be an area where standard setters could give guidance. I must acknowledge the contribution of CGAP for their research and dissemination of international practices in this area.

4. I cannot talk of financial inclusion in India without a reference to the issue of regulation of micro finance. India has been a dramatic story of success and failure of market based MFIs. The major lessons learnt were: (i) systemic risk can prevail even if share of the sector is not significant if the numbers involved are large enough to have political constituency; (ii) consumer protection needs to be intensified as financial inclusion progresses; (iii) non banking financial

companies need higher capital adequacy ratios and need to be much less leveraged as compared to banks; (v) regulators need to be alive to governance practices of larger MFIs which in India saw remuneration practices that encouraged exponential growth without sufficient due diligence. (vi) Supervisors and banks need to adopt specific risk management and consequently supervisory approaches for this sector as articulated in the BCBS report; and (vi) While the genuine demand for savings products among clients of non banking entities and the risks of their turning to the informal sector is recognised, allowing deposit taking by such entities could be hugely risky unless the supervisory resources are commensurate to supervise such entities on lines similar to banks.

5. Dealing with the cooperative banking system in India, I understood the importance of deposit insurance for financial inclusion. Depositors in such banks are usually first entrants to formal financial system. The large scale failure of urban cooperative banks when we started enforcing the prudential norms strictly could be managed in a non-disruptive manner thanks to deposit insurance, which covered most of the depositors in such cooperative banks. While effective regulation and supervision cannot be substituted, the fact that deposits are credibly insured offers a safety net for small depositors. This is a very powerful message for financial inclusion that needs to be conveyed by IADI and the SSBs.

6. Another example where regulatory comfort and balancing of risks and benefits determined the choice of policies for financial inclusion is in relation to mobile banking. As elsewhere we were confronted with the choice of " bank led or non bank led model". While making the decision to opt for a bank led model the considerations we had were: (i) avoiding control over quasi money in the hands of non banks; (ii) inability of telcos to provide the full range of services required for financial inclusion; and (iii) regulatory comfort with banks in the area of adherence to KYC/ AML norms. The strength of the telcos in achieving penetration can be leveraged by mutually beneficial partnerships where telcos can act as business correspondents of banks.

7. An attempt to formalise informal moneylenders was attempted in 2006 when RBI constituted a group of finance secretaries from a few State Government regional look at money ending legislation. They came out with a model legislation which had a separate chapter on moneylenders with provision for being accredited by banks after due diligence and become agents of banks. This would assist in formalising them while taking advantage of their fact that they were in fact walking talking credit bureaux! Oversight by the bank branch to which such moneylender was linked could ensure that they did not charge usurious rates and followed fair lending practices. This

proposal however was not pursued by any State Government. I find that one of the issues we will be discussing in this Conference is formalisation and hence I have cited this example.

Affirmative policies for facilitating financial inclusion

I will now turn to how affirmative policy action has been used in India to encourage socially optimal business behaviour by financial institutions. As Dr Reddy, the former Deputy Governor, has argued, the justification for such action are the implicit subsidies to those who have a banking franchise (deposit insurance, bailouts due to the public utility and systemic importance of the banking system, etc.). Mandating banks to offer 'no frills' accounts, directing credit to priority sectors (without any interest rate controls or any compromise on prudential norms for such lending), use of branch licensing as a regulatory tool to further banking presence in unbanked areas, separate guidance for micro insurance brought in by the insurance regulator as early as in 2005 are some examples of affirmative action.

My objective in pointing out the importance of affirmative action is not to advocate regulatory forbearance or relaxation of prudential norms – far from it – but to support the use of regulatory prescriptions to have a set of incentives and disincentives that lead socially optimal behaviour by financial firms.

The provision of safety nets such could indeed be one form of affirmative action. As financial crises of different dimensions recur periodically, regulation needs to ensure that the engagement of small businesses with the formal financial system is within a framework which supports their survival during downturns. This could be achieved through some form of insurance/credit guarantees. For example many countries took special measures to support SME financing in the post-crisis period. Such intervention is generally through: policy mandate (directed credit); subsidised credit guarantee schemes, assignment of lower risk weights and provisioning (Basel already allows 50 per cent weights); and ensuring the better availability of credit records and credit information. Similarly ring-fencing of trade credit – which is of critical importance to small enterprises – could be an important area for regulatory reform while drawing up living wills of financial institutions.

In a joint seminar of regulators that we in CAFRAL, organised with BIS last year, to which Jaime alluded in his opening remarks, the theme was the implications of the emerging regulations for growth, equity and stability in a post crisis world. The consensus that emerged was that it is imperative for equity to be an explicit objective for regulation. However, regulation needs to be by broader policy and institutional framework – very much in the ambit of the G20. One of the papers in the conference also highlighted that there is a need to expand time horizons for current accounting standards, regulatory guidelines and institutional behaviour which tend to focus on the short term while investments made for financial inclusion reap benefits in the longer term. The papers of the conference are available as BIS paper 62. I hope the deliberations on implications of regulation for equity will engage the attention of the GPFI and the SSBs.

I have been fortunate to accumulate a number of years of experience working or interacting with the SSBs, especially the BCBS, the CPSS, FATF and IADI. These have shaped quite significantly my own thinking while evolving regulatory policies for financial inclusion.

Before closing, I would like to recount a true story of my husband who was dong field studies in remote Maharashtra for his doctorate when an impoverished woman dismissed his questionnaire and told him that poverty is a prison where the jailer has lost the keys. She said that all that is needed is an opportunity to get out of poverty. In the task of finding the key, the role of the financial regulator is perhaps as critical as the government. The task for the SSBs is to find the keys in the interest of stability, integrity, consumer protection and inclusive growth.

Thank you!