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The Future of Financial Inclusion in India: Need and Challenges

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ABSTRACT

Financial inclusion can be broadly defined as the process of making financial services available to people, especially the weaker sections and low-income groups of the society. It includes the timely and adequate availability of a wide range of financial products and services like:

- Bank accounts for saving & transactional purpose
- Equity products
- Insurance
- Saving products
- Loans

For economic growth in developing countries, this aim is furthermore towards ensuring financial inclusion to the unbanked and the underprivileged community who are either unaware of or unable to affordable financial services and products. Penetration of financial services to all sections of society at a swift pace can be achieved through Digital Banking and FinTech.

Goals to achieve Financial Inclusion are:

- To maximize the use of the latest technologies to transform the existing raditional financial or banking service models.
- To better the existing products or services of the financial sector.

Keywords: financial inclusion, future, India, products, economy, banking, community

Bharat Financial Inclusion Limited (formerly known as SKS Microfinance Limited) BFIL is a banking & finance company (NBFC), licensed by the Reserve Bank of India. It was founded in 1997 by Vikram Akula, who serve as its executive chair until working. The company's mission is to provide financial services to the poor under the premise that providing financial service to poor borrowers helps to alleviate poverty. The company operated across 11 Indian state

I. INTRODUCTION

India's financial services sector typifies the progress and opportunity of its economy. The sector will grow rapidly out driven by rising incomes, heightened government focus on financial inclusion and digital adoption – India's digital payments could pass $1 trillion.As the Indian market matures, Australian businesses could partner with Indian financial services companies in sectors that align with our competitive strengths in asset management, general insurance and fintech[1,2] .Partnership opportunities will be niche, targeting the economically advanced parts of India and in segments not dominated by state-owned enterprises.While Australian expertise may not be transferable on a large scale to an Indian context given differences in target markets and goal orientation, India's financial services sector will become more globally connected.Success in India will require strong local knowledge and a willingness to operate on longer time horizons than Australian financial services firms are used to, and for India to have made progress in regulatory clarity and investor protections.[3,4] Out to future, technological change will have a transformational effect on this sector. India is set to benefit and could leapfrog Australia while our industry struggles with legacy systems.While the financial services sector and investment decisions are

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commercially-led, government can play a role in bridging knowledge and expectations gaps. Sharing Australia's regulatory experience and work on setting standards with Indian policy makers could also facilitate commercial engagement[5,6].

Rising incomes will drive demand for financial services across income brackets in India, including in insurance and retail banking services

- the number of HNWIs is forecast to triple to over 1.2 million .
- India's five largest cities will have economies of comparable size to middle income countries today
  - Mumbai alone is projected to have an economy as big as Malaysia today

High competition and many local players limit opportunities in the Indian retail banking sector

- State-owned banks represent 70 per cent of India's retail banking sector yet are responsible for only 43 per cent of profits
  - privatisation is unlikely, but the need to improve provision of credit could see the Indian Government approve the entry of more private banks[7,8]
- fragmentation has forced a large number of smaller private banks to compete on price and thin profit margins
- regulations in place since 1972 require at least 40 per cent of bank lending to be directed to agriculture and 'economically weaker' sectors.

India's state-owned Life Insurance Corporation holds over 75 per cent of the life insurance market while 20 other firms compete for the remaining share

- industry premiums, coverage and pay-out rules are highly regulated and subject to frequent change
- Indian companies have strong distribution networks and local expertise, and foreign players may struggle to identify suitable segments of the market to target.[9,10]

There is greater capacity for private sector and foreign entrants in general insurance, which is expected to grow between 13–19 per cent annually , especially since many Indian insurance firms lack expertise in product development.

With its high growth economic trajectory, structural reforms aimed at lifting productivity and recent loosening of foreign investment caps, India offers genuine investment opportunities for Australian institutional investors.

Australia's sovereign wealth fund, Future Fund, has found success by pursuing a long term investment horizon and moving away from using quarterly benchmarks to define performance.

Rather than focusing primarily on equities, Future Fund has selected investments in alternative asset classes such as infrastructure, property, private equity and hedge funds. This diversification gives an edge across geographies and emerging economies.[11,12]

The Future Fund approach requires a sophisticated understanding of risk – and it pays rewards. Future Fund has delivered returns of 7.7 per cent over its first 10 years of operation – a performance that has captured international attention and strengthened its brand.

Future Fund acknowledges that investing in India comes with challenges, particularly the lack of recognition of sovereign immunity for tax purposes.

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Further reforms to address sovereign risks that impact on the stability of cash flows will continue to grow India's attractiveness as an investment destination. In particular, Future Fund is watching for success in combating corruption, improving regulatory quality and the rule of law surrounding investor protection.[13,14]

Demand will also rise for financial services at the lower end of the income spectrum

- the Government of India has made financial inclusion a top priority by launching and expanding multiple programs, creating and strengthening transparency and digital systems, and enforcing regulatory measures to increase competition
- government efforts to persuade cash-based vendors to embrace formal banking, including through device-based and digital payments, will also accelerate financial services demand from micro and SMEs
- Australian firms, however, do not have experience or expertise in serving this market.

II. DISCUSSION

Fast digital adoption from consumers and skilled IT clusters, such as those in Hyderabad and Bengaluru, will continue driving the expansion of India's fintech industry, which is expected to double to $3.2 billion

- the rate of technological change makes it difficult to forecast long term projections of the size of the fintech market in India.[15,16]

The development of India's technological and entrepreneurial ecosystem will make it easier to expand the financial services market into regional and rural areas

- while financial inclusion has been a focus of Indian policy makers for decades progress is now being seen
- new technologies are now making it viable
    - for example, the rollout of the Aadhaar card, a national biometric identification system now covering over one billion people, creates a comprehensive picture of prospective customers.

Indian fintech companies are driving change by specialising in targeted services along specific parts of the value chain which were previously the domain of brick and mortar companies

- for example, aggregators like BankBazaar.com offer a range of services such as loans, credit cards, deposits and insurance, and receive payments from banks for assisting in new business generation[17,18]
- India offers the highest expected return on investment on fintech projects, at 29 per cent (not risk adjusted) versus a global average of 20 per cent.

India's mutual funds segment is sizeable, equivalent to approximately one-tenth of the country's GDP

- growth prospects are good, given India's high savings rate and its well-developed equity market.

The equity mutual funds market, with a boost from demonetisation, saw its assets under management cross $430 billion double what it was three years earlier

- further development in the mutual funds sector will be hampered by modest demand beyond tier one cities, a lack of asset class diversity and narrow pension coverage.

India's pension system is at a nascent stage, dealing with challenges related to customer awareness, penetration and regulation

- pension funds under management stand at 1.1 per cent of GDP – compared to 1.5 per cent of GDP in China – and its subscriber base of 8.7 million is a small fraction of the working population
- India's regulatory framework limits investment avenues for money raised through pensions[19,20]
- however, this is changing with the Employees' Provident Fund Organisation granted approval to invest a part of its assets into exchange traded funds.

But the demand for pensions is expected to rise considerably on the back of an increase in the elderly population, a higher life expectancy and decrease in the prevalence of the extended family structure

- this creates a pressing need to create a robust pension system in India, which would raise investment prospects, including for foreign companies.

Growth in India's financial services sector will be driven by expected increases in FDI and FPI, particularly into Indian infrastructure
Despite India's high savings rate, the country will be an importer of capital to meet its growth ambitions

- while the relaxation of some FDI limits has spurred significant capital inflow in the last 12 to 24 months, the double digit return potential across large parts of India's financial services sector, including infrastructure, has yet to spark the magnitude of foreign investor activity India's Government had hoped.

Foreign investors may be waiting for evidence that Indian policy makers are serious about introducing new financing models to facilitate greater private sector participation

- efforts already underway by the Indian Government to attract foreign investment, such as the establishment of an equity fund in the form of the National Investment and Infrastructure Fund, could help reduce some of the risk profile for foreign investors, including from Australia
- however, India's financial markets have not matured to the point where they can realistically use bonds to fund infrastructure, and there is little indication that addressing this will be a priority for Indian governments in the medium term.[21,22]

The financial services industry is on the cusp of substantial change

- rapidly advancing technologies, rising consumer expectations and disruptive innovations will reshape the structure of the industry across the globe.

In India, the extent to which changes are evolutionary or revolutionary will depend on whether incumbents continue to develop technologies in-house, acquire or partner with new entrants to rollout technologies, or whether the new products bypass existing intermediaries and markets.

III. RESULTS

The pace of change in India's financial system has the potential to be faster than in other countries due to the rapid take up of digital devices combined with India's track record of frugal innovation.

Technology leapfrogging in telecommunications, in which India will jump past the fibre cable stage to mobile network infrastructure, will be central to the future development of India's financial services sector[23,24]

- mobile phone penetration in India is set to rise to 85–90 per cent later (from the current levels of 65–75 per cent), while the smartphone user base is expected to expand to about 500 million people in the same period.

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Other digitisation projects, such as the United Payment Interface and associated mobile application Bharat Interface for Money – a safe, instant payment system – and DigiLocker, a cloud based platform for authentication and sharing of identity documents, will be linked to customers through Aadhaar

- the result could revolutionise document processing and enable end-to-end digital credit underwriting.

The digital finance is forecast to boost India's GDP by $950 billion and create 21 million new jobs.
With an assist from the demonetisation campaign, the digital payments sector in India is expected to benefit the most from rising technological adoption in India[25,26]

- digital payments could grow as much as tenfold to $500 billion and pass the $1 trillion mark
- digital banking adoption will also continue its rapid ascent
- nearly 80 per cent of all customer transactions in new private banks are conducted through digital channels
    - the average volume of monthly transactions at ATMs increased 1.5 times, EFTPOS by 2.7 times, mobile banking by 9.6 times and e-wallets by 11 times.

Adoption of new technologies and processes, including blockchain ledgers, could reduce the cost of managing loans and make microfinancing commercially feasible

- the NITI Aayog-led IndiaChain plans to implement a fully-fledged blockchain infrastructure that uses 'electronic Know Your Customer' and Aadhaar to reduce fraud, speed up enforcement of contracts and increase transparency of transactions[27,28]
- microfinancing for commercial purposes will require a change in India's banking culture, which has traditionally preferred to lend large amounts to limited clients rather than lending small amounts at scale
- while India's incumbent players may not be agile enough to adjust, they are unlikely to hinder new firms that may look to service this market.

The need for cyber security and personal data privacy will inform how financial institutions approach off-shoring, data storage and the use of big data
Fintech start-ups are already encroaching on established financial services markets

- unencumbered by legacy systems, they are developing customer friendly solutions from the ground up[29,30]
- consumers are showing signs of preferring non-traditional financial service providers, largely due to more targeted product offerings and a greater focus on customer choice and experience, especially in areas of payments, loans and personal finance information tools
    - the most successful Indian fintech company to date has been Paytm, an electronic payment and e-commerce giant with over 200 million users.

Big data analytics will allow financial service providers to target and tailor products and services with greater precision[26,27]

- firms can anticipate needs, price offerings and risk more effectively.

In financial services, brand loyalty and effectiveness of discounts will decline as value will increasingly be derived from the degree of personalisation and adaptability of the product

- platforms may emerge to give consumers the ability to build a portfolio of financial services from many providers that meets their specific needs
- in insurance, for example, business models could shift from being a reactive claim payer to preventative risk advisor.

State Bank of India General Insurance Company (SBI General), is a joint venture between Insurance Australia Group (IAG) and the State Bank of India (SBI), India's largest and oldest bank with more than 24,000 branches across India.

SBI General was established building a portfolio in the corporate, retail and SME markets across India. SBI owns 74 per cent of SBI General and IAG 26 per cent. IAG has an option to increase its shareholding to 49 per cent, insurance law amendment to the foreign direct investment limit.

SBI General has continued to grow strongly and has achieved significant growth from nil revenue from to $750 million of Gross Written Premium reaching 14th in the market with a 2.3 per cent market share.

However, such successes have not been without challenges. The development stage of the Indian economy and the insurance industry means regulatory frameworks continue to evolve rapidly which creates some uncertainty for investors/shareholders. There is also less concern and protocol in relation to making retrospective regulatory/legal changes. An example would be retrospective changes that impacted foreign shareholders' rights in JV Agreements, forcing them to be re-written with rights removed. Cultural differences, both generally and commercially, also create different processes and benchmarks for assessing what makes good or bad sense in relation to business decisions.[24,25]

Nevertheless, enormous growth and significant portions of the market remain untapped. The non-life insurance industry grew by 18.9 per cent in the opening nine months of fiscal year led by the new government backed agricultural insurance schemes and increased penetration in motor insurance.

The healthy growth rate is expected to continue as economic growth boosts disposable income and the insurance market expands to reach more first-time buyers. A rapidly growing middle class is also driving increased insurance penetration and density, while a strong development/growth drive in commerce needs to be balanced with profit ambitions.

Australian industry can benefit from India's financial inclusion drive and economic modernisation by investing in segments of the financial services sector that are open to foreign participation, such as general insurance, or providing services to enable investment in other sectors, such as infrastructure.

Australian expertise in financial services may not be transferable on a large scale to an Indian context because of a misalignment in target markets and goal orientation. Australian industry is primarily focused on making a profit and products are geared to a sophisticated investor base, whereas India's financial ecosystem has a marked social undertone.[29,30]

Niche opportunities will emerge as India's capital markets mature, including in asset management and fintech collaboration.

There is also potential for Australian financial institutions to source fintech capabilities and skills from India.

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We should improve institutional ties in financial services segments where both Australia is world-leading and India is reform-leaning

- government engagement could facilitate the entry of more Australian players in this space and improve growth prospects for Australian companies investing in India's financial services sector, and vice versa
- India will also have opportunities to absorb regulatory best practice through their exposure to the Basel process and Financial Stability Board.

The most prospective area for regulatory cooperation is in fintech

- India is in the early stages of developing its fintech regulatory architecture
- the Australian Securities and Investments Commission (ASIC) is well placed to work with India on fintech regulatory cooperation.[29]

Both countries will also benefit from establishing robust international standards in the blockchain industry, which will provide market confidence and trust that proprietary information and money will remain safe

- it will help provide a common language for industry, policy makers, regulators and technology developers, and the basis for interoperability, as the use of blockchain expands

IV. CONCLUSIONS

India's financial services industry is heavily regulated by a range of authorities, many of which are averse to foreign debt and foreign players

- the RBI, SEBI, Insurance Regulatory and Development Authority of India, and Pension Fund Regulatory and Development Authority all have regulatory power in the sector
- extensive regulatory requirements for the formation of new companies in the banking, financial services and insurance sector have long posed a barrier to entry for prospective companies.

The complex regulatory environment particularly impinges on India's emerging fintech sector

- new regulatory hurdles, such as protocols around 'know your customer' and anti-money laundering, as well as digital identity authentication and data storage requirements, slow the adoption of new technologies.[27,28]

Like their global peers, Indian regulators are still figuring out how to recalibrate to innovative disruptions

- the treatment of new business models enabled by fintech, including peer-to-peer transactions, crypto-currencies, crowd funding, systems integrity and data security are the biggest grey areas
- the lack of a regulatory framework makes significant investment in fintech a risk for Australian businesses.

The Future Fund, Australia's biggest institutional investor in India, has also suffered from a lack of regulatory clarity

- SEBI's 'clubbing' rule, which brings the Future Fund and a range of state government funds under the same banner, effectively limits Future Fund holdings to 2.5 per cent of any listed entity, whereas a single foreign portfolio investor would be able to hold 10 per cent.

India has made notable recent progress in reducing FDI caps in some sectors

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- the FDI limit on pensions and insurance increased from 26 per cent to 49 per cent
- the limit in 'other financial services' category, which includes fintech and asset management, increased to 100 per cent
- India will need to go much further in opening up the financial services sector to foreign investment if it wants to increase capital inflows and accelerate adoption of world-leading technology and practices in these sectors.

Opportunities in the retail banking sector are curtailed by the dominance of public sector banks and the prevalence of many local private sector banks

- some foreign banks have succeeded in India but many have exited, including Australian banks
- those Australian banks with a presence in India primarily service corporates and HNWIs from Mumbai and New Delhi or outsource back office functions

  - India would need to secure investment from big name firms in Australia, New Zealand and other parts of the Indo-Pacific for significant opportunities to emerge for Australian firms in India's retail banking sector.

Unlike many other industries, the financial services market in India is a national market in which businesses do not have to rely upon the business conditions set by state governments. Nevertheless, India does have well-formed financial services and fintech clusters. These cities should be the entry point for Australian companies seeking to establish a presence in the market. In the medium term, Indian cities with the greatest unmet demand for capital and insurance are unlikely to offer the best prospects for the types of financial services in which Australia specialises. Australian efforts should also focus on the Central Government to bridge knowledge and expectation gaps and share regulatory expertise.[29]

Much like other parts of the world, India's financial services sector has a high spatial concentration in one city – Mumbai

- the city is India's financial and corporate capital, housing the headquarters of regulators, including SEBI and the RBI
- by extension, the state of Maharashtra, of which Mumbai is the capital, is the most relevant for Australian financial services firms seeking to establish a presence in India.

The clustering of IT firms in Hyderabad (Telangana) and start-up culture in Bengaluru (Karnataka) has led to the emergence of a strong fintech ecosystem in both cities

- Telangana is also home to T-Hub, India's largest start-up incubator.

Andhra Pradesh and Karnataka are key states for fintech partnerships given the development of a fintech hub in each state and the existence of a strong IT and fintech ecosystem respectively.

Recognising its wide-ranging potential to modernise the economy, New Delhi, Kerala and Rajasthan are committing to develop blockchain specialisation hubs.[30]

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