

The Future of Rural Finance in India

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1 Introduction

Discussions on Indian rural finance are obsessed with three topics –

- credit,
- farmers, and
- interest rates.

We use the word “obsessed” advisedly because if we look at the literature on rural finance in India, a vast majority of it is about just these three topics. In this paper, therefore, we will not say much about these three topics because enough has already been said and there are strong frozen views on all sides. What this has led to is that several financial needs remain unmet, several population segments remain under-served and false dichotomies remain unresolved, so we focus on those.

1.1 Unmet Financial Needs

Most of the discussion is on credit, as if it is the only financial service needed. Within credit, for rural areas, it is only crop credit. This has led to several important financial services being neglected:

- Lifecycle financial needs
- Investment finance for farms and non-farm enterprises, natural resources and infrastructure
- Risk management products

1.2 Underserved Population Segments

Among various population segments, the discussion is largely about farmers even though we now know that only about half of rural workers are engaged in cultivation and the Census of India, 2011 showed the number of cultivators (farmers) has declined by about 9 million in the 2001 to 2011 decade, to 110 million. But other larger, population segments are not being adequately served:

- Women – nearly 570 million (this and the other numbers are from the Census of India, 2011)
- Youth (15-29 years) – nearly 331 million
- Elderly (above 60 years) – nearly 104 million
- Minorities – nearly 244 million

1.3 Unresolved False Dichotomies

Most of the discussions in the literature is on how to reduce the interest rates on farmers. This has led to inadequate discussion and non-resolution of three key false dichotomies:

- Affordability versus Sustainability
- Innovation versus Regulation, and
- Inclusion versus Education

In the sections below, we will deal with these three triads of issues one by one.

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2 Unmet Financial Needs

Among the three major financial needs which are unmet, the first one is life cycle finance. By this term, we mean a comprehensive, individual-in-a-household centric financial offering, which comprises different products and services at different stages of the life-cycle, literally from conception to cremation. For example, a loan could be extended to a woman when she finds herself to be pregnant, so that she could ensure good nutrition, medical check-ups and pay for the delivery expenses. If she if she was a casual worker or if she wanted longer than normally paid time-off, she could use this loan to maintain her consumption and household expenses. On the other hand when her child grows up and gets educated, she could be offered a long term savings product for the child's higher education, supplemented if needed, by an educational loan.

The young person who begins work after education can be offered a number of financial services – from a simple bank account, enabling receiving and making payments, to term-deposits, to medium term savings for buying a home, if necessary supplemented with a housing loan; health insurance and life insurance; and long-term savings for pension after retirement. Finally, in many cultures, getting a dignified burial or cremation and a death ceremony after that is important and a savings product could be designed for that. The life cycle approach is completely absent in our financial thinking, financial offering and financial regulation. Yet major demographic shifts are happening in the country where unless we adopt this approach we will be in deep financial trouble as a nation. We will explain that as we go further.

The second major financial need which is being under-addressed is that of investment finance. Capital formation in agriculture has been declining steadily. Long term finance has more or less dried up. That is well known but the fact is that it has now reached alarming proportions where, leave alone enhancing productivity, maintaining productivity levels achieved earlier has become difficult in Indian agriculture. The investment finance for diversifying within agriculture from crop cultivation to things like horticulture, floriculture, dairy, poultry etc., as well as diversifying out of agriculture to non-farm enterprises, is totally missing. There are a few instrumentalities like MUDRA loans but most of these are largely absorbed by urban areas. In addition to the need for investments in individual owned farms and non-farm enterprises, in rural India there is a great need to invest in restoring the productivity of natural resources – soil, land, pastures, forests, water bodies and rivers. This is so far being done only through budgetary resources, but the funding needs is so high that we need to think of financial mechanisms for these. Similarly, more investment is needed in rural infrastructure and services – roads, warehouses, telecom, energy, education and health and merely depending on the budgets of central and state governments will forever constrain these.

The third major financial need which is unmet is risk management. In rural India, with agriculture being the biggest part of the economy, managing crop cultivation risk is important. We have had nearly forty years of experimentation in crop insurance and we have improved the design steadily, culminating in the Pradhan Mantri Fasal Bima Yojana (PMFBY) launched in 2015. Its scope has been increased to non-loanee farmers. With increasing effects of climate change, catastrophes are becoming more frequent and we need to figure out how to handle their financial consequences. In addition to the yield risk that insurance may cover, what matters to farmers the revenue they get by selling their produce and if price crashes, the income may fall even if yield is fine. Thus managing price risk is also a very important issue. The financial mechanisms for this is commodity derivatives – futures and options. These are just beginning to be used in India.

Let us now look at each of the unmet financial needs identified above, in detail, one by one.

2.1 Life Cycle Finance: from Conception to Cremation

The life cycle approach to finance is based on the fact that all human beings need financial services of various kinds throughout their lives. Due to the fact that the ability to earn is lower than the need to consume, both in the early years typically till one is 18 years of age, and in the later years after 60 years, people require to be financed during these phases of their lives. The traditional way has been financing by the family, or by own savings in case of old age. Sometimes, if it is a major need and there is no cash inflow, then loans are taken, and when that does not work out, individuals turn to their community, and then to charitable institutions and the government.

The demographics are changing in such a way that unless we handle financial needs in a planned manner, these will be a big burden for individuals as well as for the state. For example, we could see a lot of old age poverty, as joint families and the support to the elderly is declining as a social norm. Unless we take some financial steps, we are going to see some unhappy situations 15-20 years from now. The assumption that government or charity will step in and cover everybody is not true. We know how the widows were treated, for example, whether in Varanasi or in Vrindavan. There is a limit to how much society can respond voluntarily.

Fortunately, in the working years, typically 19-59, years which is a forty year long period, generally speaking, the ability to earn is more than the need to consume. But to enable young people to be educated, skilled and productively employed also needs investment. The traditional method of family financing, or government funding or occasional charitable scholarships will not be adequate. As costs go up, these needs will have to be financed through loans from banks and specialised bodies. Once people become employed, if proper financial products and systems are there, then working people can save and invest. Initially this investment can be for having a home of their own and later for other longer-term needs like children's higher education and post-retirement living. Though we have the national old age pension scheme, it provides inadequate coverage to the elderly. We need a massive increase in long-term savings products for people to save for their retirement.

While all the needs enumerated above apply to all Indians, urban or rural, but we need to plan more for the rural Indians, because they have less access to appropriate and diversified financial services.

2.2 Investment Finance: for Farms and Non-Farm Enterprises

Coming to investment finance first let's deal with farms. Please note that we are talking about the investment in farms not in farmers because the moment we say farmer, we personalize the matter - we start looking at the face of the farmer in difficulty or distress. The whole issue is not seen from a hard-nosed financial point of view which we believe is necessary. One main reason why Indian farmers are distressed is that India's farms have been starved of investment. Farmers basically make a living out of these farms. Since 80 percent of the farms are owned by small and marginal farmers who are unable to subsist, for them further investment is just unthinkable. They are not even making enough to sustain themselves. How to handle this? We need to come up with financial instruments like 7-10 year long term loans so that the uncertain cash flows and smaller cash flows can be adequate to repay these loans.

Our political leaders also need to recognise that the banking system cannot continue to finance farmers even as agriculture is inherently becoming unviable. The present solution of declaring loan waivers is unsustainable and also destroys credit discipline by borrowers, while bankers get increasingly wary of lending to farmers and agriculture in view of political risks.

Let us now turn to the need for investment finance for diversification within agriculture from crop cultivation to allied activities such as horticulture, floriculture, dairy, poultry and fishery. Out of about 48 crore workforce in 2011, about 55% or 26.3 crore persons were engaged in agriculture in 2011. Of these, 11.9 crore were cultivators and 14.4 crore were agricultural labourers. In our view, roughly half of them, about 13 crore need to be helped to move out of agriculture. (We are lucky that two thirds of them are youth and therefore they are trainable, they have aspirations, they are mobile which aligns with this goal). Those who stay back should be helped to diversify from pure crop cultivation to allied activities.

So if 13 crore youth to be moved to from agriculture to non-farm enterprise and urban self-employment, and assuming we need an average investment of Rs 2 lakh per person employed, so we need Rs 26 lakh crore. Assuming this has to be achieved over a ten year period, bank credit of Rs 2.6 crore is well within the reach of India's banking system which had given net bank credit of Rs 79 lakh crore on 31st March 2016. Thus it is feasible that we can finance the transformation of rural India using loan funds over a decade.

2.3 Financing Natural Resources Restoration in Rural Areas

But even with loans, individual farmers can only do things like restore their farm's soil health, build farm ponds to recharge their borewells, install new technology like drip irrigation, poly houses and build silos to store their produce and prevent post-harvest losses. But there is a limit to how much a farmer can improve his productivity by just working on his own farm. Unfortunately natural resources do not respect farm boundaries. The water sources, soil zones and other natural boundaries, all run across man-made farm and village boundaries. So we need a restoration approach which is based on natural boundaries, such as watershed and river basins, ridges and valleys, but because the rural administrative unit is the village, managed by Gram Panchayat and then the block and the district, managed by Zilla Parishads, most planning and allocation of resources is based on administrative boundaries. There are a few notable exceptions – Karnataka has a Watershed Development Agency and Meghalaya has Basin Development Authority and most major river dam based canal projects have Command Area Development Authorities.

Under the 73rd Amendment to the Constitution, Gram Panchayats and Zilla Parishads have powers to make local level financial plans. These are partly funded using the 14th Finance Commission² devolution of funds directly to Panchayats and partly through the State Finance Commission mechanism. The fund availability at the Gram Panchayat level is Rs. 2,404 per capita per year for 2015-19 period, which amounts to Rs 17 lakh per year for an average Gram Panchayat. The grant may be spent on basic services and maintenance of community assets.

Though, laudable, these resources are barely enough. At present these are supplemented in a big way through central and state government schematic funds, which are always less than what is needed and often arrive late and in piece meal with too many schematic restrictions. To overcome these, we have to enable our Panchayats and Zilla Parishads with financial products like Grameen Vikas Bonds with 15-20 years of maturity. To give a simple example, the average Gram Panchayat can use its assured 14th Finance Commission grant of Rs 17 lakh to service a loan or a bond issue of Rs 1.25 crore at 10% per annum with a 15 year tenure. They can invest this in watershed development, tank de-silting and rehabilitation, ground water recharge structures, restoration of grazing land village forest lands, rather than keep waiting for uncertain schematic finance for years.

² 4th Finance Commission awards to Panchayats <http://pib.nic.in/newsite/mbErel.aspx?relid=118576>

2.4 Financing Services and Infrastructure in Rurban Small Towns

When we are talking about rural India, we need to include small towns because it is not possible any more to locate either agro processing enterprises of any significant scale or service enterprises like warehouses, sorting, grading and packaging facilities, transportation and business services in each village. So, for economies of scale reasons, these will have to be in small towns. Thus we need to increasingly think of rural as “rurban”, a region comprising a large agricultural landmass, dotted with small habitations called villages and one or two nodal small towns. Rural transformation has been a goal of economic development in India for long. To do it with budgetary allocations is just not feasible but it can be done with loans because we now have a banking system which has the ability to do this. In addition we have the ability to raise equity investments, both internal and as FDI.

Sceptics can say that such raising of funds has not been done successfully yet by even by most of the urban municipalities, except Bangalore and Ahmedabad, so it will be difficult for Zilla Parishads. But we must remember that on that front there has been progress and SEBI issued guidelines in 2015 on what could make Municipalities issue bonds on the capital market. In March 2017, 94 out of the 500 designated “smart cities” got rated and 59% of them receive an investment grade rating.³ Now, the Pune Municipal Corporation is about to raise funds through a bond issue. Similar, step by step work would have to be done for developing a market and regulatory structure for Zilla Parishad Grameen Vikas bonds also.

The Rural Infrastructure Development Fund (RIDF) is a good, though not market based, example of taking to the financial sector what would have been budgetary investment otherwise. Government of India created the RIDF in the National Bank for Agriculture and Rural Development (NABARD) in 1995-96, with an initial corpus of Rs.2,000 crore. With the allocation of Rs25000 crore for 2016-17 under RIDF XXII, the cumulative allocation reached Rs 267,500 crore. NABARD lent the RIDF funds to various state governments. This enhanced the total available resources for rural infrastructure. This also instilled a lot more discipline in state government infrastructure projects because for the first time, state agencies like PWD or the ground water board became accountable to NABARD. Even to get approval for their proposals they had to do a lot more detailed and better technical planning, better implementation, better monitoring and therefore it was a net contribution to rural India. Though a vast majority of RIDF funds have gone to state governments, but there are examples where state governments have devolved these funds to Zilla and Gram Panchayats, as in Kerala.

Moving beyond Government of India mandated transfer of banks’ under-lending in priority sector to the RIDF, to successful raising of funds through instruments like Grameen Vikas Bonds is not possible in today’s financial market, where even corporate bonds are not common. One reason for this is that the bond market is over-crowded by the Government of India and by State Governments. So the Government needs to reserve a window for Zilla Parishad and Panchayat bonds, and may have to initially guarantee those. We therefore need a whole new financial framework and infrastructure to mobilise finance for rural needs. In 1992, India built a new financial infrastructure to enable the private sector to mobilize capital - we now have world class stock exchanges with screen-based trading, SEBI the financial market regulator, a lot more transparency and accountability. We will have to slowly extend the reach of that eco-system and attract specialised financial intermediaries for managing issues of Grameen Vikas Bonds for Panchayats and Zilla Parishads. Let a small beginning be made soon using the assurance of assured 14th Finance Commission grant.

³ Credit Rating of Urban Bodies Gains Momentum <http://pib.nic.in/newsite/PrintRelease.aspx?relid=159951>

2.5 Risk Management Products: Insurance, Cat Bonds and Commodity Options

Coming back to the next financial product which is missing is risk management. For crop-insurance, the PMFBY seems to incorporate all the lessons that were learned from the Indian as well as international experience in crop insurance. Some new technologies such as automated weather stations and global positioning systems have been incorporated into it. It has been simplified at the front end while at the back end, a complex claim determination process has been specified. There is also public private partnership in the sense that the insurance provided is a private insurance company, which got this right through a reverse bidding process for different regions. This is a state of the art design. We still have to see how the PMFBY runs for three to five years.

In addition to crop insurance, other rural specific insurance is livestock insurance for – dairy cattle, poultry, piggery, fishery, etc. Though these products have been offered for three decades by the public sector insurance “general” (non-life) companies, since these were always offered as tied products with bank loans, there has been no product development, pricing improvements, nor any attempt at publicity or promotion or improving the customer acquisition or claim settlement processes. All that work needs to be done. As the work of BASIX with the Royal Sundaram Insurance Company showed, once livestock insurance is done carefully and data is collected on claims over the years, actuarial pricing can bring down the premiums as well improve the claim settlement ratios.

With increasing intensity of climate change and the resultant catastrophic events such as super-cyclones, tsunamis and earthquakes, we should pay attention to catastrophic risks. Insurance companies shy away from covering such risks because a few such incidents could be very hard for our insurance industry if they covered such risks fully. In the absence of catastrophic insurance, the government becomes the last resort. But how much can the government bail the people out? Can there be a financial sector solution?

The solution is something called “cat bonds” as these are known in the trade. These cover high-impact, low-probability events through bonds. In most cases, these bonds are not fully paid up, but are guaranteed by parties with high solvency and high trustworthiness in the financial sector that once they have said they will cover their part of the risk they will cover it. So the pay-outs occur in the event that a specified catastrophe happens. As the chances of say, Mexico and India both having an earthquake or a cyclone in the same year are much rarer than two cyclones happening in India in the same year. So the bond holders spread their risks all over the world, and thus on the whole they make a profit, despite pay-outs. This then brings more money to the cat bonds market and over the years a financial market rather than a government fiscal solution can be crafted. This approach is important for Indian rural finance to emulate.

Finally, the issue of price risk for rural commodities, remains unaddressed. The traditional method is the minimum support price (MSP) mechanism but it is increasingly unsatisfactory as it imposes too many burdens on the state governments’ fiscal situation. Except for wheat and rice, where massive procurement is done to feed the public distribution system (PDS), the MSP mechanism does not work well, or if it does, then at a scale that is large enough to serve most of the farmers producing commodities other than rice and wheat.

Farmers have to engage in distress sale because they need cash soon after harvesting a crop, both to meet consumption and social needs as well as to plant the next harvest. One way to do so is to extend credit against the produce, rather than buying it. A newer instrument that has spread for this in India since 2008 has been warehouse receipt financing, enabling farmers to avoid distress sales, because they can get about 70% of the value in cash and then the rest when they actually sell it at

the price they get when the sale happens. To ensure that the collateral (the produce stored in the warehouse) is adequately assessed, stored and not pilfered, reliable warehouse keepers and collateral managers are required. To build this whole eco-system, a Warehouse Regulatory and Development Authority (WRDA) Act, 2006 was enacted. Under the WRDA Act, warehouse receipts issued by regulated warehouses become a negotiable instrument. This is again an example of how financial innovation at a high conceptual level has been made a part of the rural financial system, after years of painstaking work by all the stakeholders including the government.

Till recently due to the enforcement of the Agricultural Produce Market Committees (APMC) Act, agricultural commodities could not even move out of sub-district mandis forget about across districts. The Central Government has recognised that the old APMC Act, which was an appropriate legislation for the period when it was enacted, needs to be liberalised and has adopted a new model APMC Act and recommended this to all the states. Along with the “one nation, one market, one tax” GST regime, coupled with national mobile connectivity, much improved road and rail connectivity, we think the dream of integrating the national agricultural commodity market will soon be possible. In 2016, the Small Farmers’ Agri-Business Consortium of the Government of India launched the e-NAM⁴ or the electronic “National Agricultural Market [which] is a pan-India electronic trading portal which networks the existing APMC mandis to create a unified national market for agricultural commodities.” At the same time, it permits bulk users like agro-processors to identify diverse and least expensive sources for their input.

The next level of price risk management requires active commodity trading in the spot as well as futures exchanges. India has established a number of commodity exchanges, both for futures and spot trading, using electronic screen based bidding and settlement platforms. The earlier separate commodity markets regulator, the Forward Market Commission, has been merged into the financial markets regulator, Securities Exchange Board of India (SEBI) and along with this the commodity market regulation is also being upgraded in line with international best practices. Recognising that for the orderly functioning of a futures market, we need more sophisticated derivatives such as options contracts, SEBI has approved options trading in commodities in May 2017. These are laudable advances, and these need to be coupled with forming many more, and strengthening the existing 3000 farmers’ producer organisations and enabling them to trade on these exchanges.

3 Underserved Population Segments

In all the noise about farmers not getting enough credit, other underserved segments of the rural population - women, youth, the elderly and the minorities, are forgotten. As per Census of India, 2011, 89 million women in rural India were main workers, 59 million were marginal workers and another 22 million were seeking or available for work. A lot more could be working if they had access to finance. Over 300 million of India’s rural youth are looking for work in this decade. The number of elderly, those above 60, was 104 million and rising at double the rate of the overall population. The percentage share of elderly in the population of India is 8.6 per cent in 2011.⁵ Finally, there were 244 million persons belonging to the minorities, of whom 172 million were Muslims. All these population segments have limited access to financial services.

⁴ <http://www.enam.gov.in/NAM/home/index.html>

⁵ Govt of India, Elderly in India:
http://mospi.nic.in/sites/default/files/publication_reports/ElderlyinIndia_2016.pdf

3.1 Women: For All the Effort, Loans to Women Were < 1% of Net Bank Credit

Coming to women who comprise half of the population, we find they have not been adequately served by the rural financial sector. The women's savings and credit self-help group (SHG) movement is about to celebrate its 35th anniversary, dating from 1992, when the Reserve Bank of India approved a pilot project to link a few hundred SHGs formed by NGOs to banks for credit. Starting from a very small beginning, the movement has truly earned its name as by 31st March 2016, 1010 lakh families in 79.4 lakh SHGs had been linked with banks, that is, their SHGs had savings bank accounts, with Rs 13,691 crore of deposits; and 46.7 lakh SHGs had loans outstanding from banks worth Rs 51,429 crore.⁶ This is the world's single largest financial inclusion program. But we must remember that for all the effort, SHG loans were 0.65% of Net Bank Credit as on 31st March 2016. Even if add the money that flowed to women through the microfinance institutions, most of whose credit goes to urban areas, the number is barely 1% of the Net Bank Credit.

Of course we should build on the very good work done over the last 35 years in the SHG and the micro finance movement in providing the composite household credit, but we will have to increase the range of products and services as well as deepen the outreach. We acknowledge the fact The Pradhan Mantri Jan Dhan Yojana (PMJDY) has helped achieve a quantum leap in access to bank accounts for all low income households. We need to establish a target that not just every household but every woman must have her own bank account and along with that will come the RuPay card and the ability to receive remittances from family members in cities and payments from the government, directly into these accounts. Account holders can then withdraw cash from business correspondent outlets or have mobile wallets and so on. In addition, women need access to insurance, particularly for health and this is increasingly being facilitated by the government paid Rashtriya Swasthya Bima Yojana for those below poverty line and to others for up to Rs 50,000 per year through insurance companies for a premium of Rs 7-800 per annum. Accident and life insurance are being offered through the PM Surakhsha Bima Yojana and Jeevan Jyoti Bima Yojana. The issue now is to enhance outreach and ensure claim settlement in time and fully.

3.2 Youth: Unless We Invest in Their Future, There Will be No Future for Us

Youth are the largest segment of population and the number of young people in the age group 16-30 is over 300 million. They need financial services and they need it now – for education, skill training and self-employment. As we know, the organized sector has got only 7% of the total employment. The non-farm unorganized sector accounts for another 33%. Rest is agriculture in which the youth anyway do not want work. So the employment in the rural non-farm sector, largely located in small towns, and into urban self-employment sector has to be massively enhanced.

At today's costs, it takes about Rs 25,000 to Rs 50,000 to give proper skill education to a young person and another Rs 150,000 to 200,000 to get her or her started off as a self-employed person with the capital going into equipment and working capital of the enterprise. Given that at least half of the young persons will be self-employed, the total capital requirement for skill building and self-employment of 15 crore youth is Rs 30 lakh crore, or Rs 3 lakh crore per year in 2016 Rupees, over ten years. This figure needs to be compared to total net bank credit of Rs 79 lakh crore in March 2016. Thus, it is conceivable that the required level of skill building and self-employment can indeed be financed using banks loans, over a period of five years.

⁶ NABARD, Status of Microfinance in India 2015-16 <http://www.nabard.org>

It is obvious that banks, even public sector banks, will not offer this kind of credit for skill building and self-employment unless they see a profitable business opportunity in it. This requires three things – (a) the process of originating, appraising, disbursing and collecting the repayments on these loans, (b) there should be incentives for prompt repayment and serious consequences of wilful default and (c) the interest rates on such loans should be good enough to yield a good net interest margin to banks. Of these pre-conditions, the first is more or less in place with what the Chief Economic Advisor, Arvind Subramaniam called JAM (Jan Dhan bank accounts, Aadhaar identity cards and Mobile connectivity, all linked to each other digitally). Add to this the existence of credit bureaus which can indicate the credit status of each borrower, again through a low cost, high speed digital process. Thus transaction costs of such loans can be brought down far below today's microfinance loans. The next two conditions, however, require a political consensus among all the parties that repayment norm must be enforced and small loans be given at viable interest rates. Though these run contrary to the demands of electoral politics, as India's democracy matures and voters realise that freebies have costs which they are paying through taxes and inflation, we are hopeful that this kind of political consensus will emerge. Till then, we must keep asking for it.

But, like in the case of women, the products being offered to youth need to be diversified. In particular, savings for accumulating home loan equity, and for pensions should become widely available. Similarly, having health insurance should be the norm rather than an exception. The author has been arguing for several years that we are in the golden era for installing lifelong universal health insurance and universal pensions. The premium payment for health insurance should begin very early in life. A young person who is between the age of 17 and 30, and who is self-employed, must be encouraged to enrol in a health insurance program as well as a pension scheme. India needs to establish a universal, lifelong, contributory health insurance program, using the experience from RSBY. If we do it today it would cost us a fraction of what it would cost for the same level of coverage than if we do it 15 years from now because the demographics are going to worsen and the monetary costs are going to increase. Likewise, self-employed youth must be encouraged to get enrolled in a pension program. A beginning has been made with the Atal Pension Yojana, in which the government contributes a matching amount up to a limit. This needs to be scaled up.

3.3 Elderly: Ensuring Their Dignity through Financial Planning

Finally, let us come to the elderly, defined as those 60 years or above in age. As the population growth rate of India declines, this segment of the population will not only increase in numbers but also in proportion. Already in the 2001-2011 decade, while the population of the elderly grew from 76.6 million to 103.8 million, a rise of 27.2 million. Notably, while the overall population rose by 17.7%, the elderly population grew at exactly double that rate at 35.5%.⁷ Along with the other demographic trend, increase in life expectancy, the number of older people is going to increase dramatically. "By mid-century, 2050, India's 60 and older population is expected to encompass 323 million people, a number greater than the total U.S. population in 2012."⁸ Given the tendency of the younger people in rural India wanting to migrate to urban areas, the rural share of the elderly is likely to be higher than the projected 19% overall share of the elderly in the population in 2050.

⁷ Govt of India, Elderly in India:

http://mospi.nic.in/sites/default/files/publication_reports/ElderlyinIndia_2016.pdf

⁸ Paolo Scomeggna, 2012. India's Aging Population, Population Reference Bureau.

<http://www.prb.org/Publications/Reports/2012/india-older-population.aspx>

Though India has made a lot of progress in old age income security, with 117.1 million persons covered by various schemes, the coverage was inequitable, as 115 million of those covered were workers in the organised sector (85.5 million covered by the Employees' Provident Fund Organisation), government and defence services. Only 2.1 million were covered in the informal sector through micro-pensions.⁹ A universal pension scheme, which provides a minimum level of security, can be built if we extend the concept of contributory provident fund to the informal sector.

3.4 Minorities Inclusion Requires Special Financial Products, not Just Targets

As per the Reserve Bank of India, the extent of priority sector lending (40% of net bank credit) which went to minorities was about 16% of the total.¹⁰ This should be compared to the percentage 20.2% for minorities in the total population. Further, the Sachar Committee (2005) had estimated that Muslims who account for 14.2%, numbering 172 million in 2011, got only about half of the total credit that goes to minorities, so about 8% of priority sector lending, or 3.3 % of net bank credit, the rest going to Christians, Sikhs, Parsis, etc. The impact of shortage of credit in holding back economic development among Muslims can be seen in the terms of the higher degree of youth unemployment among them. The Muslim community has certain self-imposed reasons for financial inclusion as well as their faith does not permit the taking or giving of money on interest. One way to overcome this is to this for the RBI should permit Islamic interest-free products like (trusted agency) Murabaha, micro-equity (Musharka), leasing (Ijara), forward purchase (bai-salam), etc. to enhance access to finance for the Muslims. In the absence of these, the better-off Muslims save in the form of cash, gold and real estate, which are not productive assets nor benefit the majority of poorer Muslims.

4 Unresolved False Dichotomies

"A dichotomy is a set of two mutually exclusive, jointly exhaustive alternatives. Dichotomies are typically expressed with the words "either" and "or", like this: "Either they are with us or they are against us." A false dichotomy is a dichotomy that is not jointly exhaustive (there are other alternatives), or that is not mutually exclusive (the alternatives overlap), or that is possibly neither." In the statement, "Either they are with us or they are against us", there is no recognition that there could be a third category – those who are neutral, neither for nor against either side.¹¹

We list below three false dichotomies that have held back progress in the Indian rural financial sector and remain unresolved. We explain in each case why the dichotomy is false and what the consequence is of being stuck with it. We also suggest means to resolve each false dichotomy.

4.1 Innovation versus Regulation

Necessity is said to be the mother of invention. That is why the financial sector has been full of constant innovation, more so in the informal and the rural part of the financial sector where necessity is the highest. Yet, as the informal becomes larger and gets formalised, it tends to get regulated. While the stated intent of regulation is laudable – protecting consumers, particularly

⁹ Sanyal, A. and Charan Singh, 2013. Universal Pension Scheme in India: Working Paper no 420. Indian Institute of Management, Bangalore. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2310453

¹⁰ <https://data.gov.in/catalog/bank-wise-lending-minorities-under-priority-sector-lending>

¹¹ <http://wiki.c2.com/?FalseDichotomy>

small depositors and investors and minimising systemic risk. But in practice, financial regulation can be very conservative and stifle any deviation from laid down rules. While credit, savings and pensions are available as products, these are being sold as stand-alone offers, without taking a life cycle approach. Not only that they are being sold as stand-alone offers but the regulatory systems are different to the point where pension fund regulatory authority is different from the insurance regulatory authority of India even though they deal with long term financial issue.

Credit and savings are both under the RBI but the RBI, the IRDA and the PFRDA are three different regulators behaving like silos, even though from the point of the individual user, the financial needs are composite and integrated. The regulations, in contrast, impose restrictions on service providers to be exclusive to the service they are regulating. For example, if a company offers life insurance they cannot normally offer non-life insurance and even if they offer both non-life and life insurance, they cannot sell pensions. For mutual funds, there has to be a different channel for which there are different qualifications, etc. So the whole point of composite services, leave alone the life cycle approach, is missing. Thus, while necessity is the mother of invention, regulation can, often unintentionally, become the mother-in-law!

The reason why this dichotomy is false, to meet the policy objectives of extending financial services to the entire population, a whole lot of innovation will be required, indeed encouraged, if the unmet needs of rural finance are to be addressed. We should also recognise that innovation rarely comes from the government, even less from the regulator, because of their (valid) concerns of ensuring user protection and avoiding systemic risk. So, the private sector, both the profit-oriented one as well as the service-oriented one should be encouraged to innovate. Thus the best regulation is one which is agnostic of or neutral to innovations as long as they have a small footprint and pose no systemic risk. This will lead to many innovations, often mutually competing, and when they start gaining traction and attracting volume, that is when the regulator can step in, study them comparatively and then establish the most appropriate regulatory framework.

Indeed, an outstanding example of this is microfinance – where both the models of reaching the poor, one through women’s self-help groups and the other through microfinance institutions, were innovated by private sector players, the first by NGOs like MYRADA and PRADAN and the latter by companies like BASIX and SKS. The RBI resorted to fairly light-handed and supportive regulation of micro-finance, even facilitating its growth by encouraging banks to lend to SHGs through their rural branches since 1996, and treating bank lending to microfinance institutions (MFIs) as part of banks’ priority sector lending obligation, since 2000. This led to a dramatic increase in bank credit to SHGs and MFIs in 20 years. Surely, there were periodic concerns due to over-lending caused by the more ambitious players, but the RBI formulated a detailed set of guidelines for MFIs in 2012, covering a wide range of steps to ensure consumer protection. An eco-system was built, including self-regulatory organisations and lenders’ forums, while existing credit bureaus, rating agencies and supervisory bodies were asked to extend their scope to cover MFIs. The result: by March 2017, the Indian microfinance sector Rs one lakh crore of loans outstanding, over 100 times that in 1997.

4.2 Inclusion versus Education

A second false dichotomy is one between financial inclusion and financial literacy, or more broadly financial education. The conservatives assert that financial education must be imparted before financial services are extended to the masses, so that they can take informed decisions about savings, credit, insurance etc. The large number of low-income persons, and even others, who have lost money by trusting untrustworthy deposit takers, is well known. Likewise, microcredit has regularly seen the emergence of hot spots, where competing MFIs have lent more money to poor

households than their capacity to use productively, thereby making them over-indebted and eventually defaulters. There is a significant extent of mis-selling in insurance. Thus the view that financial education must precede the extending of financial services to the masses seems justifiable. But the other side of the story is that education without user experience falls flat as it is not understood. So financial service provision and education need to be integrated at each step.

The way to overcome this false dichotomy is to see that the two steps are sequential and iterative. Some degree of financial education can be imparted before extending a service to a first-time user, but then the users' experience of actually using the financial service – savings, credit, insurance - should become the basis for further financial education. Given the fact the Jan-Dhan Yojana alone brought in over 200 million new banking services users, these can become a base for ongoing, step by step financial education. With the ubiquity of mobile phones, financial education snippets can be sent by SMS to users' mobile phones, in various regional languages. Of course, with increasing number of younger users switching to "smart phones", even video content can be streamed to them.

In this regard, the early efforts by the RBI and several Indian banks and MFIs are laudable. The RBI drew up a National Strategy for Financial Education in 2012. In addition, we should also take advantage of the demographics and the fact that nearly 300 million children will be finishing at least middle school by 2020. Let us educate this generation in financial matters. One way to do so would be integrate school arithmetic with financial education. An example of this was the BASIX "Rupaya Paisa" series books for class 6 to 8 students, published by Pratham Books in 12 regional languages.

4.3 Affordability versus Sustainability

The third false dichotomy is the deepest and has persisted the longest and caused untold damage to the users on one side and the financial services providers on the other. Unfortunately we translated the term Welfare State literally into the 'Mai Baap' mentality and there was a widespread view that if financial services have to be extended to the poor these must be made affordable, by lowering interest rates, etc. We need to educate our political leaders and the policy makers that the nothing comes for free and their endless attempts at subsidising or controlling interest rates and insurance premiums, just distorts the market and leads to less and less availability. Loan waivers and insurance claim indemnification, both paid by the government, lead the users into a world of false comfort temporarily and they are then cut-off from access to credit or insurance for many years after that.

The worst example of this was in Andhra Pradesh in 2010, where the state government enacted a law to regulate MFIs (which were already being regulate by the RBI). In the process, one of the largest loan defaults was triggered, in which 65 lakh borrowers did not repay MFIs their outstanding loans to extent of Rs 7200 crore. This caused a huge setback first to the MFIs and banks (who were the main source of funds to MFIs), but thereafter to the poor themselves. As a study by Sane and Thomas (2015) showed, die to the stoppage of microfinance in AP, the monthly per capita expenditure of the poor came down by 19%, of which the two main items were food, the expenditure on which came down by 17% and children's education, the expenditure on which came down by 43%. In 2016, six years later, moneylenders remain the main source of credit in AP.

5 Conclusion

In this paper we have drawn attention to the issues pertaining to the future of India's rural finance, while staying dear of the issues that have been discussed obsessively in the past – mainly provision of credit to farmers at ever lower interest rates. We argue that unless we get out of this rut, we will

not only be losing an opportunity to craft a superior rural financial system to serve future needs, but further that if do not do so, both society and the state will face severe problems. These problems will emanate from the demographic realities of India – with over 600 million women not having access to even small amount of credit for economic activities; over 300 million young people to be educated, skilled and employed; and over 100 million elderly already among us. In addition, over 172 million Muslims suffer from severe financial exclusion, partly due to their own views. We have demonstrated that these same demographic numbers offer a great opportunity, to build a new range of financial services, going well beyond crop credit to non-farm enterprise credit, adding savings, insurance and pensions.

For farmers, we have recommended long term loans for diversifying beyond crop cultivation to horticulture, floriculture, dairy, poultry, fishery, etc. as well as new generation of crop and livestock insurance to mitigate risk. For restoring the productivity of land, water and forests, we have recommended investment finance through Grameen Vikas Bonds issued by Panchayats and/or Zilla Parishads. To mitigate the financial impact of adverse events like droughts and floods, we have recommended new generation crop insurance and for larger catastrophic events, the use of cat bonds. To obviate price risk, we have recommended greater use of warehouse receipt finance and electronic spot exchanges like e-NAM and nationwide movement of commodities. For price hedging of agricultural commodities, we have recommended the aggregation of small farmers into producer companies, enabling them to use futures and options, which have been recently permitted by SEBI

We have argued that the new set of services cannot be offered under the old mind set where the government was the mai-baap and everything was subsidised, in the name of affordability by the poor. Instead, we must espouse the principle of self-help, encouraging people at all levels of income to save, in the short-term to create the ability to borrow from banks for starting up micro-enterprises, in the medium term to create the equity for getting home loans, and in the long-term to create a corpus for their retirement so they can get pensions. They must also begin to pay for insurance of their lives and health, with those with very low incomes getting state or cross subsidy.

There are now scores of examples, covering millions of persons, where these principles are being practiced. One outstanding example is the Self-Employed Women's Association (SEWA) where the members own a banks, in which they save and from where they get credit as they need, for their livelihood activities and lifecycle events. There is also a contributory health insurance coverage through Vimo SEWA and micro-pensions are also available. Though SEWA began in Ahmedabad, now a majority of its members are rural self-employed workers, including in agriculture.

To usher in the desired future rural financial system for India, political leaders will have to give up populist tactics like fomenting loan waivers and seeking interest rate cuts in the name of the poor; the government will have to shift its stance from being the provider to the facilitator and encourage private service provider, both the profit-seeking ones as well those who are either member-owned such as cooperatives banks and mutuals for insurance ; the regulators – the RBI, IRDAI, PFRDA and SEBI, will have to become more willing to permit financial innovation; and the users themselves will have to move from a subsidy and freebie dependent mentality to engaging in self-help and becoming paying consumers. Only then can we ensure *sarve bhavantu sukhina*.