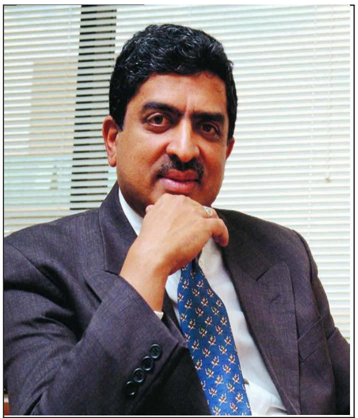
Building a Foundation for Financial Inclusion – the Aadhaar in India



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If countries tend towards a dominating philosophy for every decade, we can say that the emphasis in India during the nineties was growth, the emphasis since the 2000s has been on 'inclusion'. As India approaches a deep demographic dividend – which will expand our working population to 800 million by 2020 – our development efforts have focused on bringing these hundreds of millions into our formal economy and our institutions, and ensuring they have access to the opportunities from growth.

The informal economy however, has been a long established part of Indian life, and this particularly holds true in our financial markets. With less than 60% of the population having access to bank accounts, Indians across the country, particularly the poor, have depended on community schemes, grain banks, moneylenders and other informal mechanisms to access finance and make investments. These mechanisms have often been inefficient, and dominated by low returns; at their worst, they have been exploitative of their customers. Over the years, our banks and capital markets have attempted to expand into India's poorer communities, with limited success.

For the poor who have remained cut off from these formal mechanisms of finance, the promise of the unique identification number (Aadhaar) is a significant one. The number can play a powerful role in enabling a variety of applications that make our financial institutions more accessible, bring millions more into their fold.

Expanding the circle of inclusion

When India's financial and capital markets are discussed, it is usually in glowing terms. Our financial sector is stable, with high rates of savings, and withstood the 2009 recession remarkably well. Our stock markets continue to be a magnet for FII flows. Our young demographic profile also makes India a long-term investment, a country where high growth rates can potentially be sustained well into the next decade. We also implemented hard-won institutional reforms through the 1990s – the establishment of the NSE and modernization of the BSE, the setting up of the NSDL and the advent of T+1 and T+2 settlement cycles in our bond and equity markets – that won us stability and transparency in our capital markets, and benchmarked them to the best in the world.

From a domestic perspective, India has all the ingredients for a vibrant, stable market in place. However, one factor that limits the promise of our banking and capital markets are the low levels of participation from across the country. When we examine the pool of our domestic investors and bank account holders, it's clear that despite recent reforms, these markets remain exclusive bastions. Nearly half of India's population has not set foot in a bank, and lack a bank account; the bulk of these households keep their money in their homes. 90% of transactions in our stock markets come from just ten cities across the country. And it is a tiny proportion – less than 5% of households – who buy insurance policies or put their savings in stock or small savings instruments.

Such a small pool of investors and bank accounts in a large country contributes to the volatility of our markets – equity markets in India for example, remain substantially dependent on foreign capital, which tends to be more short-term and speculative compared to domestic investments. The health of our financial markets, as well as of our domestic firms, depends on having a deep formal banking system, and a large pool of domestic investors who think long-term and are highly invested in India's growth.

Democratizing finance in India

During field visits to villages across the country, the UIDAI team has had multiple conversations with villagers on how they save and invest their money. To many of the poor in villages, a bank account and investing in bonds and small savings instruments struck them as highly impractical, considering the distance of financial institutions from their homes. 'Why would I want to take a bus and go into town every time I need cash?' a village resident in Anantpur asked. There is thus a well-reasoned impulse behind what seems to be the worst possible savings decision – keeping money under the mattress. People would like their cash to be easily accessible, especially during an emergency, not an inconvenient distance away.

This lack of access similarly compels the poor to invest their money in physical assets such as gold, land, houses and livestock. Within poor and rural communities, these assets can easily exchange hands and be used as payments, or collateral for loans. These tradeoffs however, come at the cost of security and higher returns on their savings.

Besides the problem of distance, millions of poor across India cannot access bank accounts and financial services because they lack the proof of identity (PoI) and proof of address (PoA) documentation banks require as per their Know Your Customer (KYC) norms.

Aadhaar can enable technology infrastructure and applications within the financial sector that effectively address these problems in access. Technology has already played a significant role in making our banking and capital markets more accessible. The use of ATMs, core banking and mobile banking have brought 24/7 banking across urban India.

In our capital markets, the introduction of electronic securities and dematerialization, electronic fund transfers (EFTs) and workflow automation helped expand access to capital markets to ordinary investors. Prior to electronic trading, transaction costs on trades – taking into account broker fees, paper work and courier costs – was as high as 5%. An added problem was the lack of transparency. The investor had little way of finding out the exact price at which the trader sold their shares, and whether the profit/loss that the trader reported was the right amount. Electronic trading brought down transaction costs and allowed investors to trade without depending on middlemen. It has also enabled investors who trade in small amounts to participate in these markets.

An Aadhaar-enabled solution

We can view the unique identification number as a tool that would further advance the role of these technologies in democratizing our financial markets.

Over the last few months, an Aadhaar-enabled micropayments solution has been under discussion with the Indian Banks' Association (IBA), RBI, and the Finance Ministry. This proposed solution would employ the unique number as well as the Business Correspondents model, to bring financial access to villages and slums across the country.

The Aadhaar-enabled micropayments solution would ensure banking access in two ways. First, it would make Aadhaar sufficient to fulfill the KYC requirements of banks. Once the Aadhaar is considered sufficient for a bank's KYC, individuals would be able to open a bank account quite easily by providing their Aadhaar to the bank and confirming the associated demographic and biometric information.

Secondly, the micropayments solution would enable customers to make financial transactions remotely, through a local business correspondent (BC), who may be a self-help group or kirana store in the village. The BC would make these transactions through a MicroATM device, which connects to the bank. Real-time Aadhaar-linked authentication would ensure the security of the remote transaction – a person withdrawing or depositing money through the BC would first confirm their Aadhaar-linked biometrics to the bank through a biometric reader.

Individuals as a result, would no longer have to travel several kilometers to reach the nearest bank, and would be able to access their money through the BC whenever they need it. Aadhaar would also be an important way for banks to address financial literacy. Faced with account slips and bank statements, the poor often shy away from formal finance and turn to the simplicity of cash savings, community groups and moneylenders. The ability for the poor to withdraw money using their biometrics substantially lowers literacy barriers for the poor in placing their savings in a bank.

The Aadhaar-enabled micropayments solution would thus give customers the convenience that has long been associated with ATMs in cities – a service that would allow them to access their accounts and savings from any BC, anywhere in the country. The universality of the Aadhaar would also allow banks to easily verify the identity of customers wherever they are – particularly useful for customers from poor communities, who tend to be mobile and migrate often.

The solution has other advantages for banks. Till date, banks have balked at providing services for the very poor. Poor customers often prefer to make multiple low-value withdrawals and deposits, which increases operational costs for banks. The cost of Aadhaar-enabled electronic transactions would in comparison, be quite low, making the inclusion of such customers quite profitable for banks.

The micropayments solution is a gateway for the poor across the country to make more formal investments. Once this solution is in place across villages, selected insurance, equity and savings instruments could be made available through BCs, and would be as accessible to people as local, traditional investments of land and gold.

New possibilities for the poor

In the last two decades, India's retail and telecom sectors have tapped into new services and solutions by catering to poor customers. India's retail sector now sees the majority of its sales coming from the sale of 'single-serve' products, or micro-goods – sachets of shampoo and detergent priced anywhere from Rs. 2 to Rs. 10. Telecom companies in India similarly have over 90% of their customers on low-value prepaid connections.

Aadhaar unlocks the possibilities of such a low-cost approach for the financial sector. Once different regulators – SEBI, IRDA, PFRDA, RBI – accept the Aadhaar as sufficient KYC, stock exchanges, insurance providers, banks etc. could partner with the BC to deliver a variety of clearly regulated, low-cost offerings to the poor. One instrument with potentially significant appeal for Indian households for example, would be the Gold Exchange Traded Fund, which is designed to provide returns that track those of physical gold. The appeal of such an investment, as opposed to the traditional approach of buying jewelry for households is the easy liquidity of the ETF, as well as the security it affords – no one can break into the safe and make off with the family jewels. In rural India, it also eliminates concerns about purity, since the ETF invests in standard gold bullion.

Micro-insurance and micro-pension schemes are additional, possible Aadhaar-enabled offerings that could be expanded to households across India. Today, poor households mainly depend on community-based schemes such as chit funds in times of crisis and need, which pool resources to help each other out. These approaches however, often exclude marginal and backward groups, limiting their inclusiveness. These schemes are also constrained by the net assets that the community has, and fall apart in times of crisis that affect the entire community, such as floods, droughts and crop failure, or when one member has particularly high costs, say from a prolonged sickness.

The Aadhaar-based micropayments solution would enable institutions to offer tailored micro-insurance schemes. One such example would be index-based micro-insurance for rural communities, where insurance payouts are linked to an index such as rainfall, and payments begin once the index falls below a set threshold. Such a scheme has the advantage of being transparent and having clear payouts; it would also enable an immediate response to natural disasters. The solution would also enable both governments as well as private service providers to offer specific investment instruments for different groups – micro-schemes for child education, maternal health insurance, micro-pension schemes for the working poor, and so on.

For decades, India has focused on making financial access a reality for its poor. The RBI has consistently promoted policies to expand banks into rural areas and make the business correspondents model a more participatory one. SEBI has similarly worked to make our capital markets more accessible to the small investor. The Aadhaar is a powerful means of supporting these efforts. It would give the poor greater opportunities to expand their savings, plan investments and take risks in employment and entrepreneurship.

For India, the broader implications of this are significant. A strong economy is an inclusive one – financial inclusion would bring in large amounts of heretofore untapped savings into the formal sector, and would create new opportunities for growth, innovation and enterprise. Electronic transactions would also bring massive new efficiencies into rural markets.

Combined with our existing tools, Aadhaar would thus help us chart a program for action, and build solutions towards a genuinely accessible financial sector – one that provides choice and opportunity, increases the incomes of the poor and is truly empowering for the individual in India.