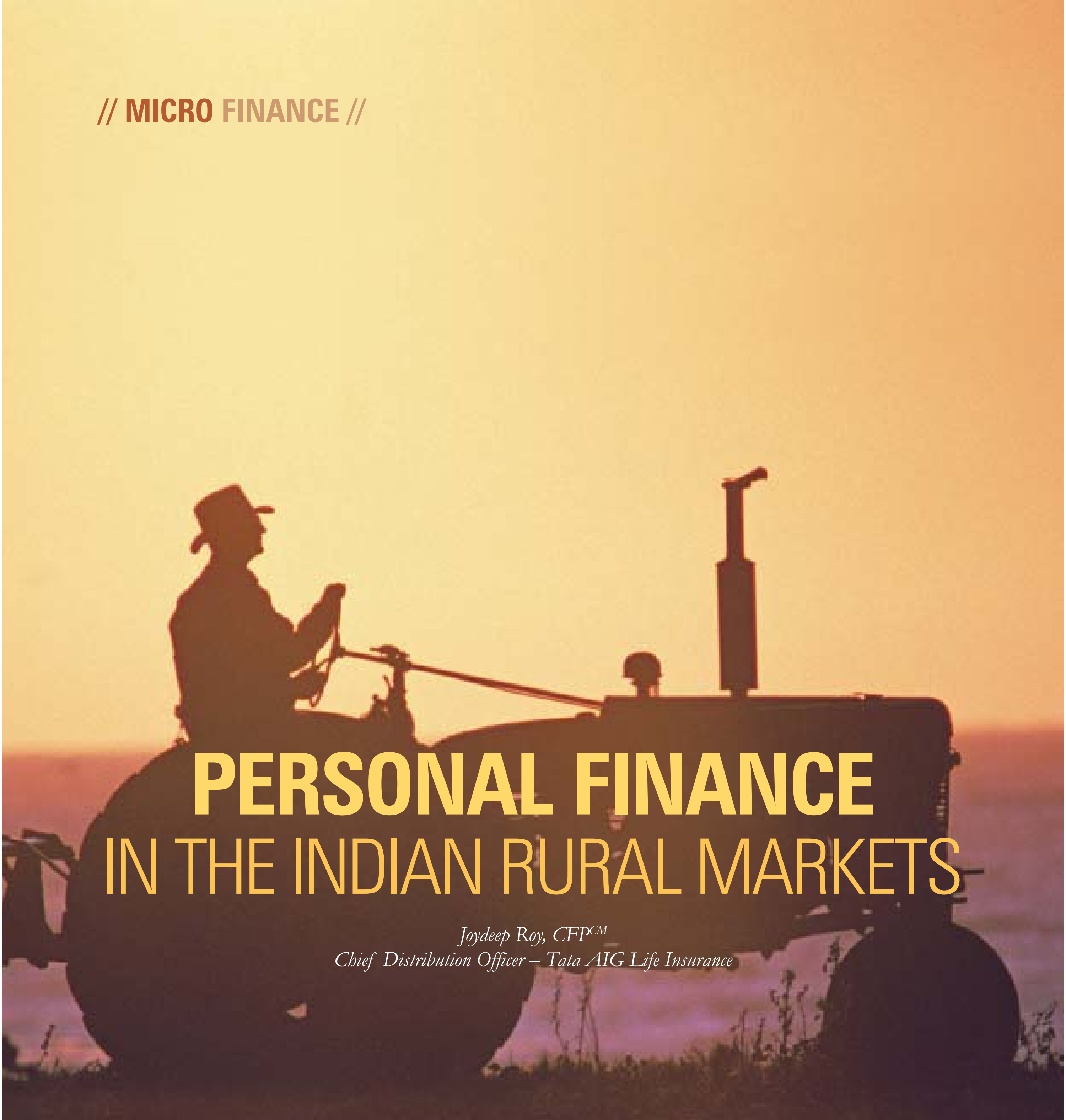

PERSONAL FINANCE IN THE INDIAN RURAL MARKETS

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The topic above has very little definitive examples of models that work effectively across geographies, economies and political systems. The reason is perhaps a cumulative effect of several basic parameters, that add to the complexity of issues that one needs to be cognizant of, before development and economic issues can even be understood leave alone addressed.

Deeper and wider penetration of organized financial services in Rural India is a far away dream if one were to consider that as of 1997 a study by PWC indicated that the dependence of low income houses (most representative segment of Rural India) on unorganized and informal sources of finance was as high as 78 % . It can be argued that things must have changed since but there would certainly still be a long way to go.

This write up is an attempt to present the some social facets of rural markets which could have a bearing on Rural Finance activity. Here the idea is to explore the value addition of rural finance to all stakeholders. The stakeholders could imply financial businesses that see the rural markets as opportunities, the non financial business (Agri commodities

, FMCG , consumer durables ,pump sets , tractors etc) that supply goods and services to the rural populace and depend on the financial infrastructure to generate shareholder value , and governments/political parties who are constantly seeking policy /fiscal / quota measures that promise development of the rural population at large (which has proved quite significant in retention of political power) .

Finance is not all credit

It is said that India's organized banking is perhaps in the top five globally. But the credit off take from scheduled banks in Rural India is stated to be below 20 % of the total credit sourced. A study of 30 million unorganized units in 1998 forming part of the economic survey revealed that less than 2.5 % sourced their credit from formal financial intermediaries (through their commercial lending programs). (As per Agricultural and Rural Development working paper 9 of the World Bank).

Much of the low credit off take figures can be explained by the risk averse processes of the commercial lending programs. Even if institutions were to lend very aggressively the quantum of lending and interest rates charged would depend on the perception of credit risk. Hence it should also be true as a corollary that there is a lack of penetration of effective risk mitigation strategies at the borrower level. Needless to say implementation of such strategies would result in formal financial institutions to be better disposed to lend and also lend at lower rates of interest which would then have an amplifying effect on the whole issue of credit off take.

There is also considerable interest in the government about ineffective tapping into the 29 % *savings rate* in the economy. While the rural savings rate may be lower than urban yet what remains unexplained is the limited ability of organized financial intermediaries to convert bulk of this rural wealth into productive use for nation building. While most families at the lower and lower middle signets of the socio economic strata do possess the characteristics of constant indebtedness it is also known that savings also takes place parallely. Every household has sporadic instances of need for unplanned / planned big expenditure and people save towards such an eventuality. One could argue that on account of risk averseness and liquidity concerns savings often are kept in physical form such as gold even with the poorest.

Rural Savings especially in the remotest locations get directed to different informal institutions like chit funds etc and are often not leveraged for access to more or better terms of credit. The main reason for this is that informal intermediaries are able to deal with the problem of informational asymmetries more efficiently since they have closer day to day link with the rural community. On the other hand formal intermediaries per force rely of documented mechanisms with little personal knowledge of their clientele.

The essence of the above is that Finance in Rural Markets needs to be looked upon more holistically by formal institutions as a combination of credit, short and long term savings, insurance. They need to leverage the relationship between these different elements as a part of a financial package. This is possible only if the inherent complementarity's between these individual needs is recognized which then can be get translated into a cost advantage that should ideally be shared by the customer, intermediaries and the aggregator service providers.

The schematic represents the impact of the financial package on the quantum of exposure and interest rates that would be applicable *(Refer Figure 1)*.

It would be interesting to look at the distinguishing features of Rural India and how these parameters could impact credit, savings and insurance. An attempt will be made here to partially focus on social parameters and some illustrations of tactics that could be used to for the penetration of financial services in rural markets:

Characteristics of Rural Markets:

Heterogeneity of Rural markets in the context of Lower Dispersal of Income :

The large dispersion in incomes in urban areas with a few high net worth individuals thrown in provides the possibility of product diversification and market segmentation which may be difficult in rural markets.

One of the prominent differences in rural and urban markets would perhaps be the depth of the middle class. Rural markets tend to be dominated by the lower and lower middle socio economic segments (in developing countries like India 75% or more of the rural population) and population density in rural areas being low there is not enough of upper income population in a limited geography. In contrast the urban markets tend to be dominated by a strong middle class with good numbers of upper middle and the lower classes as well because of the higher population density.

Financial services like long term savings and long term insurance products require provision of long term services

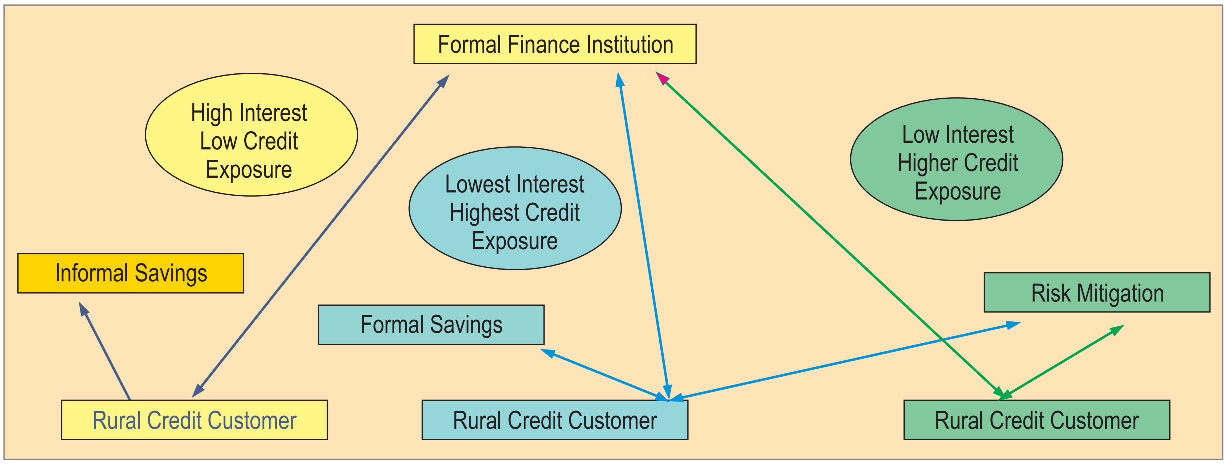

Figure 1

and in order that per customer costs are kept down it would be advisable for companies operating in rural areas to have large customer base in a given geography. Using a hub (brick and mortar) and spoke (mobile offices and technology) this cost can be further lowered.

Most long term financial services in rural areas become inefficient due to niche market approach which is alright for urban markets where a growing and large number of customers can be enrolled from the upper segments without incurring any infrastructure related costs. Adopting the same approach with rural markets finds very few customers and servicing them over a long term is not cost effective. This results in poor services, large customer drop out, poor word of mouth publicity leading to declining customer growth and overall an inefficient operation for the financial service provider.

Particularly in products such as long term insurance and savings (SIP's) where demonstration effects are important it is worthwhile exploring pockets *of customer intensity* strategy.

Education And Awareness

This is probably the most crucial aspect of rural markets when it comes to an evolved service such as finance. The rural landscape is plagued with very little education and awareness which makes understanding of the value proposition financial products that much more difficult.

Services in general do better in educated markets. To start with earnings and disposable income is better with a more educated society. In addition communicating the value proposition of a service through media becomes a possibility. Effective channels of distribution are easier to find without incurring too many costs in an educated marketplace. So a willing customer, low cost distribution and promotion are all possible. Case in example is in Kerala — an educated marketplace where most formal financial services are well penetrated despite the low population and Gujarat – high awareness market from where investment in capital markets is very forthcoming.

In the absence of education and awareness it is advisable for the organized financial sector to allocate and consciously invest towards creating awareness. Credit (a demand side product for all practical purposes) may have little difficulty in comprehension and so it's hardly surprising that we find that almost all organized financial institutions / Microfinance institutions focus on one aspect of rural finance i.e. credit.

But the challenge is to create financial awareness of risks versus returns and this is where the interventions are intense and results positive in the long term.

In the absence of an educated and aware market a quick fix approach of following the group route is always an attraction. There is a tendency to form a group of customers and address their needs through an intermediary who has some opinion leader/obligatory advantage i.e. NGO's, Cooperatives, Federations etc. There is no doubt that this approach is successful in making a quick low cost entry for the service provider organizations but it needs to be realized that in rural markets individuals and their needs are as diverse just as it is in urban markets . The best approach will therefore need to focus at community level individuals and institutions which can on one hand communicate the needs of the market to the formal service providers as well as be engaged in the delivery and servicing of innovative products that service

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providers can sustainably provide based on the communication of the needs.

Financial markets are based on exchange of information. Therefore, creating financial awareness in rural areas and enabling the formal sector to understand and provide for the financial needs of rural markets is akin to creating financial infrastructure. And in a country as diverse as India with so many languages, cultures, varied human development indices, this activity can vary both in time and cost as well as effort in different regions.

An example of the above in terms of statistics is that in 2001 the average literacy in the country was 65 % but there were several states like Jharkand, Bihar , Arunachal , Uttar Pradesh and Jammu and Kashmir where the average levels of literacy were lower than 55 %. If one factors in the gender factor it is clear why empowerment of SHG women through NABARD 's SHG – Bank linkage program has worked substantially differently in the southern states of Andhra ,Karnataka and Tamil Nadu .

Creating financial awareness, that is disseminating general/ specific awareness on financial products… has the characteristic of a public good. It typically suffers from the problem of market failure on account of which no single player (financial intermediary) has an incentive to invest as they may not be able to fully capture its benefits. It is on account of this problem that most financial intermediaries prefer to operate in markets that have reached a higher level of maturity in terms of information dissemination. Such situations are typically characterized by under investment by market players. *Therefore, in all….fairness …. to the organized sector it would be appropriate to have this part of the activity that relates to building human capital funded separately(vide public private partnerships) till critical mass of such capital is developed as only then can the services be remotely viable in the long term to formal institutions who provide them.*

Occupation and Income Sources

It's a conception that the only occupation in rural India is agriculture and that the only income that is earned comes from farm agriculture products. What is true however is that the scope of agriculture has undergone some change over the last decade. Non farm agricultural income has become an important facet of rural India and so are services such as teaching and medical , value added agriculture related activity like processing and packaging , trading , infrastructure building / construction and allied development works etc. The non-agriculture base of rural occupation and an income have been growing in the rural GDP figures are believed to be close to 40 %. This percentage does not include trading, teaching medical, infra, construction etc which are currently not captured in rural/urban terms so in reality we may find that the non farm agriculture and services today account for a larger than half share of the rural GDP.

Even agriculture is moving in many places to more productive methods, contract farming, biotechnology adoption etc. There is also a rising trend globally towards non food based agriculture which would help rural India to contribute to afforestation, biofuel and carbon credits — a development that was not imaginable a few years ago.

In the farm based agricultural credit market there are pilots in weather based risk management products combined with a small savings element that serves to integrate all the elements of financial package to the farmer. This is indeed an interesting intervention although the outlays for this product as a percentage of the credit are currently very small (order of 6-8 %). A global reinsurance pool restricts risk exposure for the insurance providers as well. This combined with a credit life insurance product if scaled across geographies can be expected to build enough volumes to make up for the low ticket size of individual outlays.

This presents a huge opportunity for innovative demand side (credit) financial services to the rural economy. Currently the big challenge for financial institutions is to design rural savings products that cater to seasonal and unpredictable inflows of money . However personal cash flows are getting more predictable with increased services share in the rural economy. This will create opportunities for wider and deeper penetration of long term savings and investment products from the supply side.

Relevance and Affordability of Products

To take advantage of the ripple down rural effects of the impressive overall GDP growth and the developments listed above financial service providers need to be able to introduce relevant and affordable products and distribute and service them efficiently. Coupled with the reach of technology and the more recent phenomenon of mobile phone communication interesting financial services can be introduced with lowered transaction costs to create win win situations.

The success of FMCG companies in the 90's was driven by product innovation in the form of sachets and single serve packaging. The offering allowed an entirely new segment of

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rural customers to experience the benefits of the product which would otherwise have been prohibitive because of the price. Coupled with education on the health and hygiene features associated with several personal product classes this opened up a big market and today a substantial portion of the FMCG volumes get accounted by sachets and single serves.

Single serves and mass marketing has a distinct advantage when it comes to products that need to be demonstrated. Financial products such as insurance need evidence of claims being settled to make them more credible. The demonstration effect is the best form of promotion in such situations. There is no rocket science in understanding that the probability of the insurance company receiving and settling a claim increases with the number of people being covered i.e. mass market strategy. In this instance it's also a win for the insurance company itself as the law of large numbers suggests that the actual claims experience moves closer to the predicted claims when the numbers are large enough.

Most formal financial service providers are unable to offer sachet type products for the lower end of the rural markets mainly because of their inability to price these products competitively .In an era where data storage and data management costs do not linearly increase with scale it could be appropriate to look at marginal costing of some low ticket size financial product offerings to the rural markets. It is also argued by many that formal financial institutions tend to get inefficient with size and then they focus on niche segments adopting the CRM strategy rather than the mass market methods that would seem more appropriate for rural markets.

The growth of Micro credit institutions and their portfolio in the past few years vindicates the proposition that sachet financial products are viable. Though Micro credit is a demand side product and yet much of the learning's on low cost delivery and services can find good application in other financial services.

The Role and Nature of Intermediaries

Supply side Financial Services as a rule are more sold than bought as the value proposition would need to be explained. When one is looking at engaging the rural markets this statement is truer than ever. As we have seen above the existing channels of distribution fall short in terms of reach and depth of coverage and hence it would be important to explore more effective ones.

While the nature and role of intermediation needs to be viewed in conjunction with the heterogeneity factors being addressed and the complexity of the product itself we need to recognize the need for looking at distribution differently to enable different things happen.

Creation of livelihoods can be the most single important deliverable as well as a by product of rural financial services. Financial services profitability is all about management of anti selection and moral hazard and nothing else can contribute more to it than periodic information gathered through grass root customer contact.

Since the earnings to the intermediary will normally be a percentage of the total money flow there is need to look at a situation where not enough income may be generated at the distribution end to qualify the role to be that of a primary livelihood earner. This is the challenge in delivery of supply side (savings and Insurance) products to the lower and lower socio economic segments. In terms of percentages we could still be incurring a distribution margin of 15 % but in value terms it would translate to an amount of Rs 500 per month that would be insufficient to be considered as a primary livelihood earning. This is where one could be better working backwards and look at people for whom Rs 500 /month is meaningful income.

With approach as above a new class of livelihood can be created i.e supplementary livelihoods. Rural women who are part of self help groups could be enrolled into distribution and they would work efficiently for Rs 500 per month which can at best be construed as a supplementary livelihood. If distribution capacities can be built around this concept then depth and width of distribution can be enhanced in a low cost manner and unserved markets can be addressed by formal institutions. Day to day Management of such a huge feet on street force could then be done by local NGO's /Rural Organizations /Women federations.

Such an approach to distribution serves many needs :

- Opening up of a huge potential market for low value and high volume products.
- Access to formal financial services for unserved segments.
- Grassroots supplementary livelihood creation – a developmental goal in rural areas.
- Women empowerment – a development goal.

Over time this grassroot channel could acquire skills to distribute more profitable and higher ticket products but that requires a different strategy and inputs to fructify.

Rural Credit Needs

Though difficult to generalize as credit needs are better analyzed at the family/community level there are a few patterns of borrowing across the rural spectrum

- Productive applications: Working capital for farming activity, mechanization needs, trading, non farm activity etc.
  - Usually there is less of a problem here for big farmers as land and assets can be used as collateral. Also better education in this class ensures that there is stability of cash flow as some family members pursue urban careers.
  - Small and marginal farmers (and those that lease out small pieces of land for their use) are most effected here. This is a fairly big segment and could form almost 40 % of the rural population. This is most vulnerable to monsoon and weather risks. Non collateralized credit is expensive /limited and often only from informal sources. When land is not owned savings are used up for paying lease and agri inputs need to be financed through credit.
  - Trading: Trading incomes are dependent on the health of the local economy and so weather / monsoon does play a role here. However credit is available from formal sources since most trading establishments are based at district and taluk level towns.
  - Petty trading establishments (owned by individual SHG women) like vegetable shops , grocery stores ,saree shops , utensils shop etc have recently come up with MFI's and bank linkage programs of SHG's.
  - Non farm agriculture: (Poultry ,fisheries , sheep rearing) Working capital as credit is available as owners tend to be big land owners, urban based but natural disasters, epidemics could change risks perceptions and hence credit rates and amounts may not remain static.
  - Livestock: Cattle rearing as an activity gets most of the SHG and MFI credit in India. Between 40 % and 70 % of the loan portfolio for most MFI's is cattle loan.
- Lifecycle events : Lifecycle events such as births, deaths, education expenses, marriage expenses constitute a big reason for credit among all rural classes but predominantly among the rural lower and lower middle who find themselves with very little saving to fund such large expenditure.
- Health and illness related: This cost head is turning out to be the largest component of unplanned expenditure in rural areas and although this item of expenditure seeks credit funding in all classes. Sometimes we find that the higher classes are covered by individual medical insurance. The lower and middle class invariably need to borrow against this.
- Credit for repayment: Especially among the lower and lower middle social strata access to different credit institutions (mostly informal) are deemed important very crucial from a borrowers viewpoint. A substantial portion of the credit that is sourced goes into overdue and due repayments of earlier credit. In fact it would be interesting to find out the exact percentage of MFI / SHG on lending that is used for credit rotation.

Finance institutions that provide credit need to have information about what exactly they are lending for and accordingly should be able to change interest rates to cover different patterns of cash flow that is facilitated by the lending. Informal institutions do just that and cover their moral hazards accordingly.

There are other social factors which do have their impacts but a detailed study of the same is beyond the scope of this text. There are no sure shot solutions but surely a holistic rural finance program only can have benefits for all stakeholders. The regulatory environment for banking and insurance mandates deliverables in rural and social sector penetration but what will make financial *inclusion of the rural poor* a reality is the intent of organizations that will show leadership in turning rural financial services into a sizable sustainable business opportunity for themselves. It has been done in FMCG earlier and quite recently in the cell phone services in India. Some imperatives for financial services as observed in some of the endeavors are:

- Top management commitment ,
- Special in-house front end teams with commitment to rural development,
- Livelihood based grassroot level capacity building
- Leveraging existing social sector relationships for mutual benefit,
- Effective Communication to channels and market.
- Integration with mainstream activity at some stage
- Relevant and affordable products/services
- Technology for reducing costs, front/back end process adaptation.
- Recognize unique characteristics – cash economy, doorstep delivery, frequent collection etc…

Primarily formal organizations need to evolve their own strategies to provide services in their competency sphere. The government /rating agencies could play a role in shaping the information interplay between the organizations so that the rural economy benefits from organized financial services.

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