

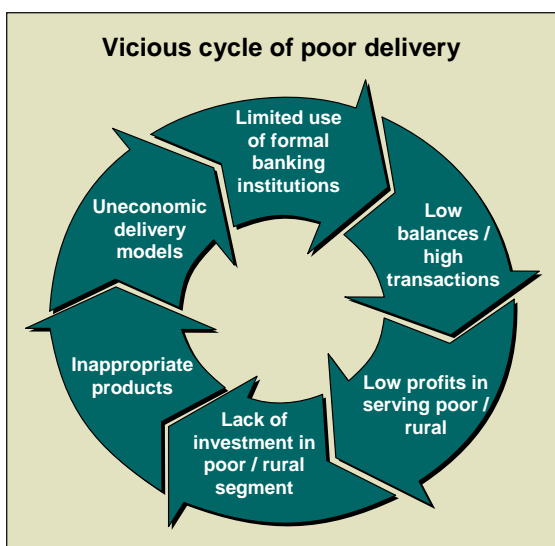
has been dominated by household saving in physical assets'. The poor use in-kind investments (especially gold), loans to relatives and reciprocal gifts. However, when appropriate institutions are available, the poor use formal bank accounts. The 6% of poor and marginal farmers who have active deposit accounts maintain average balances of Rs4,000. Average deposits per person at Basix (a micro-finance bank) is Rs5,000. 'Chit' and informal savings schemes have seen enormous growth. This, plus experience in other countries, indicates an increasing number of the poor in India will use formal savings in the future. Given the opportunity and the right products, there is likely to be a whole-scale move away from informal savings to formal institutions.

3. The need to understand the business fundamentals of the market

The business fundamentals of the deposit market have not been taken into account in the design of previous programs to mobilise deposits, leading the programs to fail. This now needs addressing.

Banking to the poor is different to banking to the middle class. The poor have different needs and use banking products differently, requiring different products and marketing messages. Transactions are smaller and customers more spread-out, requiring a different delivery model and infrastructure. However, a traditional banking model has been employed in the past – which has proven unprofitable. This has led to a vicious cycle of pessimism about the market attractiveness amongst India's bankers – low profitability leads to disinterest which leads to inappropriate delivery models and low profitability.

National Programmes and causes of failure	
<ul style="list-style-type: none"> Expansion of branch network to rural areas 	<ul style="list-style-type: none"> Branches are not an appropriate delivery model – too high cost Unprofitable
<ul style="list-style-type: none"> Ceilings and floors on interest rates 	<ul style="list-style-type: none"> Market does not respond – no demand elasticity
<ul style="list-style-type: none"> Nationalisation of banks / requirement to serve the rural & poor 	<ul style="list-style-type: none"> Many nationalised banks have not been profitable Others have not focused on serving the poor



The notable exception is 'micro-finance' – which employs delivery channels more suitable for large numbers of low-value transactions and which focuses on the immediate needs of the poor. Micro-finance, however, has not successfully addressed deposits – partly due to regulatory barriers, and partially due to a misplaced belief that the poor cannot save.

A starting point for breaking this vicious cycle is to improve understanding of customer needs. This is best addressed by identifying and evaluating the 'sources of value' of deposit accounts. Some sources of value are readily appreciated by the poor - for example surveys indicate the poor value banks' physical security. Appreciation of other sources of value, such as lower costs, ability to make partial withdrawals, etc. will build with increasing experience.

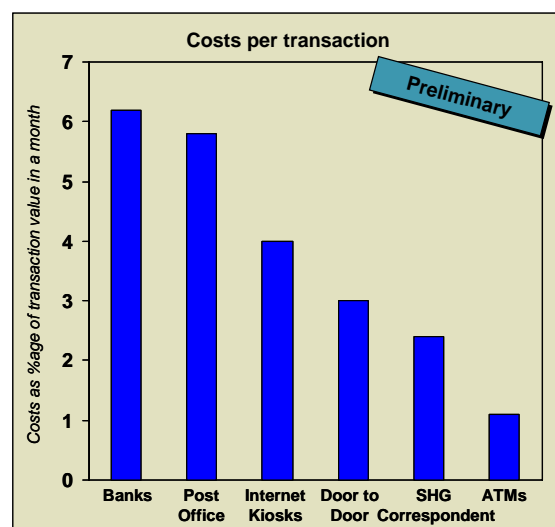
Understanding of the sources of value allows a financial services provider to design better products and determine willingness to pay for different types of services. Broadly, there is a sequential development of sources of value – from physical security at the minimum to receiving interest payments. However, the relative importance of different sources of value

Increasing financial maturity / income level				
Safe storage of irregular income	Protection from unexpected events	Motivation to save for investment	Ability to make payments over long distance	Capital accumulation
<ul style="list-style-type: none"> • Seasonal farmers • Women • Urban poor 	<ul style="list-style-type: none"> • Older • With dependents • Few safety-nets 	<ul style="list-style-type: none"> • SMEs • Home-builders 	<ul style="list-style-type: none"> • Traders • Users of utilities 	<ul style="list-style-type: none"> • Richer people

will vary by segment. For example, a seasonal farmer will be attracted by physical security of annual earnings and will want to make regular withdrawals. Understanding can be built through market research and by detailed investigation into each source of value.

The second major area that needs to be understood is the economics and implications of different delivery mechanisms. Branch based networks are unlikely to be successful due to their cost structure and the poor's disinclination to use branches. There are, however, a number of new technologies and opportunities becoming available – such as using ATMs adapted to rural needs, contracting out branch transactions to internet kiosks and retailers, employing 'mobile bankers' with direct access to clients and using self-help groups as intermediaries. These strategies have been rolled out successfully in other countries and have started to be deployed in India. There should be opportunities to scale up.

These new opportunities are clearly lower cost and have the capacity to transform banking in rural areas. But a number of questions need to be answered before these new delivery channels are deployed – for example what are the operational risk implications of placing ATMs in rural locations? would the use of SHGs be consistent with a bank's brand? would implementation of internet kiosks be complex so requires too much management time? Unless such issues are understood, banks run the risk of investing in strategies that do not promote take-up but lead to cost over-runs, leading to frustration and continued disinterest in the sector.



4. Deposits would create real benefits for the poor, for the national rate of capital mobilisation and for banks

There are three reasons why the deposits market should be developed. The first and most important reason is that it will bring significant benefits to the poor.

It is generally agreed that micro-loans have a significant impact upon the lives of the poor. Promoting deposit accounts could bring similar benefits. In India, 70% of micro-loans are for consumption purposes, the average loan size is Rs4,000. Micro-loans are often used for emergencies (such as health crises) or 'one-off' expenditures (such as weddings) – creating a bridge between income and expenditure profiles.

Money accumulated in a deposit account creates a similar bridge between irregular incomes and irregular expenditure. Moreover, since there is no risk premium, credit analysis, group formation to secure loan re-payment or bribe to secure the loan, the overall cost of using deposits is lower. For the poorest customers, an initial loan may be required to release a customer from a spiral of high interest rate debt. But once a customer is able to accumulate, it is more efficient to use deposits rather than repeat lending.

Cost of different financial instruments	
Customer gets unexpected medical bill of Rs4,000	
– Loan from local money lender - 10% / mo, for whole year	Rs 8,800
– Loan from RRB - 14% interest rate, and pays 20% bribe	Rs 5,360
– Loan from SHG . 28% interest rate, (Note: loan only available if deposit is made first)	Rs 4,800
– Uses savings	Rs 4,000

Strategies used by the poor	Issues
▶ Spend immediately	▶ Leads to inefficient purchases ▶ Cannot buy larger items
▶ Buy commodities (Gold, Grain, Land)	▶ Price fluctuations ▶ Traders margins ▶ Risk of loss ▶ Illiquid ▶ Lumpy
▶ Give gifts to relatives with expectation gift will be returned	▶ Uncertain return
▶ Invest in informal savings groups (ROSCAs, Chit schemes, etc.)	▶ Insecure ▶ Little control ▶ Unsuitable for larger savings ▶ Public
▶ Use traders as intermediaries for payments processes, or specialised services	▶ High-cost ▶ Difficult to determine total cost

Deposits create other benefits. Security concerns force the poor to spend money fast – leading to inefficient purchases. Access to deposits allows this money to be saved. It also allows the earner to retain control over the money – especially important for women.

Non-financial means of saving incur high transaction costs, which may not be initially understood. Commodity prices are unstable, margins are charged by traders, gifts may not be returned, etc. Bank accounts have lower transaction costs.

Banks bundle services with deposit accounts to provide additional value. The most important is payment services – allowing transactions to be completed over distance without face to face contact. Access to payment services may, for example, allow farmers to cut out intermediary traders when selling their produce, allow employers to reduce pay-roll costs, or reduce the cost of receiving overseas remittances.

Deposit accounts are the normal banking 'entry product' since they are simple and low risk. Once the poor have experience and trust in the institutions, and once the institutions have experience of individual customers, graduation to lending, for investment purposes, is a simple step.

The second reason why the market should be developed is that it will increase the national domestic investment rate and hence national economic growth. As the IMF says, 'the Indian government has announced a target of 7 percent or more for annual GDP growth over the next 10 years. A key question is whether India will be able to finance the investment necessary to reach this target through increased domestic saving and avoid a much greater recourse to foreign saving with its associated risks.' The same paper concludes that reform of the banking sector to increase saving is required to fuel this growth rate.

The size of the market is considerable. Assuming 10% more rural households open bank accounts and 10% of rural households increase existing accounts from Rs2,000 to Rs5,000,

Rs100bn would be mobilised. If this market could be made profitable, it will provide an additional, stable source of income to the banking sector – the third reason why the market should be developed.

5. Examples of market development

The opportunities and challenges may be best illustrated by some practical examples.

Annual current accounts for marginal farmers

70% of marginal farmers and 45% of small farmers do not have bank accounts, despite having highly variable incomes. Typically, farmers match their income and expenditure profiles by taking out loans from traders, pre-selling their crops or buying in-kind savings. However, these strategies are high cost – absorbing much of the surplus the farmer generates.

If a farmer were able to deposit his income into an account, he could make withdrawals throughout the year and avoid high interest loans. The farmer would need to have regular access to his account. He may also need to have an overdraft facility, to tie him over until the harvest season.

To be successful in this market, a bank would need to design a product that met the farmer's income profile, understand the dynamics of the local agricultural sector to determine levels of risk on overdrafts and identify marketing messages that would overcome farmers' distrust of banks.

Existing informal financial relationships may, moreover, be linked to access to commodity markets and may take time to 'unravel'. For example, a local trader may buy the farmer's produce, sell him fertiliser and provide him loans. A bank may find that it needs to provide some of these services, perhaps in collaboration with a cooperative.

Long-terms savings account for women – replacement of use of gold

Women are reported to have a greater desire to save than men and may also have funds for an initial deposit, through a dowry. Typically, this is held as gold. Gold jewellery suffers, however, from being indivisible, so smaller short-term cash needs are often covered by pawning, with resultant interest payments and risk of loss of the collateral. Additionally, while gold prices have risen relatively consistently over the past few years, the price is not stable – prices fell 20% from mid May to mid June 2006. Additionally, gold is at risk of being stolen.

Long-term savings accounts may well be a better solution. However, convincing women to convert their savings from gold to a savings account will be difficult. 'Woman only' branding, perception of strong financial security, provision of 'replacement' jewellery and time to describe the financial benefits may make the sales process more effective. Market assessment is needed to develop the marketing plan and design the delivery model.

SHGs as an intermediary

There are an estimated 1 million self-help groups (SHGs) in India. Recent changes in legislation now allow these SHGs to act as agents to banks, collecting deposits and giving withdrawals. However, it is reported that SHGs are unwilling to link to banks, as they do not have the capabilities or incentive to work with the banks.

Technology could help. Simple IT systems, either hand-held or desk-top, could facilitate the collection process. It could also calculate fees for the SHG. Banks need to understand how SHGs work to design the IT system, and need to understand SHG customers to be sure the SHG will be trusted. Banks may consider a customer relationship sales force to sell to the SHGs.

6. Need for further research

The time is right for a business focused study of the deposit market. Demand is increasing, new technologies are coming available, regulation is changing. This study should look at both the customers (sources of value, needs, concerns) and the delivery mechanism (technology, institutions, capabilities, etc.). This study would show:

- Which products and segments are especially attractive?
- Which institutions which are likely to succeed and what are the capability development needs of these institutions (i.e. National banks, regional banks, SHGs, NGOs, etc.)?
- How can RRBs increase profitability?
- What are the requirements for further regulation reform?

