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Digital Technologies: Holy Grail in India's Quest for Financial Inclusion?

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SYNOPSIS

India struggled for decades with the challenge of financial inclusion – providing low-income households the opportunities of the formal financial sector. But it proved to be an uphill task. That was until digital technologies opened up exciting possibilities over the last ten years. This revolution has yet to run its course.

COMMENTARY

Walk anywhere in urban India and you cannot miss the sight of street corner vendors briskly plying their business. The purchase done, the customer points her smart phone at the QR code proudly displayed on the vendor's pushcart to make the payment. Almost instantaneously, UPI (Unified Payments Interface), India's unique innovation, takes over and ensures that money is transferred from the customer's bank account to the vendor's bank account. Meanwhile, somewhere in the backend, the data generated by the transaction helps keep track of the vendor's business prospects and the buyer's spending habits, potentially helping better assess their creditworthiness.

The Magic of the JAM Trinity

This is an astonishing achievement in a country that has for decades struggled with financial inclusion. The breakthrough is best captured by the JAM Trinity – three significant developments made possible by digital technologies.

J – the first letter in the acronym, stands for *Jan Dhan Yojna*, which is a no-frills bank account with a lighter KYC (know your customer) protocol and no minimum balance requirement. A no-frills account has been around for many years but there were no takers for it. Then in 2014, taking advantage of digital technologies that made one-to-many transfers cost effective, the Modi government announced that all government payments – subsidies, wages, pensions and scholarships – would only be credited to bank accounts. Millions of poor households rushed to open bank accounts.

The second component – A – is *Aadhaar* which is a unique twelve-digit identity number for every person in the country based on demographics and biometrics. In a low-income country where nearly half the people do not have a birth certificate, this has been an amazing feat – again made possible by digital technologies. In what is arguably the largest enumeration exercise in history, nearly 1.37 billion people now have an *Aadhaar* number.

M - the third component of the JAM Trinity is the mobile phone which has radically transformed the way we live and think – and of course the way we do banking. Ten years ago, the fear was that the cost of a handset would be a deal breaker. But handset prices have crashed, thanks to Chinese brands and India-made Chinese brands. And in India where phones are used more for content than for communication or browsing, internet charges are among the lowest in the world.

Each of the three components of the JAM Trinity is significant but it is their coming together that has created an extraordinary synergy in digital financial inclusion.

UPI – India's Pioneering Innovation

Digital payment systems like the UPI which facilitate almost instantaneous account-to-account transfers are now common across the world, but it is significant that it was pioneered in a low-banking penetration country like India.

The growth in UPI transactions has been explosive. Data from the Reserve Bank of India show that over the last six years, the volume of UPI transactions increased by over 300 percent while their total value increased by over 250 percent. This astounding growth was aided in part by the government's surprise "demonetisation" of high value currency in 2016 followed by the COVID-19 pandemic three years later, which made people wary of handling cash. Even so, much of this shift from cash to cashless has been permanent and in the process, it destroyed the myth that "cash is king".

India has been Unique

India's digital technology-driven financial inclusion has been unique in many ways. Most importantly, India provided the digital infrastructure – the India Stack – as a public good and made it accessible to commercial players such as banks, non-banks, telecoms, fintechs and bigtechs to build their businesses on that. This was in sharp contrast to many other developing countries which left it entirely to private players, notably telecoms, to build and operate systems. The Indian model ensured uniform standards and protocols and thereby interoperability across all payments systems right from the beginning which prevented the rise of monopolies and encouraged competition based on cost and convenience.

Another unique feature of India's digital financial inclusion has been the emphasis from the start on anti-money laundering safeguards. Except for small value payments, India insists that there should be a bank at either end of a transaction to ensure that a money trail exists to deter illegal activity. Non-bank firms such as telecom and technology companies wanting to enter the payments business have to either tie up with a bank or get licenced as a payment bank so that they are subject to the same stringent regulations as a bank.

India realised early on the importance of maintaining the integrity of the payments systems because any backslash no matter how caused – fraud, theft or system failure – can shake consumer faith, possibly irretrievably. Consumer protection policies have therefore been central to India's financial inclusion.

The Reserve Bank of India (RBI), the country's central bank, mandates that any firm, whatever be the line of business – telecom, e-commerce, private wallet – holding money on behalf of a customer put it in an escrow account with a bank. This is in sharp contrast, for example, to Ant or Tencent in China which do most front-end things that banks do without being held to consumer safety standards of banks. India has also set up a separate ombudsman for cyber related complaints. Importantly, the RBI runs an extensive public awareness campaign to educate people on how they can protect themselves against cybercrime.

Second Generation Innovations

India is now embarking on second generation innovations to make financial inclusion – yes, more inclusive. To ensure that people who cannot afford a smart phone are not left behind, a modified version of UPI – UPI123 – was launched earlier this year enabling people with only a feature phone to make payments by linking their bank accounts to their phone numbers and authenticating the transactions with the help of a PIN and an SMS message.

According to the World Bank, with over US$100 billion annually, India is the largest recipient of cross border remittances. Efforts are under way to connect India's payments system with that of the country at the other end. Notably, earlier this year, India's UPI has been made interoperable with Singapore's PayNow which will allow thousands of Indian migrants in Singapore a cheaper and safer way of sending money home to their families.

The Revolution is Not Yet Complete

It is important to note though that financial inclusion is more than just payments and remittances. What poor people want most of all is microcredit and micro insurance. Many households continue to be eschewed by the formal financial system just because they are not considered credit worthy.

RBI's recent initiative to allow establishment of account aggregators who can provide a potential lender the complete financial picture of an applicant within regulated safeguards should help repair this situation, but it is too early to assess its impact. Beyond account aggregators, big data and artificial intelligence should make it possible to analyse the digital footprint that people create to assess their creditworthiness even if they have had no prior credit record.

Success in digital financial inclusion is important for India to provide opportunities to its millions of low-income households to improve their livelihoods, and for the country as a whole to move up the middle-income trajectory with widely shared prosperity. It is also important to buttress its position as a rising global player by providing a software version of China's Belt and Road Initiative.

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