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Factors Challenging Expansion of Financial Services in Rural Market

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ABSTRACT: India is said to live in its villages, a valid statement, considering the fact that 68.84% of its population lives there (Census, 2011). However, a significant proportion of its 6,50,000 odd villages does not have a banking outlet to boast of, leaving swathes of the rural populace in financial exclusion. To a large extent, India's development hinges on this segment's economic growth; hence, it is imperative to bring the unbanked rural population within the ambit of formal financial system. As per RBI Annual Report 2013, there are 40,837 banking outlets in villages, which mean close to six lakh villages needs to be covered by banking outlets plus other channels like Business Correspondents (BCs), Ultra-small branches etc. In this paper, we propose to critically examine why formal financial service providers have not expanded their footprint in rural villages despite implementation of financial inclusion initiatives from the Central Bank in a mission mode. This study is based on secondary sources like published research articles, books and reports of the Reserve Bank of India and Government of India.

KEYWORDS: Rural banks, Financial Services and Constraints.

I. INTRODUCTION

An Overview

The rural financial services delivery model in India consists of organized financial services players, semi- formal organizations and informal service providers. The organized financial system consists of commercial banks, Regional Rural Banks (RRBs), co-operative banks, primary agricultural co-operative societies (PACS), post offices, insurance company outlets, Non-banking finance companies (NBFCs), and regulated microfinance institutions. Semi-formal institutions comprise of Self-help groups (SHGs), Non- government organizations (NGOs), unregulated MFIs. Informal providers consists of local landlords, money-lenders, local fertilizer or other input providers extending credit, besides friends and relatives.

Since independence, expanding the outreach of formal financial services to the rural population has been the thrust of poverty alleviation policy in India. The successive surveys of the National Sample Survey Organisation (NSSO) and All India Debt and Investment Surveys (AIDIS) present a steady rise in the importance of banks as a source of rural household credit since 1951-52. While there was a decline in the share of banks in debt of rural households between 1991-92 and 2002-03, it is expected that there will be a revival of this predominant share over the last decade considering the extensive policy efforts for financial inclusion by RBI and Government of India, in collaboration with NABARD (Khan, 2014).

RBI's approach to financial inclusion has been aimed at connecting people with the mainstream financial institutions. Goal of financial inclusion is better served through mainstream banking institutions as only they have the ability to offer the suite of products required to bring in meaningful financial inclusion (Chakrabarty, 2012). RBI had chosen the bank-led model for financial inclusion leveraging on technology. Other intermediaries and technology partners like mobile companies have been allowed to partner with banks in offering services collaboratively.

II. RESEARCH QUESTION:

1. Age Distribution

How does age influence the level of financial inclusion, including bank account ownership, usage of financial services, and perception of accessibility among rural populations?

2. Gender Distribution

What is the impact of gender on financial behavior and participation in formal financial systems, and does a gender disparity affect trust or access to financial services in rural areas?

3. Education Level

How does educational attainment affect financial literacy, awareness, and the use of various financial services (e.g., savings, loans, insurance) among rural residents?

4. Occupation

To what extent does occupational status (e.g., farmer, laborer, service employee) determine access to and usage of formal financial services in rural communities?

5. Monthly Household Income

How does the monthly household income of rural residents influence their financial behavior, bank account ownership, and ability to access or use diversified financial products?

6. Bank Account Ownership

What demographic or socio-economic factors influence whether individuals in rural areas own a bank account, and how does ownership correlate with financial inclusion levels?

7. Financial Services Usage

What are the patterns of financial service usage (savings, fixed deposits, loans, mobile banking, insurance) in rural populations, and how are these patterns influenced by demographic, income, and occupational factors?

8. Distance to the Nearest Bank/ATM

How does the physical distance to the nearest bank or ATM affect the frequency, type, and ease of financial service usage among rural residents?

9. Perceived Accessibility of Financial Services

What factors shape the perception of accessibility to financial services in rural areas, and how does this perception influence actual engagement with the financial system?

10. Challenges in Accessing Financial Services

What are the primary challenges faced by rural individuals in accessing financial services (e.g., lack of trust, awareness, documentation), and how do these barriers affect their inclusion in the formal financial system?

Objectives of the study**1. Age Distribution**

- To analyze the relationship between different age groups and financial inclusion levels.
- To identify which age group is most actively engaged in formal financial services.
- To evaluate how age influences financial behavior, adaptability to digital tools, and trust in financial institutions.

2. Gender Distribution

- To assess the influence of gender on financial access and usage patterns.
- To explore gender-based differences in financial literacy and trust levels.
- To identify barriers that disproportionately affect women in rural financial systems.

3. Education Level

- To examine how education level impacts understanding and usage of financial products.
- To measure the correlation between education and financial literacy.
- To suggest effective communication and training strategies based on educational profiles.

4. Occupation

- To classify financial behaviors based on occupational categories (e.g., farmer, laborer, business owner).
- To determine which occupational groups are most excluded from formal financial systems.
- To recommend targeted financial products for specific occupational segments.

5. Monthly Household Income

- To understand how income levels affect access to and usage of various financial services.
- To analyze the affordability and suitability of financial products for low-income groups.
- To propose income-sensitive financial literacy programs and inclusion strategies.

6. Bank Account Ownership

- To determine the demographic and socio-economic factors influencing bank account ownership.
- To evaluate how account ownership affects broader financial inclusion.
- To identify gaps in access and suggest ways to improve account penetration.

7. Financial Services Usage

- To investigate the types of financial services used by rural populations.
- To understand the barriers to adopting advanced financial services like insurance and mobile banking.
- To promote diversification in financial service usage through targeted interventions.

8. Distance to the Nearest Bank/ATM

- To evaluate how geographical distance affects access to and frequency of using financial services.
- To identify whether proximity correlates with higher financial inclusion.
- To recommend location-based outreach strategies such as mobile banking vans or digital kiosks.

9. Perceived Accessibility of Financial Services

- To assess the perception of service accessibility among rural respondents.
- To explore the disconnect (if any) between physical proximity and perceived ease of access.
- To identify structural and procedural reforms needed to enhance user-friendly service delivery.

10. Challenges in Accessing Financial Services

- To identify the key barriers (e.g., trust, language, documentation) affecting financial inclusion.
- To evaluate how these challenges vary across age, gender, income, and occupation.
- To propose policy and design solutions to reduce systemic barriers and promote inclusive access

Hypothesis and Correlation**1. Age Distribution**

Hypotheses:

- H_0 : Age does not significantly influence access to or use of financial services.
- H_1 : Age significantly influences access to or use of financial services.

Correlation Insight:

- Younger age groups (18–35) may show greater adaptability to digital banking and a higher frequency of usage.
- Older age groups (46+) may be less involved due to technological resistance or low awareness.

2. Gender Distribution

Hypotheses:

- H_0 : Gender has no significant effect on financial inclusion or service usage.
- H_1 : Gender significantly influences financial inclusion and service usage.

Correlation Insight:

- Male respondents may report higher financial product usage, while women may face trust or accessibility issues.
- Gender imbalances may correlate with cultural or economic constraints on women's financial decision-making.

3. Education Level

Hypotheses:

- H_0 : Education level has no impact on financial awareness or service utilization.
- H_1 : Education level significantly affects financial awareness and service utilization.

Correlation Insight:

- Higher education correlates positively with digital banking, mobile apps, and awareness of insurance or loan products.
- Respondents with no formal education may avoid financial services due to comprehension difficulties.

4. Occupation

Hypotheses:

- H_0 : Occupation does not influence access to or usage of financial services.
- H_1 : Occupation significantly influences access to and use of financial services.

Correlation Insight:

- Farmers and laborers may rely on informal savings or credit, showing lower financial inclusion.
- Service holders or business owners may use banking more for savings, loans, or investments.

5. Monthly Household Income

Hypotheses:

- H_0 : Income has no effect on financial behavior or inclusion.
- H_1 : Income significantly affects financial behavior and inclusion.

Correlation Insight:

- Higher-income households ($> ₹20,000$) may correlate with greater usage of fixed deposits, mobile banking, or insurance.
- Low-income groups ($< ₹10,000$) may prioritize cash use and basic savings over formal instruments.

6. Bank Account Ownership

Hypotheses:

- H_0 : Bank account ownership is not significantly related to income or occupation.
- H_1 : Bank account ownership is significantly related to income and/or occupation.

Correlation Insight:

- Formal workers or higher-income groups may show nearly universal account ownership.
- Farmers and laborers may show partial inclusion or shared family accounts.

7. Financial Services Usage

Hypotheses:

- H_0 : Type of financial service used is not affected by income, education, or access.
- H_1 : Type of financial service used is influenced by income, education, or access.

Correlation Insight:

- Savings accounts are common across most demographics.
- Usage of loans, insurance, and mobile banking is positively correlated with higher education and income.

8. Distance to Nearest Bank/ATM

Hypotheses:

- H_0 : Distance to bank/ATM does not significantly affect usage of financial services.
- H_1 : Distance significantly affects financial service usage.

Correlation Insight:

- Respondents living further than 5 km may show lower service usage, especially for non-basic services.
- Proximity positively correlates with convenience, leading to more frequent interactions.

9. Perceived Accessibility of Financial Services

Hypotheses:

- H_0 : Perceived accessibility is not influenced by distance or socio-economic background.
- H_1 : Perceived accessibility is significantly affected by distance and socio-economic background.

Correlation Insight:

- Even when banks are nearby, perception of poor service or unfriendly staff may correlate with negative accessibility feedback.
- Lower-educated or labor-intensive workers may report lower perceived accessibility.

10. Challenges in Accessing Financial Services

Hypotheses:

- H₀: Facing challenges (trust issues, documentation, fraud fear) has no significant impact on service usage.
- H₁: Facing such challenges significantly reduces financial service usage and trust.

Correlation Insight:

- Lack of trust correlates negatively with advanced service use (e.g., insurance, loans).
- Low awareness and language barriers are more common among older, less-educated respondents, reducing inclusion.

III. METHODOLOGY

1. Market Research and Segmentation:

- Conduct thorough research to understand the demographic, socio-economic, and cultural factors specific to rural areas.
- Segment the rural market based on factors such as income levels, literacy rates, access to technology, and existing financial behaviors.

2. Product Development and Adaptation:

- Develop financial products and services that cater to the needs of rural customers, such as microfinance loans, savings accounts with low minimum balances, and agricultural insurance.
- Adapt existing products to suit the preferences and requirements of rural customers, considering factors like language, accessibility, and simplicity.

3. Distribution Channel Expansion:

- Establish a robust distribution network that reaches deep into rural areas, including partnerships with local cooperatives, post offices, mobile banking agents, and community organizations.
- Invest in mobile banking and digital channels to overcome geographical barriers and provide convenient access to financial services.

4. Education and Awareness Programs:

- Implement financial literacy programs to educate rural communities about the importance of savings, investment, and financial planning.
- Conduct workshops, seminars, and community outreach events to raise awareness about available financial products and services.

5. Localized Marketing Strategies:

- Develop marketing campaigns that resonate with rural audiences, incorporating local languages, customs, and traditions.
- Utilize traditional marketing channels such as radio, print media, and community events, alongside digital marketing tactics tailored to rural audiences.

6. Building Trust and Credibility:

- Establish trust through transparent communication, fair pricing, and reliable customer service.

- Leverage word-of-mouth referrals and testimonials from satisfied customers to build credibility within rural communities.
- 7. Continuous Evaluation and Adaptation:
 - Monitor the effectiveness of marketing strategies and customer feedback regularly.
 - Adapt marketing tactics based on evolving needs, preferences, and market dynamics in rural areas.
- 8. Government and Community Partnerships:
 - Collaborate with local governments, NGOs, and community-based organizations to leverage existing infrastructure and resources.
 - Participate in government-led financial inclusion initiatives and subsidy programs aimed at rural populations.
- 9. Data Analytics and Technology Integration:
 - Utilize data analytics to gain insights into rural customer behavior and preferences, enabling personalized marketing strategies.
 - Leverage technology such as AI and machine learning to improve customer targeting, streamline processes, and enhance the overall customer experience.

IV. CONSTRAINTS OF BANKS

No significant headway by banks in furthering financial inclusion in rural India till now can be ascribed to following important reasons:

Majority of commercial banks are now listed on the stock exchange. Stock markets normally have a short-term focus. 'Profitability concern of banks may have discouraged business that create a "visibility gap". This means that the cost of providing these services is larger than the benefits from them, at least in the short run, because of initial high fixed costs. So banks may have tended to frown on financial inclusion or, at best, grudgingly consider these as social or holding costs.' Hence, banks, like most formal-for-profit institutions, are not willing to spend lot of time and resources to create a market because of high initial set-up cost, especially if they are to satisfy the immediate needs of their shareholders. It has been seen that historically large formal financial institutions prefer to move into markets that have already been built and nurtured by smaller companies or by informal sector players (Ananth and Oncu, 2013).

Transaction costs of rural lending in India are high, mainly due to small loan sizes, the high frequency of transactions, the large geographical spread, the heterogeneity of borrowers and wide-spread illiteracy (Basu, 2006). The nature of financial inclusion means that this component of the balance sheet (i.e., priority sector advances) is generally small as compared to the total portfolio of banks. In a capital-starved country such as India, where banks invariably have a long list of borrowers, credit to large number of the rural poor spread over vast areas seems less efficient and more costly than providing credit to a few large borrowers in concentrated areas.

Serving the rural poor is a high risk, high-cost proposition for banks (Basu, 2006). Providing financial services in rural areas is a challenge as agriculture and other rural economic activities have unique characteristics of dependence on natural resources, long production cycles and vulnerability to multiple risks (Khan, 2014). As the income streams of rural clientele are irregular and there is volatility in their expenditure patterns, there is a doubt in the mind of bankers about their repayment capacity. This problem is further compounded by the borrower's lack of collateral.

The rural poor invest substantial resources to build houses, often without titles or on land allotted by the government or even on encroached land. There is a constant tendency to invest a substantial part of their income in housing, land and related assets. A substantial portion of the investment in such housing and landed assets is by assuming debt. Similarly pledging these assets to raise liquidity for either unforeseen contingencies/health related shocks or for consumption needs is common. These property titles are not acceptable to banks. Banks normally refuse to accept these as mortgageable assets and refuse to fund these investments despite the existence of a liquid, dynamic market (both for mortgage

and sale) for such assets among the poor themselves (Ananth & Oncu, 2013). It is the refusal to accept these housing assets as acceptable collateral by banks, is also one of the reasons that forces the rural poor to approach other high-cost debt providers like MFIs and informal lenders.

Banks find that the recovery of overdue loans portfolio in rural areas is a problem unless institutional structures become more efficient. Government has not been able to develop and enforce a legal and regulatory framework conducive to rural finance, so that contract design, contract renegotiation, and contract enforcement remain weak, making it even more difficult for lenders to provide borrowers with the right incentives for repayment (Basu, 2006). What has compounded the problem for banks is the populist scheme of Agricultural Debt waivers announced by the government at various points of time. This has led to a culture where borrowers think that if they are regular in their repayment history that may not be able to avail the benefits of waiver in some point of time in future. This has also led to a psychology where no incentive is attached in the mind of customer for having a good repayment history with banks rather there is a greed factor attached to not clearing dues.

“Formal banking sector has a remarkable lack of specialized knowledge on the needs of the rural poor and the success of the informal providers has been mainly because of their familiarity with local communities.”

RBI's credit planning policy, whereby each rural branch is assigned a set of defined villages (typically 15 to 20 villages) within which it can operate, known as “Service Area Approach”, has restricted competition in rural banking. Bank branches are not in a position to optimize branch infrastructure, and the entry of new non-service area bank branches, including private sector bank branches, in the service area is impeded since this requires a “no-objection certificate” from the service area branch, which is often not easily forthcoming (Basu, 2006).

Further, if a region has a small economic base, banking services may not be offered due to the lack of economies of scale on the side of banks. Operational costs may be a consideration when banks need to decide whether or not to serve remote or sparsely populated areas (Claessens and Perotti, 2007; Andrianaivo and Kpodar, 2011).

Another constraint faced by banks is the reluctance on the part of bank staff for accepting rural posting. Often this resistance comes due to non-availability of good schools, decent health care facilities, no social life in rural areas, besides distance from home town of concerned official.

Lack of branches may also be influenced by security problems, like where there is inadequate safety of life and property (areas with inaccessible communication and domination of extremist elements), which constraint bank expansion to remote areas.

V. CONSTRAINTS OF RURAL CLIENTS

The first major constraint is the lack of necessary documentation for opening an account with a formal institution. Lot of rural people do not have either a valid identity document or an address proof for being able to open an account with a bank, popularly known as ‘Know Your Customer’(KYC) documents. Even where documents are available, they are misplaced due to no safe place available for keeping these documents. The process of obtaining a duplicate document is a cumbersome process, where the applicant has to visit the concerned government office number of times wasting a number of working mandays.

Where KYC documents are available, the rural clients face another major hurdle in filling up the Account Opening Form. Although all bank branches should have “May I Help You” counters to facilitate customer transactions, in majority of rural branches lot of other services are also attached to this counter (due to lesser number of staff members, keeping in mind low business volume). Another formality that needs to be complied with for opening an account is furnishing three photographs plus photocopies of KYC documents, which rural customers find difficult to comply with. Higher processing time for loans, together with bribes, could result in higher effective cost to borrowers and consequent credit rationing. It takes, on average, 33 weeks for a loan to be approved by a commercial bank (Basu, 2006).

Absence of flexible products and services is another major bottleneck faced by rural population. As mentioned earlier, small rural borrowers have irregular/volatile income sources and expenditure needs, and therefore prefer to borrow frequently and repay in small installments. Although General Purpose Credit Cards (GCCs) and Kissan Credit Cards (KCCs) were introduced to meet this latent need of rural customers, penetration of these products has not been spectacular and lot of rural banks/branches do not offer products to suit the needs of their clients. Also, while small rural borrowers seek savings and lending products, they also seek insurance (life, accident, health, crop), which banks do not generally offer.

Transaction Cost is another major hurdle in the path of effective financial inclusion in rural India. In part, high transaction cost stems from distance to the nearest financial institution. According to the Rural Finance Access Survey (RFAS), 2003, the median distance to the nearest financial institution ranges from two kilometers (post office branches) to five kilometers (commercial banks, co-operative banks). Procedures for opening an account or seeking a loan are cumbersome and costly (with high rejection rates). The practice of obtaining "No Dues Certificate" from every other lender in the service area to the effect that they do not have a loan outstanding is a time-consuming and cumbersome procedure.

Another factor that makes banks less attractive for rural borrowers is that banks demand collateral security, which poor rural borrowers lack. Indeed, the majority of loans extended by commercial banks, RRBs and co-operatives are collateralized, with 89% of households who borrowed from RRBs and 87% of households who borrowed from commercial banks, reporting that they had to provide collateral (RFAS 2003). Land remains the predominant form of collateral. Here the weak and vulnerable sections of the community consisting of landless labourers, migrant communities, oral lessees, women are excluded from credit from formal financial institutions due to this insistence on collateral. It may be noted that although collateral security is insisted by formal financial institutions, this collateral is seldom executed, thus making this as another cost, with little benefit in practice.

For rural clients, poor quality of customer service, extremely long waiting time to make financial transactions, and inadequate information about the financial services offered are some other irritants in dealing with formal financial institutions.

VI. CONCLUSION

Financial inclusion is a buzzword nowadays not only in India, but in the entire world. Given the dominance of banks, bank-led model for financial inclusion has been adopted by the Government of India as well as the Central Bank of the country, besides tapping the synergies embedded in non-bank financial players. Keeping in view the resources and time constraint in opening brick-and-mortar structure, banks have been encouraged to use Business Correspondents (BCs)/Business Facilitators (BFs) to further their financial inclusion efforts in remote rural locations. Certain restrictions of earlier days like not using the services of for-profit NBFCs and BC location to be within 30 kms of the base branch has been removed recently by RBI. Launch of 'The Pradhan Mantri Jan-Dhan Yojana' on August 28, 2014 is a significant effort by the Government to extend financial inclusion to each & every household. What is heartening to note is that both the government and the central bank of the country remain committed to create a conducive environment for providing a hassle free environment of financial inclusion to the poor without jeopardizing the financial stability. In this changed environment, introduction of innovative delivery channels like micro finance institutions, NBFCs to work in collaboration with other large regulated financial institutions like Banks, Insurance Companies, Pension Funds and Asset Management Companies holds a lot of hope for a better financially included rural India. Further, licenses issued by the Reserve Bank of India for Small Finance Banks & Payments Bank is another important step for deepening financial inclusion in the country besides providing the customer a wide choice in selecting appropriate delivery channel for financial services.

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