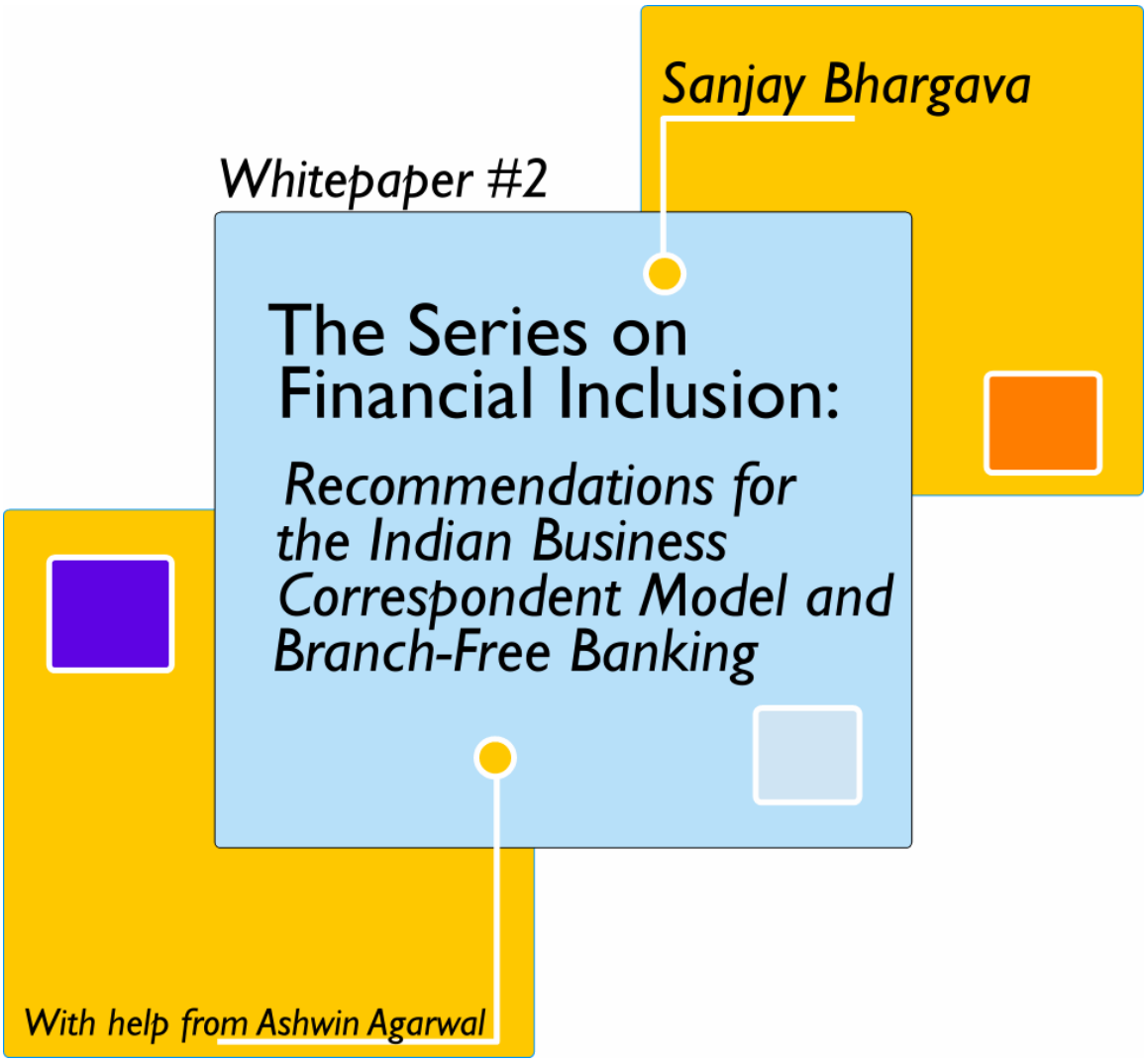

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The **Business Correspondent** model allows non-financial service providers to provide financial services (savings accounts, money transfer etc.) on a small scale basis (maximum limits imposed). The money is still held at a financial institution, however is serviced by the BC.

The Business Correspondent (BC) model coupled with "Branch-Free Banking" can become a major enabler of financial inclusion in India and enable "Universal Financial Access" just as the telecom revolution in India has made "universal mobile access" close to becoming a reality. To make a financial revolution possible we need to make more and more transactions electronic (because the cost of an electronic transaction at scale is close to zero) and reduce the cost of a cash transaction to Rs 2-3. We also need to operate in a paper-less and card-less environment and leverage existing infrastructure while raising a large deposit pool to meet the credit needs of the unbanked.

The Paper suggests that 300000 crores of deposits can be mobilized for priority sector lending (See section: Deposit Mobilization later in the paper).

Business correspondents are vital to making the dream of Universal Financial Access a reality. This paper gives concrete suggestions on how to make this happen. Foundations that fund BC's, regulators of the BCs and anyone else that is interested in achieving sustainable financial inclusion should find the paper useful and provocative. The author welcomes comments and believes that we have no answers as of yet. The purpose of these papers is not to propose the final answer but take a step towards finding one.

The main points that the paper makes are:

- The cost of financial exclusion is very high and could potentially cause a mass revolt. Regulators and the government need to actively support innovation.

- Risks of using the BC model can be controlled relatively easily. We do not need to reinvent the wheel and can learn from the prepaid telephone model.

- BC's should not be limited to serving just the rural poor. To make them economically viable and sustainable they should serve the rich and the poor globally. This paper shows that the revenues BC's can earn are substantial if they think big. If BCs think small then an economically exciting model is not possible.

- BC's should be large non profit entities that strive to attract top quality talent. They should be well managed to provide distribution, financial literacy, customer service and demand aggregation to multiple service providers (Banks, MFIs, and other non financial institutions).

- Just as competing airlines share airports, service providers should share BC's. By serving multiple service providers, customer segments and

geographical regions, BC's can lower costs.

- BC's should receive soft loans and not grants to get started. They must repay the loans with interest as they scale. Later they should cut cost as they achieve scale and finally if they still have a surplus, they should build a corpus and support entrepreneurs who create jobs with soft loans.

- A level playing field should be provided for all innovators and any attempts to cut cost through the sharing of infrastructure and limiting of capital expenditure should be actively encouraged.

Innovation and Regulation

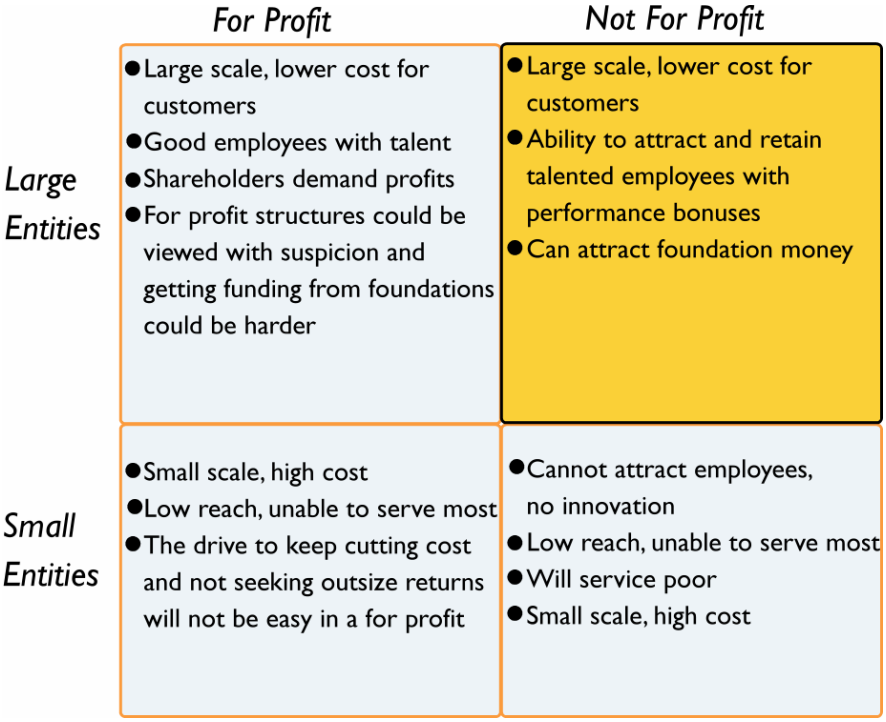
The Indian financial services industry has offered many schemes that have not adequately protected consumer deposits. Additionally, some Indian banks may view the BC model as a potential source of competition and worry that the flexibility of the model could hurt their business. Money laundering and financing of terrorism are another area of concern.

Ultimately, it is important that regulators consider the cost of financial exclusion and weigh it against the possible fraud they are protecting against. In many cases such an analysis will reveal that opening up the system to innovation will far outweigh the risks involved. At the end of this whitepaper, interested regulators will find specific suggestions to make the BC model a powerful force for change. By trusting innovators and banks to do the right thing, regulation can increase possibilities and decrease failures. Indeed, the micromanagement of laws to address specific issues is rarely successful.

Much of this paper draws conclusions from the successes of telecom and we have seen telecom successfully move towards universal access with negative use of public money. Financial services regulators should see if universal financial access can be significantly increased in a similar manner.

The Optimal Structure for BCs

When constructing a BC there are two crucial factors to consider: the profit structure and size. Both factors are important because of the way current regulation is structured. Among the most influential of BC restrictions is that they must operate as non-profits. In addition there are structured rules that keep the reach of BCs small. As such, the current BC is a small non-profit. The following pictorial evaluates the mix of possible structures.



BCs that are large and non-profit are the best option. Let us evaluate why.

Non Profit

Non-profit models will reduce many risk factors including the issue of non banking firms using the BC model as a back door method of becoming banks. In addition, because the BC model was implemented with impoverished Indians in mind, they should continue to focus of servicing the customer rather than providing excess market returns to investors.

Large Entities

To lower costs, have good management, and reward its employees well, a BC must have scale. Scale provides a clear cost advantage to BCs because they are dealing with infrastructure networks that will result in diminishing marginal costs as the cost of servicing accounts is spread out over many customers. Traditional banks need not fear the "large monopolistic BC" due to its profit structure (non profit) and the fact that BCs are servicing a market that traditional banks currently do not service.

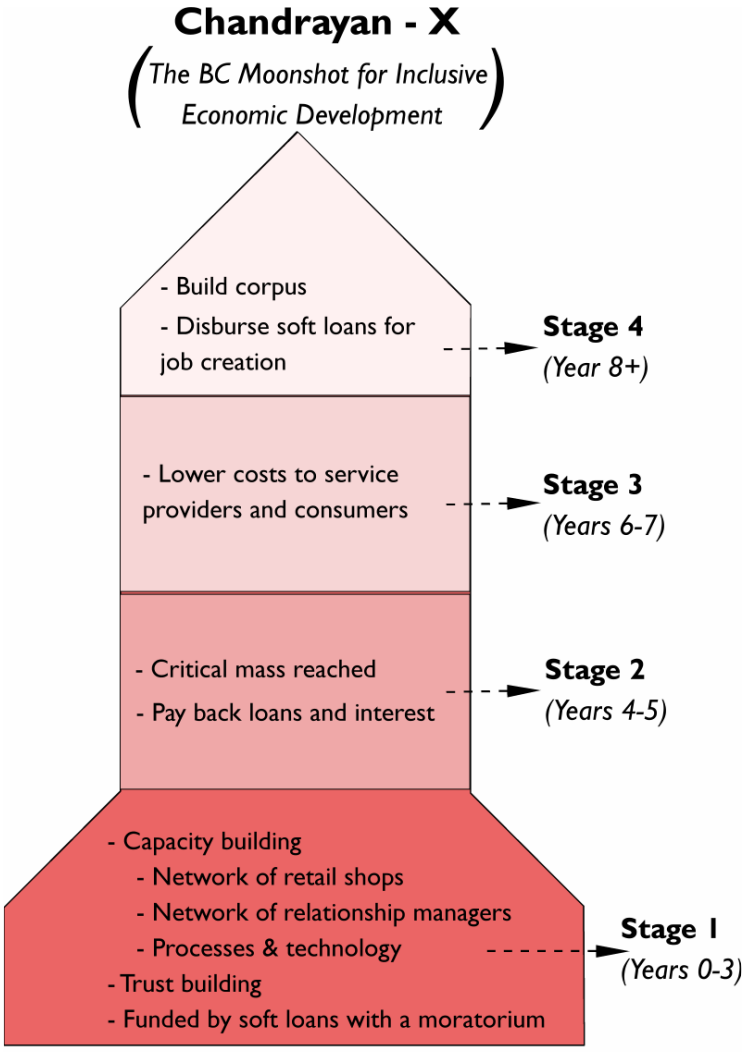
The Issue of Talent

The issue of attracting top performing talent is very important. In order to ensure BCs have extraordinary people, the BCs must compensate their employees very well. Because BCs as non profits are at the disadvantage of being unable to offer equity, BCs should offer reasonable base compensation along with high performance based bonuses.

A Win-Win BC Business Model

The large non profit BC outlined above is the perfect starting point for a revolutionary business model. Such an entity can use the ideas outlined below to further improve its impact and sustainability.

In the first phase of its model a BC will need to attract capital to build scale. It is crucial that capital accumulation by the BCs is completed without the help of grants. When the goal is self sustainability, the BC should have built enough scale to pay back whatever loans received. Once the loans have been paid back with interest, the BC should aim to lower costs to the customer. Finally if there is still a surplus then a corpus can be built to give soft loans to entrepreneurs who create jobs. These four stages are illustrated in the graphic below:



Two fundamental design principles

1. Talent – We already talked about the importance of compensating talent well. The importance of attracting and retaining top drawer talent cannot be over

emphasized. Indeed, a failure to recognize the importance of good people can cause a failure to execute even if the model is sound.

Cross Subsidization can occur whereby the fees and money earned off of affluent clients can be used to subsidize banking expenses of poorer clients.

2. Serve All & Cross Subsidize – A misconception with many financial products that are geared towards the poor is that they should only be available to the poor. In the case of BCs, they can service the rich as well and actually increase revenues and lower costs. Cost reduction will happen through additional scale being built up by a larger consumer base as well as the possibilities that cross subsidization brings. As we will see later on, by introducing a savings account geared towards the rich, cross-subsidization can additionally help micro-lending grow.

A Revenue Model and 6660 Crores

Because one of the primary goals is to create self sustaining entities, the revenue model is crucial. BC's can earn revenues from:

1. Customer Acquisition Fees
2. Deposit Mobilization Fees
3. Customer Servicing Fees
4. Demand Aggregation Fees

The calculations that follow are rough and illustrative and transaction fees earned from banks and paid to retail access points are excluded as it is assumed that whatever transaction fees are paid by the bank will be given to the retail access points. It will surprise some to hear that the potential for revenue in this market is large and the opportunity to do good while being sustainable exists. Revenue streams for BCs can be 6,600 crores annually. In addition 300,000 crores can be mobilized for priority sector (microfinance) lending.

Arriving at these numbers is based upon the general assumption that India has 300 million productive workers who are without bank access [whitepaper #1]. Therefore we assume the BC model attains 100% market saturation. This is not a wild dream; all we have to do is look at the banking markets in the US where credit and debit cards have attained such a status and realize that the vehicle of financial access comes in many shapes and sizes.

(Please note that all values are demonstrative and are not meant to be fixed values. Instead of placing a focus on numbers, the concepts that drive the revenue model will be far more useful.)

Customer Acquisition Fees:

With 30 crores in customers (300 million) and a customer acquisition fee charged to the bank of Rs 10 per customer, The revenue potential for customer acquisition is *300 crores*.

Customer Service Fees:
With 30 crores of customers who are potentially financially illiterate and have never had a bank account, customer service is an issue that can cripple the system. Instead, banks can provide BCs with an incentive to provide financial literacy programs. For every month that an active client does not call or access the banks customer service, 1 rupee is paid by the bank to the BC. The banks will agree to this because it will lower overall customer service costs and the BCs will then have a strong incentive to provide financial education. Per annum, a BC stands to then make 12 rupees a customer. Spread over the 30 crores in customers that comes out to *360 crores* of revenue per annum. This is an impressive figure, and more than enough to fund financial literacy programs while leaving some extra for the BC bottom line.

Deposit Mobilization Fees:
Deposit mobilization is a key to financial sustainability. If there are large amounts of savings deposits, the government can earmark the funds for microfinance lending purposes. Really, the possibilities are endless with the mobilization of savings deposits. Deposit mobilization can create *3,000 crores* in revenues for the BCs. The following shows how.

The High Income Savings Account for Economic Development:
If the government were to allow a savings account scheme at BCs whereby customers could get a 5% tax free interest payment on the savings kept in these accounts, the demand for them would be enormous. The Indian upper class would find these to be smart investments and also would be especially inclined to save in such schemes if it was in the name of rural development. If these funds were mandated by law to be lent out to only microfinance institutions (MFIs), the benefit would be tremendous. At 5% interest paid to the saver, 1% service fee for the BCs, 2% fee for bank costs (tech, distribution) and 3% bank spread profit (to cover risk), rural banks and microfinance institutions could get money at the rate of 11%.

If MFIs are able to then keep 3% to cover their capital costs and charge 4% for operational costs, then the low-income Indian can take out microfinance loans at 18%. Currently a microloan customer can expect to pay upwards of 35% on their loans. Therefore this account will also dramatically reduce lending costs allowing poorer Indians access to capital. Indeed many talk about a shortage of funds in the microfinance sector. However, by creating a self sustaining ecosystem whereby Indian deposits fund Indian microfinance efforts, the whole microfinance industry can be revolutionized.

In terms of BC profits, you can assume that the average balance on a BC account will be Rs 10,000 for 300 million users. We arrive at this average by assuming that 50% of the savings account users are high income and 50% are low income.

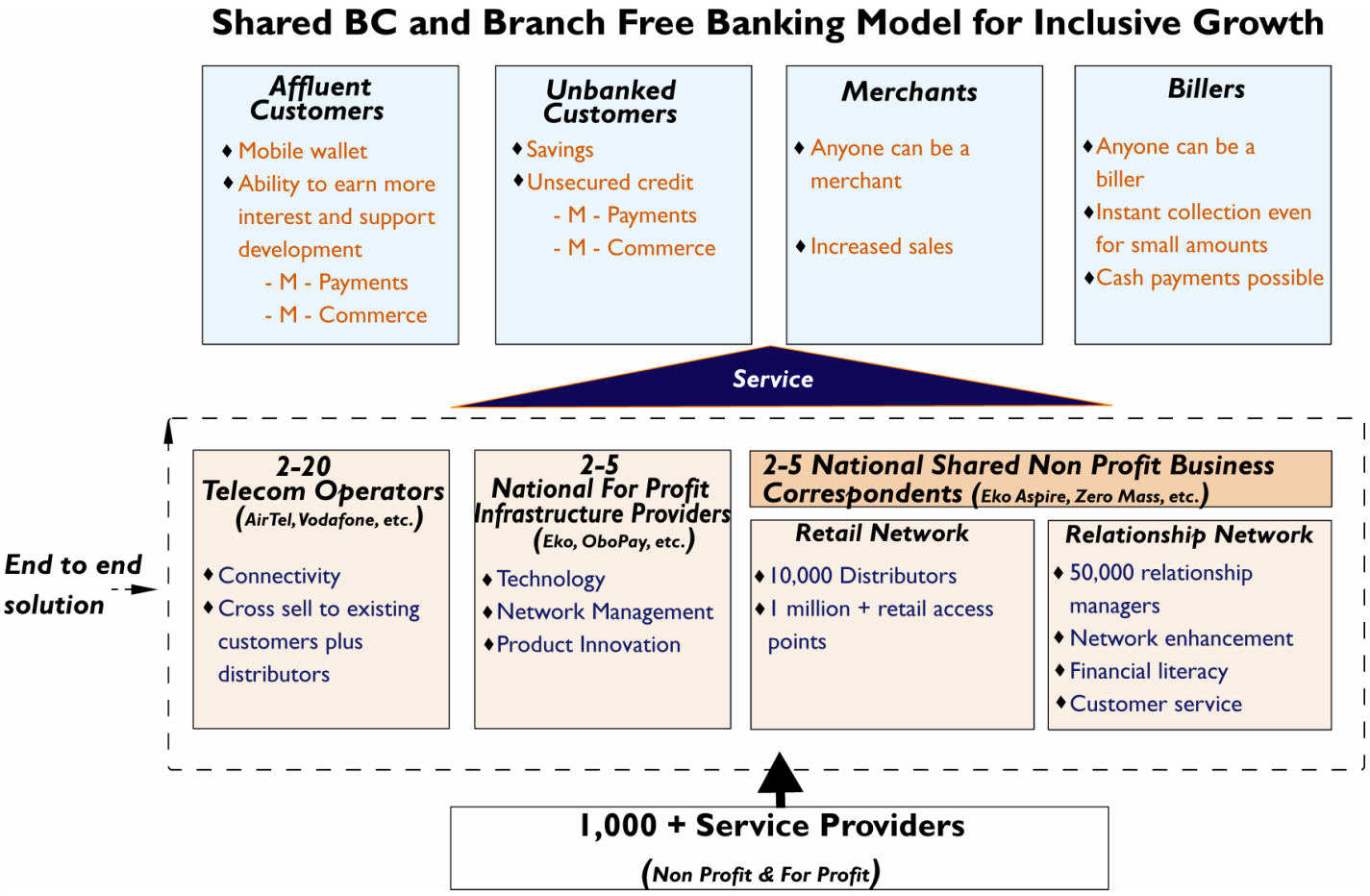
Additionally on average a low income user keeps Rs 2,500 in the account while high income users keep around Rs 17,500 which is a very conservative figure. Under this scenario, 300,000 crores of savings deposits are mobilized for MFI/ rural development loans. BCs can see 1% of this and earn returns of *3000 crores*.

Demand Aggregation happens in the USA when certain groups like the AARP and AAA negotiate better rates on consumer goods for their members.

Demand Aggregation – Another 3000 crores

Finally, BC's could build trusted relationships with customers and aggregate demand to negotiate deals for customers with service providers. If BCs take no commissions from service providers and aggregate demand to get the best possible deals for their customers for their financial and general expense needs then they can charge a nominal annual fee to their customers. At Rs 100 annual fee (which could be more for rich customers and less for poorer ones) the market potential for 300 million customers is 3000 crores. Indeed, customers will only pay this fee if the BC is able to negotiate deals on goods that will save them over Rs 100 per year. But the customer can be sure there is no conflict of interest because the BC will not get distribution commissions. This idea of demand aggregation further strengthens the idea that BCs act as advocates for their customers.

The graphic below captures the main thoughts in this whitepaper.



A Summary of Recommendations for Regulators

Encourage Universal Access & Cross Subsidy

1. Anyone can be a customer. Anyone can be a merchant or a biller.
2. Global electronic solution which improves on Visa and MasterCard.

Encourage Innovation

1. Reverse image and perception of being an innovation "blocker" to that of an innovation "encourager".
2. Provide a level playing field which does not favor any particular technology or process.
3. Do not protect large incumbents or inefficient processes and encourage smaller players who want to cause disruptive innovation.

Prudent & Pragmatic Risk Control

1. Question controls that increase costs and do not provide effective control. These are controls which increase barriers for honest people and are easily circumvented by undesirable elements.
2. Encourage controls such as capital adequacy for BC's and pattern recognition which lower costs and are effective at preventing scalable fraud.
3. Set up an ethical hacking group which helps innovators provide cost effective and robust solutions.

The BC High Yield Account for Economic Development

1. A 5% APR on savings deposits.
2. Tax free interest.
3. 50,000 maximum (per BC regulations).
4. Mandate that the majority of the money in the savings accounts be re-invested into economic development projects such as MFI lending.

Demand Aggregation

1. Allow BCs to charge their customers a fee in exchange for membership "perks" (lower cost of daily goods).

Encouraging BC Growth

1. Allow BCs to scale.
    a. Abolish the rule requiring all BCs to be within 15KM (rural)/ 5KM (urban) of a bank branch that they service.
    b. Implement capital requirements to ensure sustainable BC growth.

A Summary of Recommendations for Foundations

1. Find and fund high quality BC entrepreneurs with soft loans and demand rapid outcomes which are large, sustainable and scaleable
2. Allow performance based bonuses for employees of BCs in order to keep the talent level high.
3. Allow BCs to pay employees a market competitive base salary.

Conclusions

Promoting the BC & Branch-free movement is vital for UFA by 2013. Regulators must make this a national priority and encourage innovation. In an Indian context, mobile penetration is high and an efficient distribution infrastructure already exists.

In terms of structure, BCs should aim to be not for profit and scaleable. This means regulators and other entities should promote BC growth and allow the proliferation of large BCs that can competitively reduce price through scale.

If these goals can be achieved and implemented, the BC & Branch-free model of India will have a far greater impact than the BC model of Brazil.