Asian Research Consortium

Asian Journal of Research in Banking and Finance
Vol. 7, No. 8, August 2017, pp. 76-86.

Asian Journal of Research in Banking and Finance

ISSN 2249-7323
A Journal Indexed in Indian Citation Index
DOI NUMBER: 10.5958/2249-7323.2017.00093.1
UGC APPROVED JOURNAL

www.aijsh.com

Extent of Financial Inclusion: a literature Review

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Abstract

A strong financial system is a foundation of economic growth, development and progress of an economy. A financial system which gains impetus from being functionally diverse, displays competent performance, is precarious to our national objectives of building a market-driven, productive and advancing economy. Growing system forefronts levels of investment and economy growth with its depth and exposure. In this period of becoming economic power and self-reliant, it is vivacious for any policy implications to resultcordial conditions for persons, households and private institutions. The affluence of contact of banking services and vigorous bank branch network are the major enablers of developmental and expansionary activities in India. India has an dynamic financial market/system comprising of money market, Forex market, capital market, debt market to cater to financial needs and wants of various participants and segments of the society. It guarantees smooth and proficient flow of monetary resources, meeting the financial needs required for extension of wealth. India has a remarkable and well-structured banking system to satisfy the pecuniary needs of individuals and households' and which back the progress and development of the economy. Towards attainment of these needs, basic reforms, supervision and constant monitoring are envisioned to confirm a modern and up-to-date banking practices, healthy competition, and financial inclusion and well-balanced de-regulation.

Keywords: Financial inclusion index; Multidimensional variables; Computation.

1.1 Introduction

The Indian banking sector includes of the Reserve Bank of India (RBI), commercial banks and co-operative banks. Bank nationalization in India leading a standard change in the field of banking as it was intended to shift the focus from class banking to mass banking. The rational for forming Regional Rural Banks was also to outreach advantages of the banking services to underprivileged people. The banking industry has shown outstanding growth in capacity and complexity over the last few years or so. In spite of creating extraordinary advancements in all the areas relating to financial viability, productivity and competitiveness, still banking services have not touched a vast section of the population, particularly the underprivileged sections of the society. Financial inclusion is new prototype of economic growth which plays a major role in lashing away the scantiness. There are numerous factors which create an scorching need for financial inclusion like lack of access to financial services in most of rural areas due to high educational hurdles and less awareness, poor operational and financial history of financial institutions, near lack of insurance and pension service. Indian economy has moved on a long path of economic development but the consequences show that benefits linked to this have hardly reached 50% of the Indian population primarily because of no access to loan and insurance. All these factors pushes immediate need for financial inclusion. Financial inclusion swirls around deposit mobilization and credit intermediation to a varied section of population and is painstaking to be an significant part of inclusive growth process and sustainable development. The process of financial inclusion plays a major role in reducing the poverty from the country. Financial inclusion refers to supply of banking services to masses including under-privileged and disadvantaged people at an affordable and inexpensive terms and conditions. It increments financial concentration of agriculture and also helps in escalating rural non-farm activities which complements to development of rural economy and betterment of economic condition of people. The three main facets of financial inclusion are (i) financial market accessibility (ii) credit market accessibility (iii) awareness of financial matters.

Section 1.2 discusses the conceptual framework of financial Inclusion

Section 1.3 discusses the different indicators and dimensions used by other researchers in the past justifying the inclusion of more variables in the proposed index.

Section 1.4 discusses the initiatives taken so far and elaborates the road forward.

1.2 Definition of 'Financial Inclusion'

Financial services among other includes a variety of products such as savings, appropriately designed loans, insurance, credit, payments, etc. The efficiency of the financial system rest on its ability tosource funds from surplus units and finance deficit units. This role becomes more stimulating when the units that experience the deficit do not have access to the formal sources of finance. Financial inclusion initiatives concentrates on efforts undertaken by the financial system or any constituent thereof to bring into its fold sections of the economy that have been excluded from access to affordable credit and other financial services.

"The stark reality is that most poor people in the world still lack access to sustainable financial services, whether it is savings, credit or insurance. The great challenge before us is to address the constraints that exclude people from full participation in the financial sector. Together, we can and must build inclusive financial sectors that help people improve their lives."

Kofi Annan (2003).

Claessens (2006) has defined financial inclusion as the "availability of a supply of reasonable quality financial services at reasonable costs, where reasonable quality and reasonable cost have to be defined relative to some objective standard, with costs reflecting all pecuniary and non-pecuniary costs."

To quote the Committee on Financial Inclusion chaired by Rangarajan, (2008) "Financial inclusion maybe defined as the process of ensuring access to financial services and timely adequate credit where needed by vulnerable groups such as weaker sections and low income groups at an affordable cost".

Access to finance has been defined by Demirguc-Kunt and Levine (2008) as the 'absence of price and non-price barriers'.

1.3 Dimensions of Financial Inclusion

Financial Inclusion has been extensively recognized as the cure for the disease of poverty and to shoot for growth and development. Even so, literature on financial inclusion reveals the constant recaps that are being made to find an exhaustive measure of the extent of financial inclusion. This measure should ideally take into attention various factors that impact financial inclusion, be easy to calculate using the available data and be comparable across countries.

Many authors in the past have been able to found the impact of availability and access to formal sources of finance on poverty alleviation. Banerjee and Newman (1993) have professed that a critical factor that enables people to exit poverty by augmenting productivity is access to finance. Binswanger and Khandker (1995) have proven that Indian Rural expansion programme significantly depressed rural poverty and significantly enlarged non-agricultural employment. Eastwood and Kohli (1999) in their study have found that branch expansion programmes focused on lending programmes that have boosted small scale industrial output. An inclusive financial system can help in reducing the improvement of informal sources of credit specifically the money lenders which are often found to be biased. Bell and Rousseau (2001) have empirically proven that financial intermediaries have affected India's economic performance. Beck et al (2009) observed that a well-developed financial system accessible to all, lessens information and transaction costs, influences savings rates, investment decisions, technological innovations and long run growth rates. The prominence of Financial Inclusion to national economies is apparent from the support drawn-out by individual governments and international bodies around the world.(Frost & Sullivan Report, 2009) Banking services are being witnessed increasingly as a public good that necessities to be made available to the complete population without discrimination. Although, the degree of 'publicness' in financial inclusion may be dissimilar from a typical public good like 'defense'. But being as vital as access to water or basic education, it does qualify to be termed as 'quasi-public good' (Mehtrotra et.al2009). This acknowledgment has made financial inclusion a policy objective for policy makers and others engaged in developmental activities.

It is measured that globally about 2.9 billion people do not have access to financial services, (World Bank, United Nations 2006). According to the National Sample Survey Organisation, (2003, 59th round) 45.9 million farmer households in the country (51.4%), out of a total of 89.3 million households do not have access to credit, either from institutional or non-institutional sources. Further, despite the enormous network of bank branches, only 27% of total farm households are using formal sources (of which one-third also borrow from informal sources). Farm household's not accessing credit from formal sources as a proportion to total farm households is especially high at 95.91%, 81.26% and 77.59% in the North Eastern, Eastern and Central Regions respectively. The report of the Committee on Financial Inclusion set up by Government of India (Rangarajan, 2008) states that 73% of farmer households have no access to formal sources of credit. India itself has 560 million people who are left out from formal source of finance and it is in strong correlation with the 41.6percent of the population (457 million) that still lives underneath the poverty line i.e.US $ 1.25/day (NCR Whitepaper on Financial Inclusion, 2009). The acknowledgment that financial inclusion is a central tool to not only eradicate poverty but also supportive to economic growth has carried this concept to the limelight since early 2000 and is seen as a policy preference in many countries.

To quote C. Rangarajan, Ex- Governor RBI and Chairman, Committee on Financial Inclusion, Government of India "The country has moved on to a higher growth trajectory. To sustain and accelerate the growth momentum, we have to ensure increased participation of the economically weak segments of the population in the process of economic growth. Financial inclusion of hitherto excluded segments of the population is a critical part of this process of inclusion". Inclusive growth as a strategy for economic development got consideration because of the accumulation of concerns that the paybacks of economic growth have not been equitably shared (Chakraborty, 2010).

According to the United Nations the main objectives of Inclusive Finance are as follows (2003):

a) Access at a reasonable cost for all households and enterprises to the range of financial services which are "bankable," including savings, short and long-term credit, leasing and factoring, mortgages, insurance, pensions, payments, local money transfers and international remittances

b) Sound institutions, guided by appropriate internal management systems, industry performance standards, and performance monitoring by the market, as well as by sound prudential regulation where required

c) Financial and institutional sustainability as a means of providing access to financial services over time

d) Multiple providers of financial services, wherever feasible, so as to bring cost-effective and a wide variety of alternatives to customers (which could include any number of combinations of sound private, non-profit and public providers).

Increasing access to financial services would help eliminate a host of constraints that have slowed down growth both at the level of the individual and that of the country. Obstacles that recognise need for facilitation may either be specific to the individuals or may be caused by systemic or institutional insufficiencies and/or limitations.

Some of the limitations that can be attributed to individuals are low literacy levels, low level of income, psychological and cultural barriers, place of living, and lack of awareness. Despite governments coming up with innovative methods to aid in overcoming these obstacles, the course of adjustment is generally overextended and depend on as much on the individual's degree of motivation to remove these hurdles. However, the same is not true of constraints caused by systemic or institutional inadequacies. These are constraints that occur due to the insufficiencies and/or limitations of the system which leads to incompetence to offer smooth access to financial services. These constraints may be effectively eliminated by creating availability of legal identity cards, rationalising complex procedures for availing these services or relaxing rigorous terms and conditions relating to financial products and services and making them available at affordable costs. Financial inclusion policies are generally multi-pronged and are anticipated to cater to all the systemic and institutional shortfalls, at the same time letting individuals to overcome barriers at their personal level. The means towards financial exclusion are either initiatives - such as a charter of codes of practice developed by the banks themselves, (Elaine Kempson et al, 2004) - or are orders given by the central bank of the country or are part of the vision statements of the economy and hence backed by special legislations sanctioned by the governments. The policy initiatives for financial inclusion are being announced at regular intervals by Governments, CentralBanks of countries and developmental organizations like the United Nations. For example the GermanBankers' Association accustomed a voluntary code in 1996 endorsing for an 'everyman' current banking account that simplify basic banking transactions.

In the United States, the Community Reinvestment Act (1997) requires banks to offer credit throughout their entire area of operation and prevents them from targeting only the rich neighborhoods. In France, the law on exclusion (1998) highlights the right to have a bank account. In South Africa, a low cost bank account called 'Mzansi' was forcefully introduced for financially excluded people in 2004 by the SouthAfrican Banking Association. In the United Kingdom, the Financial Inclusion Task Force had been shaped by the government in 2005 to observe the progress of financial inclusion. The British government has set up a fund of 120 million Pound Sterling to address concerns of financial inclusion. Brazil has pushed the state banks to reach to the rural areas and the poor. Out of the 45% sight deposits that a bank is directed to keep with the central bank, it is encouraged to use 2% for micro loans at an interest of 24 to 48%. This has facilitated in gaining eight million new customers within a span of three and half years. Kenya has also passed a Micro Finance Act in 2006 to target financial inclusion. The central bank of China has also stimulated micro lending since 2006 and seven domestic micro credit corporations were acknowledged. In India, the government has envisioned the National Rural Financial Inclusion Plan to achieve far-reaching financial inclusion by the year 2015. Towards this, in 2005, the Reserve Bank of India guided Indian Banks to help basic 'no frills' accounts with low or minimum approved balance and in 2006, banks were encouraged to establish bank linkages with micro-finance and self-help groups (Sarma 2008, Frost & Sullivan, 2009).

1.3.1 Measuring Financial Inclusion – Financial Inclusion Index

The first step towards outlining the extent of financial inclusion is to establish the indicators that quantity the level of accessibility of financial services in a country. Policy creators need reliable information about the extent of inclusiveness which helps to gauge policies and influence actions to eliminate barriers.

Kempson et al (2004) have documented six common reasons for financial exclusion but the extent of incidence would vary from country to country. These barriers are identity requirements, terms and conditions of bank accounts, levels of bank charges, physical access to bank branches, psychological and cultural influences and ease of use of banking services. Chakraborty (2010) has classified these barriers as supply side barriers (expected to be moderated by banks) and demand side barriers (estimated to be overcome by the financially excluded). This will happen only with rigorous efforts to overcome these barriers, extent of financial inclusion will increase. The measurement of the extent of financial inclusion complements the examination of the movement and policies formulation to tackle with the menace of financial exclusion. These studies made an attempt to construct a Financial Inclusion Index (FII) so as to quantify the extent of financial inclusion in India using data published by CGAP the World Bank Group in 2009 and 2010. The other studies in this arena are detailed as follows:

Patrick Honohan (2007) has made evaluations of the segments of the households who have approach to formal financial intermediaries and hence matched these estimates to poverty and inequality using the Gini coefficient. To calculate the estimates, Honohan has adopted the ratio of Micro Finance accounts and bank accounts to the total population, household survey-based access and the average deposit size and the per capita GDP for more than 160 countries.

MandiraSarma, (2008 a) in her concept note 'Index of Financial Inclusion' has reflected three dimensions to measure the extent of inclusion namely:

1) Depth (penetration) of access using a proxy measure of the number of bank accounts per 1000 population.

2) Availability to measure proximity of access using the number of bank branches and number of ATMs per 1000 population.

3) Usage to find the extent and frequency of use by the customers.

Using three variables for outreach and one for usage, Sarmaused the methodologyadopted in the calculation the Human Development Index (HDI).

Sarma, in her study (2008 a) has assumed equal weights to the various dimensions. Depending on the value of IFI, countries are classified as high financial inclusion (an index of above 0.6), medium financial inclusion (an index of 0.4 to 0.6) and low financial inclusion (an index of less than 0.4). Finally, she has categorized the 45 countries (for which data on all three dimensions was available to her) and 81 countries (for which data on only two dimensions are available) in order of the IFI to point out their relative position among other countries. Following Sarma (2008) who used the notion of the UNDP Human Development Index to develop the Index of Financial Inclusion (IFI), several researchers, have created the IFI for specific states (Chandan Kumar and Srijit Mishra,2009, Nitin Kumar ,2011) , or have empirically observed the relationship between financial inclusion and development by investigating whether socioeconomic factors, such as income , inequality, literacy and urbanization or even physical infrastructure for connectivity and information are also significantly associated with financial inclusion (MandiraSarma and Jesim Pais,2008. Mehrotraet al. (2009) also fabricated an index for financial inclusion using similar kind of aggregate indicators like number of rural offices, number of rural deposit accounts, volume of rural deposit and credit from banking data for sixteen major states of India. NABARD (2009) also estimated values of Financial Inclusion Index at the various district of India.

Chakravarty and Pal (2010) axiomatically measuredthe degree of financial inclusion. It compliments the IFI proposed by Sarma (2008) so that the index can be functional to determine the percentage of influence made by the various factors on IFI. Rashmi Umesh Arora (2010) in her paper ‘Measuring Financial Access’ has intended to evaluate the extent of financial inclusion using the similar rational as used by Sarma for two major groups of countries – advanced economies and developing & emerging economies, embracing the IMF classification as the base. Her study has been limited to 98 countries from both categories for which data was available. Arora has encompassed more variables in the outreach dimension (measured as depth and availability by Sarma). She got hold of not just the demographic penetration but also geographic penetration. She also expands the dimensions of ease and cost of transactions (not included by Sarma).

1.4 Initiatives for Financial Inclusion in India

RBI has been emphasizing financial inclusion rewards in a ‘mission mode’ through a blend of strategies varying from introduction of new products, relaxation of regulatory guidelines and other reassuring methods to achieve sustainable and far-reachable financial inclusion.

Beginning with nationalization of banks, priority sector lending, lead bank scheme, creation of Regional Rural Banks, service area approach, self-help groups – bank linkage programs, the banking industry in India has limitlessly tried to generate an environment favoring to patterned financial inclusion. Some of the current initiatives include offering no frills account, announcing Business Correspondents and General Credit Card (GCC) for small deposits and credit.

Based on the stimulus of the policy initiatives they can be divided under two major types namely initiatives ensuring outreach and initiatives resulting in ease and cost of transactions.

1.4.1. Initiatives Impacting Outreach

a. Self Help Groups (SHG) - Bank linkage program: The SHG-Bank Linkage program driven by NABARD in 1992 was an vitaltactic in stimulating financial inclusion and inclusive growth. The program started as a pilot project to finance 500 SHGs across the country, causing 34.77 lakh SHGs being credit linked by March 2008. Further, the program has lead approximately 409.5 lakh poor households to gain access to micro finance from the formal banking system as on 31 March, 2007. Studies conducted by various experts (Rangappa, Bai,) confirmed that the program has positively assisted in the social and economic empowerment of rural masses, especially women, affecting not only significant upliftment of social capital but also simultaneously offering crucial financial services. Thus, it has evidenced to be a successful model with widespread reach can considerably achieve many advantages like micro savings, timely repayment of loans, fall in transaction costs to SHG members and banks, etc.

b. Kisan Credit cards: As per an announcement of Minister of State for Finance, MrNamoNarainMeena on 10, August 2010, India's banking system has distributed 9.25 crore Kisan Credit Cards (KCCs) grossly, as on March 31, 2010 since the initiation of the KCC Scheme in August 1998. Rs.4,17,326 crore had been officially permitted under KCCs till March 31, 2010, since the beginning of the scheme. Joint studies undertaken by NABARD (Mehrotra, Puhazhendhi,2009 et.al)and the financing banks on application of the KCC Scheme have been observed that the Scheme was well received both by farmers and bankers and the elasticity in banking operations has improved loan recoveries.

c. Opening of branches in unbanked areas: The bank branches as on March 2011 are 89622 (approx) as matched to 59752 in 1990. These include the Regional Rural Banks opened by various scheduled commercial banks in the country. In the April 201, the monetary policy of central bank have been directed to assign at least 25% of the total number of branches to be opened in the next year to unbanked rural areas. It has been sensed that the backing provided by base branches in cash management, documentation and redressal of customer grievances substantially improved the effectiveness of the Business correspondents (BC's) model.

d. Micro finance institutions: With the extraordinary growth noted by microfinance in recent years– 62% per annum in terms of the number of distinctive clients and 88% per annum in terms of portfolio over the past five years–and around 27 million borrower accounts, India boast to havemajor most microfinance industry in the world (M-CRIL, 2010). The remarkable growth rate of microfinance has been fueled by commercial bank funds which essentially swings towards for-profit institutional structures. Thus, there is a sustained India-wide progressive approach towards the transformation of MFIs into for-profit nonbank finance companies (NBFCs) and hence now over 50% of the 66 MFIs in the MCRIL analysis consist of such institutions.

1.4.2. Initiatives impacting Ease and Cost of Transactions

a. No frills account: In 2005, RBI introduced 'no frills' account with nil or minimum balance as well as charges that make such accounts accessible to vast sections of population. Banks have also been advised to provide ATM facility & small overdrafts in such accounts. According to the Skoch Development Foundation report(2011), 25 million no-frill accounts were opened between April 2007 and May 2009, which enlarged to 50 million(approx) in 2010. The Government is preparing to facilitate the banks in affording the cost of opening no frills account to the tune of Rs. 200-250 crores (28th February,2011, Business Standard)

b. Relaxation on Know your customer norms: KYC requirements for opening bank accounts were eased for small accounts in August 2005. The banks have been permitted to take any pro offor the identity and address of the customer to their discretion. Lately, it has been further eased to include letters issued by the Unique Identification Authority of India including details of the name, address and Aadhaar number of qualified individuals and entities that can act as business correspondents have been increasing. Recently, in 2010 'for profit' companies have also been allowed to function as BCs. The numbers of villages where business correspondents are offering services have reached to 76,801 in March 2011 as compared to 33,158 villages in March 2010.

c. Adoption of Electronic benefit transfer (EBT): Banks are executing EBT by capitalising ICT-based banking through business correspondents to relocate social paybacks electronically to the bank account of the beneficiary. Itreduces the dependence on cash and cuts the transaction costs. As per the scheme, the RBI would reimburse the banks a part of the cost of opening accounts with bio-metric access/smart cards at the rate of Rs.50 per account by which payment of social security benefits, National Rural Employment Guarantee Act (NREGA) payments and payments under other Government benefit programs would be directed to persons belonging to below poverty line (BPL) families.

d. General Credit cards (GCC): With anview to improve accesses to easy credit, banks have offered a general purpose credit card facility up to Rs. 25000/- at their rural and semi-urban branches. It has the feature of revolving credit allowing the account holder to withdraw up to the limit approved. It is trouble free credit to the bank's customer based on the evaluation of cash flow without any claim on security, purpose or end use of the credit.

1.5 The road Ahead

An index has always been documented as a standard to evaluate the performance because it aids comparison across countries and institutes the relative ranking. An index which is developed considering the minimum and maximum values across countries provides a rich measure of comparison. While its importance which cannot be tested, the explanation of the same should be detailed with attention because the max-min values across countries, which will impact the index of one country and may not imitate the extent of impact made by financial inclusion initiatives of a given country. It is therefore crucial to measure the extent of financial inclusion within a country and study the expansion without mention of the world's min-max values so that it will emphasize the absolute performance within a country and also help in appraisal over a period of time. Such an analysis will undertake the modifications in the various variables included in this study and will give feedback and direction to policy makers. Further research could focus on structure of such an index.

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