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Policy Brief #12

How a 1% DBT Commission Could Undermine India's Financial Inclusion Efforts

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Executive Summary

The Government of India is undertaking the most ambitious financial inclusion drive in history. The effort has two key elements: the financial inclusion plan called Pradhan Mantri Jan Dhan Yojana (PMJDY) and direct benefit transfer (DBT) payments from the government into beneficiaries' bank accounts. The success of these efforts hinges on one factor above all: the quality of the last-mile banking agent (Bank Mitr[1]) networks that will disburse DBT payments and enable customers to access their bank accounts.

Bank Mitr networks in India have been weak, with a recent study showing an annual attrition rate of 25-35%. A *MicroSave* analysis[2] found that nearly a third of Bank Mitrs are unavailable at their stated locations. Many have stopped offering services because commission rates for processing government benefit and subsidy payments are too low.

The Task Force on Aadhaar-Enabled Unified Payment Infrastructure estimated that a 3.14% DBT commission would be needed to ensure a robust rollout of Bank Mitrs. A new *MicroSave* costing exercise found that the cost to banks of processing transactions through the agent network is at least 2.63% of each transaction. However, the government released an Office Memorandum on 16th January 2015[3] setting the DBT commission rate for rural areas at 1%—a rate that is far too low and could potentially derail the entire financial inclusion effort.

While the cost to the government of paying DBT commissions may seem high, it should be evaluated in light of the significant savings that the government will realize through reduced administrative costs and reduced payment leakages to unintended recipients. A 2011 McKinsey & Company analysis of India's government payment system, estimated it to be Rs. 1 lakh crore annually (US$22.4 billion).

We recommend that the government set an adequate rural DBT commission rate (*MicroSave* estimates this to be a minimum of 3%) for the first few years of PMJDY that is more sustainable for the Bank Mitr network and will help ensure quality services. Over time, as payment volumes increase and the cost of processing DBT payments decreases, market forces and the bargaining capacity of banks will lead to lower commissions.

Introduction

In August 2014, Indian Prime Minister Narendra Modi launched Pradhan Mantri Jan Dhan Yojana (PMJDY), the National Mission for Financial Inclusion. PMJDY has the ambitious objective of giving all households in the country access to banking services and providing a bank account for each household. By 31st January 2015, more than 125 million accounts had been opened under PMJDY, which is a stupendous achievement. The scheme promises account holders significant benefits, including a zero-balance account with interest on deposits, RuPay debit cards, accident insurance coverage of Rs. 1.00 lakh (USD 1,613), and life insurance coverage of Rs. 30,000 (USD 484).[4] After satisfactory use of the account for six months, each household will receive overdraft protection with credit of up to Rs. 5,000 (USD 81), preferably for a female member of the household. The most attractive aspect of the programme, however, is direct benefit transfer (DBT) payments of social benefits and subsidies into bank accounts.

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[1] *Bank Mitr* translates to "friend of the bank", the last mile access for banking services
[2] http://www.microsave.net/files/pdf/IFN_114_Assessment_of_Bank_Mitrs_under_PMJDY.pdf
[3] http://finmin.nic.in/the_ministry/dept_expenditure/plan_finance2/Revised_DBTL_Commission.pdf
[4] The debit card must be used at least once in 45 days to maintain the insurance coverage.

The move to digital benefits transfer is timely and is expected to provide significant savings to the government and bring about greater transparency in the transfer of benefits and subsidies. The government transfers more than Rs. 3 lakh crore (about 3.5% of India's GDP in 2012) as benefits and subsidies, according to the 2012 Report of the Task Force on Aadhaar-Enabled Unified Payment Infrastructure.[5]

However, the success of the DBT programme and PMJDY depends to a large extent on the network of banking agents called Bank Mitrs,[6] who will serve as transaction points for individuals to access basic banking services and potentially cash out their subsidy payments. The importance of Bank Mitrs cannot be overstated since only about 41,000[7] rural bank branches exist to serve 650,000 villages in India. The PMJDY presupposes a well-functioning network of Bank Mitrs.

If Bank Mitrs are well trained, have adequate physical and digital cash, and are transaction ready, customers will be able to access their cash when they need it and their trust in the formal banking system will increase. On the other hand, if a Bank Mitr lacks cash or is not transaction ready, customers will not be able to access their cash when they need it. This will undermine PMJDY and weaken trust in the banking system.

In the past, Bank Mitr networks in India have been weak, in part because of low or no commissions from the government. A 2013 study by the Consultative Group to Assist the Poor[8] (CGAP) estimated an annual attrition rate among India's Bank Mitrs of 25-35%. A *MicroSave* analysis[9] conducted across 41 districts in 9 states in November and December 2014 found that 31% of Bank Mitrs were unavailable at their stated locations. Many of them stopped offering services because commission rates for government-to-person (G2P) payments were simply too low.

DBT commissions have always been a contentious issue, and even state governments have differing approaches. CGAP's Overview of the G2P Payments Sector in India[10] points out that state governments exercise significant control over the management and administration of central government–mandated payment schemes, with some states paying 2% commissions and others paying none. "This weakens the business case for banks and fails to generate enough money to feed the many mouths in the G2P value chain", the report says.

The Ministry of Finance's Department of Expenditure released an Office Memorandum (OM) on 16th January 2015[11] that fixes commissions for banks distributing DBT payments. For urban schemes such as Direct Benefit Transfer for LPG (DBTL), commissions will be paid at the National Electronic Funds Transfer (NEFT) rate[12] or the Aadhaar Payment Bridge (APB) rate[13] as per extant Reserve Bank of India (RBI) or National Payments Corporation of India (NPCI) circulars. For rural schemes, the rate will be 1%, subject to an upper limit of Rs. 10 per transaction.

Unfortunately, the 1% commission in rural areas is far too low and could potentially derail the entire financial inclusion effort.[14] Indeed, the Task Force on Aadhaar-Enabled Unified Payment Infrastructure[15] estimated in its 2012 report that a 3.14% DBT commission would be needed to ensure a robust rollout of Bank Mitrs. Moreover, the government need not pay 3% in perpetuity. According to *MicroSave* estimates, as the network of Bank Mitrs

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[5] http://finmin.nic.in/reports/Report_Task_Force_Aadhaar_PaymentInfra.pdf
[6] *Bank Mitr* translates to "friend of the bank".
[7] "Strategy adopted for Financial Inclusion" (speech delivered by Dr. Deepali Pant Joshi, Executive Director, Reserve Bank of India, at a workshop organised by the Government of Madhya Pradesh at New Delhi on January 24, 2014) https://www.rbi.org.in/scripts/BS_SpeechesView.aspx?Id=871
[8] 2013 India: National Survey of Branchless Banking Agents, CGAP and College of Agricultural Banking
[9] http://www.microsave.net/files/pdf/IFN_114_Assessment_of_Bank_Mitrs_under_PMJDY.pdf
[10] http://www.cgap.org/blog/overview-g2p-payments-sector-india
[11] http://finmin.nic.in/the_ministry/dept_expenditure/plan_finance2/Revised_DBTL_Commission.pdf
[12] As per RBI circular no. DPSS CO (EPPD) /98/04.03.01/2012-13 of Jul 13, 2012, banks can levy no more than Rs. 2.50 (exclusive of service tax) for funds transfers up to Rs. 10,000. Charges for transfers beyond this limit would remain unchanged—that is, Rs. 5 for transfers between Rs. 10,001 to Rupees one lakh; Rs. 15 for transfers between Rupees one lakh and above and up to Rs. 200,000; and Rs .25 for transfers beyond Rs. 200,000.
[13] ABP charges are to the tune of paise 55 per transaction, charged to the sponsoring bank.
[14] Our recent blog post (http://blog.microsave.net/so-many-steps-forward-and-now-one-big-step-back/) highlighted how the OM may be a setback for the branchless banking environment. The OM seems to have not only forced ecosystem participants to rethink their strategies but also, once again, raised questions around the viability of agent-based financial services delivery models in India.
[15] The government established this task force in 2012 to analyse the direct transfer of subsidies for kerosene, liquefied petroleum gas, and fertiliser. The committee was chaired by Shri Nandan Nilekani, then Chairman of Unique Identification Authority of India (UIDAI), and had members from the National Payments Corporation of India; Controller General of Accounts; National Informatics Centre; Indian Banks Association; Reserve Bank of India; Unique Identification Authority of India (UIDAI); the Ministries of Food & Public Distribution, Rural Development, Agriculture, and Petroleum & Natural Gas; and the Departments of Fertilizers, Financial Services, and Expenditure, covering almost all ecosystem participants, with the exception of Business Correspondent Network Managers (BCNMs).

expands and DBT schemes flow through these accounts, the cost of processing DBT payments through an agent will fall to 1.4% (assuming that LPG, MNREGA, and PDS[16] subsidies all flow through the network).

While the cost to the government of paying a 3% DBT commission may seem high, it should be measured against the significant savings that would result from reduced administrative costs through digitisation and reduced leakages to unintended payment recipients.

Benefits to Government of Digitising Payments

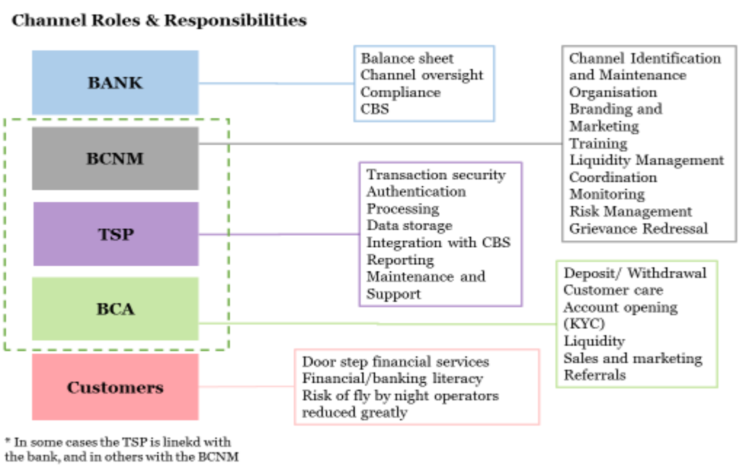
A 2011 McKinsey & Company analysis of India's government payment system, Inclusive growth and financial security: The benefits of e-payments to Indian society,[17] estimated that an e-payment model can reduce current payment inefficiencies estimated to be Rs. 1 lakh crore annually (US$22.4 billion), with a large share of that amount—Rs. 71,000 crore (US$18.3 billion)—attributable to welfare schemes disbursed by the government (G2P Payments). This would equal 8% of the total value of G2P flows in India. (To put this figure in context, the planned outlay for the Department of Rural Development in 2015-16 at Rs. 71,642 crore[18] [USD 11.56 billion] could be fully funded out of the savings through digitisation of payments.) Eighty percent of the savings would come from reduced leakages to unintended recipients. The remainder would come from the lower administrative cost of making payments digitally rather than using cash or checks.

More recently, a randomised control trial conducted by the Abdul Latif Jameel Poverty Action Lab (J-PAL) in association with the Government of Andhra Pradesh in eight districts of Andhra Pradesh[19] tested the impact of digitising National Rural Employment Guarantee Act (MNREGA) payments. Beneficiaries reported a 24% increase in weekly earnings while fiscal outlays did not change, resulting in a 10.8% reduction in leakages. *The leakage reduction was estimated at almost nine times the cost of implementing the programme.*

Compared to these benefits, a 3% commission for DBT delivery in rural areas is a small price to pay to ensure a high-quality network of Bank Mitrs. The government can potentially use the savings from lower administrative costs and plugging of leakages to finance delivery to beneficiaries.

Costs of Running a Bank Mitr Network

MicroSave conducted a bottom-up costing exercise and found out that, *at a minimum*, it costs banks INR 2.63 to transact INR 100 using the agent network—2.63% of each transaction. The transaction costs were split across at least three constituent parts—BC Agents (BCAs or Bank Mitrs), BCNMs (BC Network Managers), and banks.



Several activities are required of various parties to ensure a transaction-ready, high-quality banking agent network. The chart of Channel Roles & Responsibilities highlights how the activities are divided among the parties. The relative importance of the activities and how they are distributed across the ecosystem may vary, but the chart shows that there are significant costs to keeping the wheels well-oiled.

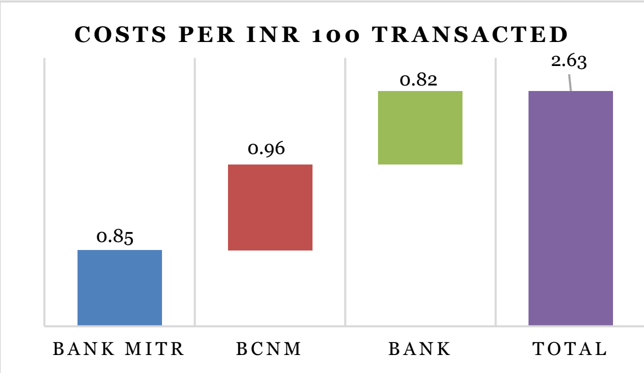
Running an agent network is similar to running an ATM network, where keeping the ATM transaction ready is important. In the absence of hard data on the cost of delivering DBT payments or any form of cash-in/cash-out service at a banking outlet, we can look at data from other, similar services. Banks such as the State Bank of India (SBI), HDFC, and Axis Bank charge Rs. 22.47 (35 US cents), inclusive of taxes, for cash withdrawals at ATMs from the sixth transaction onwards. ATM presence is largely in urban and semi-urban areas, whereas DBT is a predominantly rural phenomenon; if anything, the cost of transporting cash and disbursing it will be higher.

[16] Liquefied petroleum gas, National Rural Employment Guarantee Act, and Public Distribution System
[17] http://mckinseyonsociety.com/inclusive-growth-and-financial-security
[18] http://indiabudget.nic.in/ub2015-16/eb/po.pdf
[19] http://www.nber.org/papers/w19999.pdf

In its 2012 report, the Task Force on Aadhaar-Enabled Unified Payment Infrastructure benchmarked its recommended last-mile transaction processing fee of 3.14% (with a cap of Rs. 20 per transaction) against India Post's 5% fee for money orders and the average mobile operator fee of 3.5% (down from 16% they used to charge at the launch of the new business). The task force also estimated the total cost per account (issuing cost plus acquiring cost) at Rs. 179.98, which also includes technology costs at the last mile.[20]

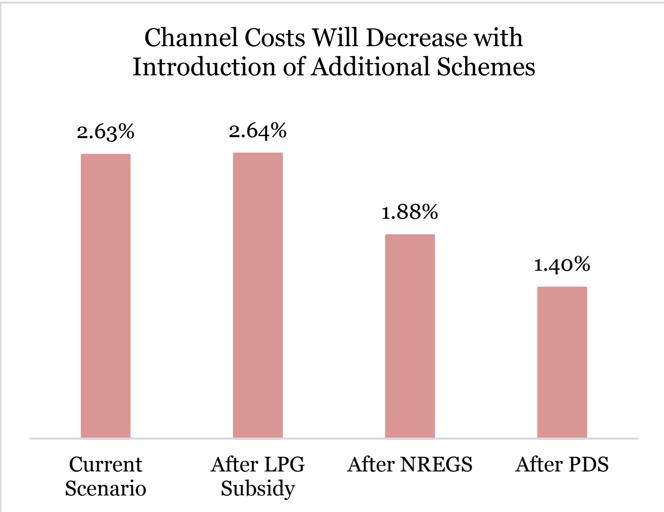
MicroSave's [Policy Brief #11](#) noted that banks were losing money when handling DBT payouts. Based on our on-the-ground research and analysis of costing data from the business correspondent network managers (BCNMs) who manage the Bank Mitrs (also often referred to as business correspondent agents – BCAs) and financial data provided by state governments, we concluded that a 3% DBT commission would be needed to ensure a viable distribution channel.

In addition, *MicroSave* recently conducted a costing exercise, covering 4 BCNMs and 50 agents, to arrive at the cost per transaction for the business correspondent (BC) channel. The BCNMs involved were primarily serving rural customers, and their services included deposits, withdrawals, remittances, and other payments. None of the assessed BCNMs were yet offering G2P payments. The study covered both rural and urban agents and averaged the costs incurred on the basis of transaction volume processed by each BCNM. Costs and revenues were studied in isolation.



The transaction costs were split across at least three constituent parts—BC Agents (BCAs or Bank Mitrs), BCNMs, and banks. The cost per Rs. 100 (USD 1.60) transacted was about Rs. 2.63, or 4 US cents (2.63% for the entire channel). The cost was about 0.96% for BCNMs, 0.85% for BCAs, and about 0.82% for banks. Since costing data from banks was not available, we extrapolated costs for banks, which form the apex of the BC channel, using data cited in the 2012 report of the Task Force on Aadhaar-Enabled Unified Payment Infrastructure. Given the actual transaction costs in the BC channel, the 1% commission being offered by the government seems grossly inadequate.

We also looked at these costs while overlaying DBT transactions from various other government schemes such MNREGA and [PDS](#). This showed that, over time, the cost per Rs. 100 transacted could indeed potentially decline to Rs. 1.4. This is because most costs at the BCNM level as well as the BCA level are fixed, and with increased volumes due to the introduction of new schemes, the cost as a percentage of transaction value would decline substantially. However, for that to happen, nearly all DBT transactions (including DBTL, MNREGA, and PDS) would need to go through the BC channel to enable volumes to build up.



The costing exercise also revealed that it costs about Rs. 11,400 (USD 185) per month to maintain a transaction-ready BC channel, with the costs split between the BCNM, the BCA, and the bank. (As mentioned earlier, bank costs were extrapolated.) This is an important finding because several BCAs (Bank Mitrs) will operate in low-population-density locations, such as tribal areas, where the volume of transactions will never be adequate to cover the costs. In such locations, some other mechanism of compensation, such as fixed payouts for the channel or a combination of fixed and variable compensation structures will have to be worked out.

[20] http://finmin.nic.in/reports/Report_Task_Force_Aadhaar_PaymentInfra.pdf

Likely Impact of a 1% Commission on the Distribution Network

A 2013 survey[21] by CGAP and the RBI's College of Agricultural Banking found an annualised attrition (dormancy) rate of 25-35% among BCAs. *MicroSave*'s own surveys[22] in the last three years have shown that as many as 22-43% of the agents appointed by banks to deliver financial services have become dormant. In large measure, this can be attributed to inadequate compensation, leading to lack of economic viability, at the level of BCAs.

Bank Mitrs are typically small village shopkeepers or educated youth looking for entrepreneurial or employment opportunities. Low payouts make it difficult for them to remain viable in the medium to long term. The recommended commission structure for DBT will be counterproductive and will deter investments at the level of BCNMs and Bank Mitrs.

All reports on agent dormancy point towards inadequate compensation as one of the key reasons for high dormancy and churn at the level of retail agents. This OM also does little to boost the confidence that agents will receive reasonable compensation for providing last mile services. If anything, the A 1% DBT commission in rural areas may lead to even greater churn and dormancy. Also, while the government's OM deals only with DBT payments, it sets a precedent for commission payouts across the financial services value chain. Banks will use the 1% rate as a benchmark for negotiating fee and commission structures with BCAs and with BCNMs.

Other issues include:

- As older agents become dormant, it will not be easy to find new agents to replace them. Local entrepreneurs are a well-connected lot. Stories of low revenue potential coupled with the significant efforts required to engage with customers and local bank staff will spread. Recruiting onboarding and training new agents will take more time, effort, and money—thus potentially making the business case for the channel weaker than before.

- Dormancy among agents will severely reduce trust in banks among the very population the government is trying to serve. People are unlikely to use accounts if they are unsure whether the local agent will still be available in three months' time. This does not bode well for the government's larger goal of active bank accounts for all.

- Lack of trust manifests itself in several ways, one of which is already visible and has been a problem for some time—client dormancy, in which clients with accounts do not use them over a period of three months or more. Another challenge is that customers tend to withdraw the entire DBT subsidy as soon as they receive it. This may be due to lack of communication[23] about the features of the account and its potential as a savings instrument and/or a perception that the agent may not be functional or, worse, may disappear with the money.

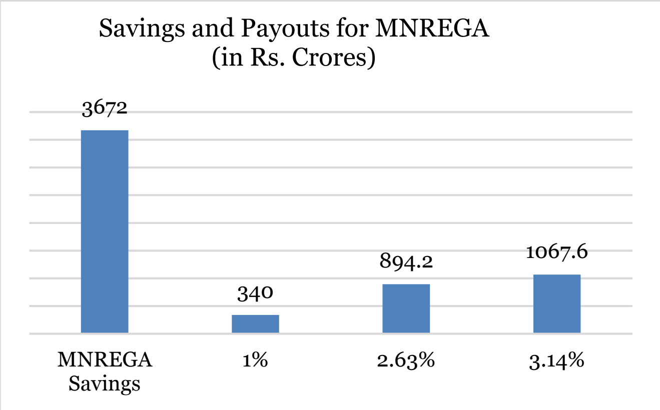
- Continuation of business at the 1% compensation level will hit BCAs and BCNMs the hardest. If every transaction results in a loss, more transactions will only increase losses. This is unlikely to be covered by economies of scale because of the direct costs of digitising money.

- Compensating the agent at current levels, banks will likely insist that their BCNMs continue to process loss-making DBT transactions through their network. This practice will come at a cost. The BCNMs may be forced to cut corners in areas that affect service to clients, such as communication, training, client protection measures, and liquidity management.
- Institutions applying for the newly launched Payments Bank have been planning to deliver significant numbers of DBT transactions, among other transactions. With the 1% commission rate, the time they will need in order to break even will suddenly increase.

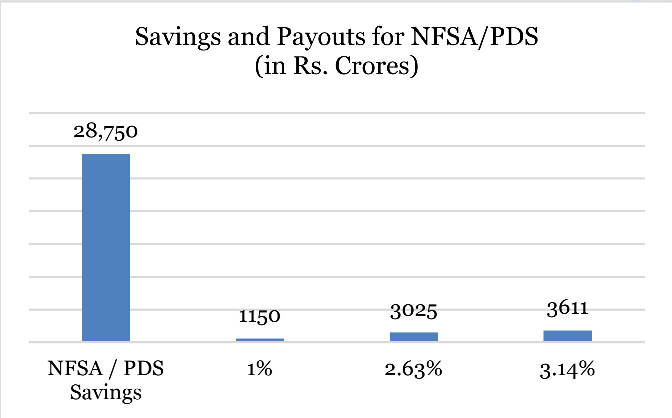
[21] Source:2013 India: National Survey of Branchless Banking Agents, CGAP and College of Agricultural Banking
[22] http://www.microsave.net/files/pdf/1370951943_PB_2_The_State_of_Business_Correspondence_Agent_Networks_in_India.pdf
[23] "Communication – The Achilles Heel of Direct Benefit Transfers – Part 1", http://bit.ly/RjbXRf

Can the Government Afford Higher DBT Commissions?

It's important to explore whether the Indian government can actually afford to pay higher DBT commissions. McKinsey's 2011 report estimates that automating all government payment flows could save the government up to USD 22.4 billion annually—almost 8% of the total payment flows between the government and households (which are estimated to be USD 296 billion, or USD 250 per capita).[24] The savings would come from plugged leakages, reduced transaction costs both for the government and the customer, and reduced administrative and overhead costs. Part of the savings could be used to pay for delivering the services to the needy.



The budget outlay for MNREGA for 2014-15 was Rs. 34,000 crore (USD 5.48 billion).[25] The aforementioned J-PAL study estimated that DBT digitisation would reduce leakages from MNREGA by 10.8% annually. Extrapolating from this, the government could potentially save Rs. 3,672 crore (USD 592.3 million) per year, whereas a payout at 3.14% would mean expenditures of just Rs. 1,067 crore (USD 172.1 million)—or 29% of the total savings. *(A 1% commission would mean Rs. 340 crore [USD 54.8 million]) in annual payouts, a 2.63% commission would mean Rs. 894 crore [USD 144.2 million], and a 3.14% commission would mean Rs. 1,067 crore [USD 172.1 million].)*



Similarly, the official budget (2014-15) for implementing the National Food Security Act (NFSA) is Rs. 1.15 lakh crores, covering 67% of Indians.[26] The High Level Committee on restructuring of Food Corporation of India (FCI) stated that leakages in PDS range from 40-50%, and in some states are as high as 60-70%.[27] The leakages equal Rs. 57,500 crore (USD 9.27 billion) at an average leakage rate of 50%. Post digitisation, this amount could, at a very conservative estimate, potentially reduce by half. However, unlike with MNREGA, the cost of DBT commissions for NFSA/TPDS[28] would be just 13% of the total savings, at Rs. 3,611 crore. (A 1% commission would mean Rs. 1,150 crore [USD 185.5 million] in annual payouts, a 2.63% commission would mean Rs. 3,025 crore, and a 3.14% commission would mean Rs. 3,611 crore [USD 582.4 million].)

Alternatively, the government could explore dipping into the Universal Service Obligation Fund (USOF) for telecom, which remains largely unused, or potentially create another, similar fund for financial services for the poor to enable service delivery without compromising quality.

Next Steps

Given the foregoing analysis, we believe that the key to ensuring the successful rollout of PMJDY is to arrive at a reasonable cost of service delivery for Bank Mitrs and a commission rate that is acceptable to all and helps ensure quality services and a quality network. The following steps, among other possible solutions, could lead to progress in that direction:

- We could make the *MicroSave* costing exercise, which is limited to BCNMs and BCAs, more comprehensive by including banks and making the geographic coverage more representative. We could include DBT payments in both rural and urban areas, direct payouts through bank accounts/branches and cash-out through Bank Mitrs, and various technology platforms used by banks and BCNMs. The DBT commission rate could be based on the outcome of the costing study.

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[24] http://mckinseyonsociety.com/inclusive-growth-and-financial-security/
[25] http://indiabudget.nic.in/ub2014-15/eb/po.pdf
[26] http://mrunal.org/2015/02/shanta-kumar-report-fci-restructuring-buffer-stock-food-security.html
[27] http://pib.nic.in/newsite/PrintRelease.aspx?relid=114860
[28] Targeted Public Distribution System

- The government and banks could conduct or commission a more comprehensive exercise to supplement and strengthen what has already been done. This would enable sustainable pricing for the Bank Mitr network, put to rest the debate around commission structures, and ensure that the network is viable.

- Once the network is up and running and payment volumes have picked up, market forces and indeed the bargaining capacity of banks would ensure lower commission rates. Telecom is a great example: the initial commission paid to agents was 16%, and over time it has fallen to about 3%. Sliding scales could be mapped to the number of transactions, and as transactions increase the fixed remuneration can decrease. This would also need to be mapped to targets for the agents so they do not think they can continue to earn that money without doing any work.

The government has a powerful policy lever to ensure that banks can build a strong Bank Mitr network and that the rollout of PMJDY is successful—the commission it pays to banks to disburse DBT payments. Setting an appropriate rate will remove unnecessary hurdles in providing access to financial services to the people who really need them.