**MPP Professional Paper**
In partial fulfillment of the Master of Public Policy Degree Requirements
The Hubert H. Humphrey School of Public Affairs
The University Of Minnesota

# India's Urban Poor Financial Services Needs:

## Challenges and Solutions

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**May 14, 2013**

[*In this paper I identify the institutional and consumer barriers that have kept the urban poor out of the banking network. I also analyze how informal mechanisms overcome these barriers to create a sustainable and reliable network of financial services for the urban poor. I end by discussing the need to rethink existing policies in order to make the formal financial services more accessible and user friendly to the unbanked.*]

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# *Contents*

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# *Abbreviations*

| | |
|---|---|
| ATM | Automated Teller Machine |
| BC | Business Correspondents |
| CBS | Core Banking Services |
| GPS | Grameen Pension Savings |
| IMPS | Immediate Payment Services |
| KYC | Know your Customer |
| MFI | Micro Finance Institution |
| MPCE | Monthly per capita expenditure |
| NABARD | National Bank for Agricultural and Rural Development |
| NBFC | Non Banking Financial Company |
| NEFT | National Electronic Fund Transfer |
| NPCI | National Payments Corporation of India |
| NREGA | National Rural Employment Guarantee Scheme |
| PACS | Primary Agricultural Credit Societies |
| PAN | Permanent Account Number |
| PDS | Public Distribution System |
| RBI | Reserve Bank of India |
| RoSCA | Rotating Savings and Credit Association |
| RRB | Regional Rural Bank |
| SBI | State Bank of India |
| UCB | Urban Co-operative Bank |
| UID | Unique Identity Number |
| UIDAI | Unique Identification Authority of India |

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## Introduction

> *Baijnath & Jagannath are recent migrants. The brothers live in a rented hut in Indira Camp, a slum in Delhi. They work in a garment factory in a nearby industrial estate and earn between ₹1800-₹2000 ($36-$40) per month.*[1] *In September 2000 both of them lost their jobs and all their savings worth about ₹2500-₹3000 ($50- $60) were stolen from their hut. Unemployment through the rest of the year forced them to secure groceries on credit and their rent went into arrears. Since they could not remit money back to their family in their native village, the family also took on high-interest loans in the village to survive. The two brothers were close to going hungry and being evicted from their huts if they remained jobless much longer. However, they had a supportive network of local shopkeepers who were willing to provide them with credit due to their good credit history and cordial interpersonal relationships. The social network kept them from falling through. The brothers would like to have banking services, but they do not have a ration card, a document that lists all members of a family, so that the household may access public distribution system (PDS) shops (fair price shops) in India to buy food and fuel if it is a low income household. Since this doubles up as an identity proof, they have been unable to open an account.*[2]

A comprehensive literature review of randomized control trials conducted to examine the impact of access to financial services on income and poverty in lower income countries suggested a strong correlation between access to banking institutions and rise in income (Pande, Rohini 2010). In India, financial inclusion received a push mainly in rural areas. The National Bank for Rural and Agricultural Development (NABARD), the primary regulatory and supervisory authority for all rural and development policies led efforts to take banks to the rural heartlands through Regional Rural Banks (RRBs), co–operatives and Primary Agricultural Credit Societies (PACS). Microfinance also focused mainly on women and the rural areas. The extent of rural poverty is believed to have declined in India between 1969 and 1990 as the Reserve Bank of India (RBI) put in place strong measures to ensure the spread of banking and access to credit in the rural areas (Burgess, Robin 2005).

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[1] $1 = ₹62 approximately today, it was about ₹45 in 2000-01 when most of these interviews were done.

[2] Collins, Daryl, Jonathan Morduch, Stuart Rutherford, and Orlanda Ruthven Portfolios of the Poor: Household Stories, India-Urban-2brothers accessed April 2012, http://www.portfoliosofthepoor.com/pdf/ Mr_K_Mr_J_Mr_R_KBH03_India_Profile.pdf

However, the number of urban centers in India is growing; slum populations and low income populations in these urban centers are also growing, and poverty is declining slower in the urban areas than the rural areas (Government of India, Planning Commission March 2012). The financial needs of the urban poor have been overlooked. In the urban areas, despite the existence of a good banking network, 32% of the total urban Indian households do not have a savings bank account (Census of India 2011). An excerpt from a speech made by K.C. Charabarty, deputy governor of the Reserve Bank of India (RBI) best illustrates the lack of attention towards the financial needs of urban poor.

> "*The rural inhabitants have largely remained the focus of our financial inclusion efforts since a large proportion of our villages are still unbanked. This has also been under the premise that the reach of banking network in urban areas is already quite high and, hence, access to banking services should be available to all. The ground reality, however, is quite shocking. The problem of exclusion is widespread even in urban areas, especially, for the disadvantaged and low-income groups, despite there being no dearth of bank branches."* (Chakrabarty, K. C. 2013).

In this paper I identify why 32% of urban Indian households do not have access to a basic savings bank account with a formal bank or post office (Census of India 2011). I will analyze the barriers that have prevented financial services from reaching the urban poor in India. Identifying these obstacles and studying how the informal mechanisms overcome them helps to create a sustainable and reliable network of financial services for the urban poor.

## *Who are the unbanked urban poor?*

I will focus on the transient poor. Access to financial services is more valuable to those who have a source of income but no safe saving places to put away their extra cash. The chronic poor need other forms of policy interventions in addition to access to financial services to pull them out of chronic poverty. The poor are not a homogeneous category. Studies have distinguished between the chronic poor (always poor and usually poor); transient poor (churning poor and occasionally poor) and; never poor (near poor) (Hulme, David 2003). A substantial proportion of the 13 million households who live in urban slums in India are transient poor (Census of India 2011). In other words, they are not the poorest of the urban populations unlike people such as footpath dwellers (homeless) who live on the pavements. They have homes in the slums and informal jobs that keep them out of absolute poverty most of the year. However their income is unpredictable. During some periods they may fall into chronic poverty due to economic shocks such as income loss, obligatory visit to the village, sickness or temporary job loss. Access to financial services is more valuable to them as a little financial help – ability to generate a pool of savings they can fall back on or access to timely credit - to tide over the shock can prevent them from falling into chronic poverty (Baulch, Bob 2002), (Sen, Binyak 2003). I will refer to the target population as the urban poor throughout this paper although I will focus mainly on the transient poor who have an unpredictable income. They are best described by the characteristics outlined below.

Informal work: A high proportion of the urban poor are employed in the informal sector. Over 90% out of the bottom 40% of non-farm workers in India work in the informal sector (Sakthivel, S. 2006). This is not a homogeneous group. It includes people with diverse occupations such as daily wage workers, construction labor, petty traders, hawkers, street children, sex-workers, rickshaw pullers, domestic workers, drivers, small-shop owners, service sector employees such as mechanics, waiters, guards and watchmen, salesmen among other occupations (Government of India, Planning Commission March 2012). These are people who have a regular job or are self employed and have fairly regular earnings. However, these jobs lack protection in the event of non-payment of wages, include compulsory overtime or extra shifts, lay-offs without notice or compensation, unsafe working conditions and the absence of social benefits such as pensions, sick pay and health insurance (International Labour Organization).

Low and unpredictable income: Although the urban poor have regular jobs, their income is low and unpredictable. Since jobs are not 'secured' by a contract (or involve a short duration contract with no guarantee of renewal) their source of income is risky (Daryl, Collins 2009). If they are fired without a notice, they are unlikely to earn anything until they find a new job. However, they are likely to earn something daily as long as they maintain their job but the amount of earnings fluctuates. For instance, the street vendors are likely to have above average sales and profits during peak festivals; the rickshaw drivers are likely to earn above average on rainy days; while domestic helps experience a sudden fall in income if they lose a job. This makes their financial lives insecure and risky. The emergencies that they have to deal with could mean skipping meals they can no longer afford to buy.

Their income inflows and expenditure outflows rarely coincide. They do not always need money the moment they earn it. For instance, a domestic help may receive her salary the first weekend of every month, but she may really need money to pay the school fees of her children once every six months. The urban poor thus foster strategies of consumption smoothing by diversifying their economic activities and developing financial ties with networks of individuals, groups and agencies (Matin, Imran 2002).

The income details of the unbanked population are not well documented (Government of India, Planning Commission March 2012). Though most of the unbanked urban poor fall in the lower income-consumption quintiles, only the chronic poor are likely to fall below the official poverty line. The 2009-10 poverty line for urban India is ₹859.6/- (about $18) per month per head (Government of India, Planning Commission March 2012). The transient poor earn more than that. For instance, street vendors, beggars and rickshaw pullers make anything between ₹150 – ₹300 (₹6000 or $120 a month on average) while small business persons, drivers, domestic helps make anything between ₹8000 – ₹10,000 ($160-$200) a month. The incomes and consumption patterns of the unbanked households are as diverse as their occupations.

## *Formal financial services available to the urban poor*

A basic savings account is one of the most valuable financial services for the urban poor. Money put aside regularly allows the urban poor to store additional cash to fund small and temporary cash shortages instead of relying on loans that may have to be accumulated from various sources (Daryl, Collins 2009). In India, the formal institutions that have attempted to take banking services to the urban poor include banks and post offices (Postal Savings' Bank).

1. *Banks*

Commercial banks were obligated by the Reserve Bank of India (RBI) to promote financial inclusion by offering small accounts and no-frills accounts, two types of basic savings accounts to the lower income groups. A small account is a basic savings account that can be opened using a National Rural Employment Guarantee Act (NREGA) card, a job card provided to beneficiaries of the NREGA, a government employment guarantee scheme or a Unique Identification (UID) number, a number similar to the social security number in the U.S. that is unique to every resident of the country. It is a zero balance account and has certain transaction limits tied to it. The maximum balance you can maintain in it at any given point of time is ₹50,000 ($1000). Besides, the total of all withdrawals and fund transfers from the account should not exceed ₹10,000 ($200) per month and the total limit on all the transactions done through the account in a year should not be higher than ₹1,00,000 ($2000). Since a small account is opened using documents that do not satisfy know-your-customer (KYC) requirements, a stringent customer identification process laid down by the RBI mainly to prevent money laundering; the account is valid for just a year and is closed by the bank if the necessary documentation is not provided by the client within the year. A no-frills account is also a basic savings account similar to a small account but it is opened by fulfilling all the KYC requirements. It thus does not have any of the transaction restrictions imposed on small accounts. However, most of the no-frills and small accounts remain dormant, in other words there are no transactions in the account for over two years; indicating that they are not adapted to the needs of the poor (Ramji, Minakshi 2009). While one may initially believe this is due to a lack of demand, it is far more likely that these accounts remain dormant due their lack of usability and accessibility.

Apart from introducing basic savings accounts, other innovations that have been tried out on pilot basis to help banks serve the unbanked populations include business correspondents (BC), cash based NEFT (National Electronic Fund Transfers) and mobile banking.

Business correspondents: In order to further its goal of financial inclusion, the RBI has allowed banks to appoint NGOs, Post Offices, Insurance agents, *kirana* shops (mom & pop stores), retired bank and government employees, petrol pumps (gas stations) as business correspondents to do basic banking transactions such as identification of borrowers, collection and preliminary processing of loan applications, collection of small value deposits, receipt and delivery of small value remittances, sale of micro insurance, pension products and such other tasks. The RBI requires transactions done though BCs to be accounted for on a real time basis so that customers receive immediate verification of their transactions through visuals (screen based) or other means (debit or credit slip).

Cash based remittances through NEFT: National Electronic Fund Transfer (NEFT) is a mechanism of transferring funds domestically (and in Nepal) endorsed by the RBI. It can be used as a remittance and payment facility and is the most widely used system next to physical paper checks by most banks in India. The system is used mainly to transfer funds between individuals and firms having bank accounts. However, the RBI recognized the unique need of migrants who have bank accounts in their native villages but not in cities. It allows such individuals to deposit money into their accounts held individually or jointly with family members in branches in the native villages connected through core banking services (CBS), a system that allows banks to work though a centralized data center (servers) that enables them to access information of accounts held in other branches of the same bank. Migrant workers use this facility to remit money back to their families in the villages or to deposit money in their own bank accounts in the villages. The RBI restricts these cash remittances / deposits initiated without a bank account to a maximum of ₹50,000 ($1000) per transaction.

<u>Mobile banking / money</u>: In 2010, Bharati Airtel Ltd, a leading telecom company in India became the first telecom company in the country to be permitted by the RBI to issue mobile money, a semi closed instrument, an instrument that allows individuals to purchase credit in advance that cannot be converted into cash again. The credit purchased in advance and stored in the mobile phone account can be used to pay bills, and shop via mobile. Mobile money can be cashed out only if the mobile money account is held by the client in collaboration with a bank. Currently the only banking collaborator of Airtel is Axis Bank. In the same year (2010), the NPCI (National Payments Corporation of India), also launched a pilot of the immediate payment system (IMPS) platform to induce real time remittances that can be initiated though mobile phones. Currently remittances up to ₹5000 can be done through unencrypted SMS sent using a low end basic mobile phone as against transactions through more secure mobile applications on java enabled phones that have no limit.

Prepaid instruments: The State Bank of India (SBI) launched a 'Smart Payout Card' in April 2013 targeted at households and firms who wish to transfer payments to their workers who do not have bank accounts through non cash modes. The prepaid debit card can store cash, can be swiped in shops that accept card payments to make purchases and also used to withdraw money from the bank's ATM. Since KYC norms are relaxed for the employee if the employer fulfils the KYC requirements, it would be easier to access and could be a useful money management tool for the urban poor till they get access to a bank account. Unlike mobile money that is a semi-closed instrument meaning money cannot be withdrawn from the system unless the account is co-held with a bank the Smart Payout Card is an open ended instrument, an instrument that allows cash withdrawal from the system.

2. *The post offices (Postal Savings Bank)*

One of the big challenges banks face is establishing low cost distribution channels to reach out to the urban poor, banking on the postal network will help resolve this difficulty. The postal network already has a brick and mortar presence in urban areas and a fairly good coverage in rural areas. This network is not optimally used to help the urban poor remit money. Besides, the Postal Network is subsidized by the government and the postal savings bank is hence posed to absorb some of the high transaction costs instead of passing it on to the consumers. The postal savings bank was conceptualized in the early 19$^{th}$ century in India to help mobilize small savings. It offers savings and remittance services such as savings accounts, sending and receiving money orders and long term savings products such as National Savings Certificates to help mobilize the savings of small investors.

## *Barriers to accessing formal financial service*

1. *Demand-side Barriers*

Formal institutions have to adhere to non-negotiable regulations and policies creating hindrances to the unbanked poor who may try to avail of their services or find the services provided by formal financial institutions unsuitable.

High opportunity and transaction cost of the time spent in accessing a bank: Banks and Post Offices have fixed working hours that may not suit the schedules of the urban unbanked. The transaction cost of the time spent in going to a bank, and completing the transaction is high for people in the lower income segments (Platt, Ann-Byrd 2011). Since they work long hours and often do not have fixed work hours, their income earned is directly correlated to the number of hours of work they put in. The transaction cost is especially high for women who may have to juggle childcare, household responsibilities and their own work.

Inability to access funds due to limited coverage of formal banks: Some of the urban unbanked; migrate back to their villages during the planting or harvesting season. They may be unable to access the money stored in their bank accounts, if the bank does not have core banking services (CBS), a system that allows clients to operate their accounts and avail services from any branch of the bank; or if there is no bank branch located close to their village. If there is an ATM facility, ATM transactions could be possible. In India, the minimum withdrawal amount permitted in most ATMs is usually ₹100 ($2) and not all ATM machines have deposit facilities. If they do they cannot read old or soiled notes. Local markets in India operate mostly on cash basis so shopkeepers and service providers would be unwilling to accept a card payment. Post Offices have a better reach in rural areas, however the Postal Savings Bank has not adopted core banking services yet, and hence savings accounts held with the Post Offices are branch specific so these accounts can be accessed only from the branch where they are held (home branch).

Procedural difficulties: In order to open a savings account in a bank or a post office, an individual must produce an identity proof and an address proof. The documents accepted as a identity or address proof include passport, PAN card (an identification number issued by the income tax department), voter identity card, driving license, identity card (subject to the institution's satisfaction), letter from a recognized public authority or public servant verifying the identity and residence of the customer to the satisfaction of institution, telephone bill, bank account statement, letter from any recognized public authority, electricity bill, ration card or a letter from employer (subject to satisfaction of the institution) (Reserve Bank of India, 2011). While some of them are likely to have a ration card, voter id or driving license; not all of them are able to produce the necessary documents. In addition to this the applicant must produce a document to verify the signature and until recently two people who hold accounts with the institution already and are willing to introduce the applicant. The urban unbanked may have difficulty finding those two introducers as employers are generally reluctant to come forward as introducers and the people in their network are not likely to have savings accounts. This last requirement was reversed in January 2013 so it may not be a limiting factor in the future at least on paper. Women are also less likely to have all the documentation necessary to open a bank account than men as most of the services and assets are obtained on the men's name.

*2. Supply-side Barriers*

The nature of urban lives and awareness about the utility of formal financial services has created a demand for financial products and service. The lack of services despite the existence of a strong demand can be explained using the concept of incomplete markets. Incomplete markets exist when the conditions for a market exist, but some pre-requisites for a self regulatory market such as information symmetry, clearly defined property rights and reliable enforcement mechanisms are not present. These institutional barriers also create a hindrance to provide financial services to the urban poor.

High transaction cost incurred by the institution and the low profit-margin: Banks have not penetrated the urban poor market for several reasons. One of the main deterrents that has kept banks out of this space for years is low profit margins. Banks are generally for-profit companies and their main goal is to earn a profit. They will not venture into a business unless there are profits to be earned or they are obligated to by law. The transactions at the 'bottom of the pyramid' are high-frequency low-volume transactions (i.e., these transactions involve frequent withdrawal and deposit of small amounts). Many transactions make the administrative cost for the account rise (Matin, Imran 2002). The margin for profits is also very low as high user fees could deter the buyers.

Difficulty in enforcing contracts: Another main reason banks are unwilling to lend money to the poor is because there is no mechanism in place to ensure that the obligations to the bank are respected. Besides, the poor are perceived to be high risk borrowers as they are assumed to have higher default rates. This results in higher interest rates in the formal financial market as formal markets are based on the principle of reward the rule-abiding and punish the defaulters (Collins, Daryl 2009).

Information Asymmetry: The lack of formal documentation makes it difficult to create client records. Since most of the urban poor live in urban slums that are informal housing arrangements and / or work in the informal economy, they have very little documentation to prove their identity, background and credit history. This information asymmetry creates a hesitation among formal institutions to select who is worthy of credit.

Microfinance institutions (MFIs) have tried to address some of these issues. MFIs have also illustrated the demand for formal financial services among the poor.

## ***Microfinance Institutions***

The popularity of micro finance institutions and the evaluations that accompanied micro finance programs brought to light the need for financial services at the bottom of the pyramid. The poor were assumed to be uncreditworthy as they were believed to not have enough resources to save. In reality however, the poor save because they are too poor to not save (Daryl, Collins 2009) Given a choice, the poor would not only save for the near future but also for long term goals just like middle class families. This is illustrated by the popularity of the retirement savings product introduced by Grameen 2 in Bangladesh. The Grameen Pension Savings (GPS) is a major source of the Grameen Bank's growth in savings (Rutherford, Stuart 2002).

<u>Reducing information asymmetry:</u> Initially micro finance models eliminated the obstacles associated with lack of credit information and low transactions costs. Microfinance in India was underwritten by non-profit organizations and was introduced only through self help groups. Since individuals were free to form their own groups, the selection process ensured use of existing information between the participants and individuals who were uncreditworthy would be automatically dropped. This could also explain the high repayment rates experienced by the self-help groups.

<u>Lowering transaction cost:</u> The group members were first asked to lend and save individually within the group and discipline their finances in accordance with the requirement of formal institution. Once, all individuals had begun to save in a disciplined manner and the group members had gained some proficiency in using loaned money and repaying it, the group could approach banks for credit. In addition, since transactions are lumped together and money is

passed directly from the lenders (or the savers) to the borrowers (or the dissavers) some cost of intermediation and the overall transaction cost are also reduced. This model, unique to India enabled the unbanked to gain access to banks armed as a group and underwritten by an NGO.

The first wave of microfinance thus focused on a basket of financial services – savings & credit and also brought along social changes. The second wave of microfinance that involved several private for profit players had a wider reach but could only meet credit requirements. These institutions can only give out loans as most of them did not have banking licenses. In India, companies without a banking license that provide financial services are called non-banking financial companies. Non Banking Financial Companies (NBFCs) are not allowed to collect deposits or hold public money. In India, MFI are classified as NBFCs and therefore are not allowed to collect deposits and hence MFIs are not designed to meet the entire portfolio of financial needs of the poor.

Microfinance has mainly focused on just one type of credit requirement – capital for business investment or expansion. A considerable chunk of the urban poor households have no need business capital. They have a fixed job in the service industry and hence do not need any credit for business expansion. However, they do need loans and savings for other purposes such as life cycles expenses and consumption smoothening.

The loan cycles of micro finance companies also have very rigid time cycle for loan repayment. Borrowers are expected to pay back predetermined installments on fixed days. However, the incomes of the urban poor are volatile and cannot match the predetermined nature of cycle. Individuals gain membership to several MFIs with different repayment schedules in an attempt to match the cash outflows with their inflows. The possibility of repaying back more frequently will make the repayment schedule more user-friendly.

## *Currently how do the urban poor meet their financial needs?*

Given their exclusion from formal financial institutions, the urban poor have evolved their own informal devices and systems to meet their financial needs. Currently, many of these do not distinguish between savings and loans. These mechanisms help in putting together small amounts to create a useful large sum. Sometimes the lump sum occurs at the end of the cycle when the different amounts loaned out to peers earlier in the year are reclaimed while sometimes it occurs at the beginning in the form of a loan or it can even occur in the middle of the cycle depending on how members decide to draw the lump sum. In case of individuals who are members of savings group cycle after cycle, whether the lump sum came first or last does not matter anymore and hence the distinction between loans and savings may be lost (Daryl, Collins 2009).

The urban poor use savings and credit mechanisms as substitutes for insurance to recover from shocks (Platteau, Jean-Philippe 1987), (Alderman, Harold 1992). The risks they face include demolition of hutments by civic authorities, confiscation of street vendors' goods, accidents at construction sites, and sudden loss of jobs. All the risks they face are very diverse and are not covered by insurance companies.

In the section that follows I will analyze how informal money management mechanisms overcome challenges faced by institutions in reaching out to the urban poor. I will also highlight limitations of these informal services compared to formal financial institutions, and highlight how formal institutions could be more successful in reaching the urban poor if they took into account the needs and limitations of the urban poor.

1. *Hiding cash at home or carrying it on person*

The simplest way of saving money for future use is simply storing it away at home in a trunk or cupboard or under the mattress (Daryl, Collins 2009). Having cash at hand is the most accessible way of storing money for emergencies. Money stored at home also has the least transaction cost, as individuals do not have to step out of their way to access it; this is especially important to women. In India it is not uncommon for women to store some money in the bottom of the rice bins or some other place in the kitchen where a man is not likely to look for it. In fact there is even a word in some Indian languages to describe this stash maintained by women. For instance, in Bengali, money tied in knot at the free end of a *sari* is called *jula.*

However, having cash at hand has its disadvantages too. Money saved at home is more prone to being spent on pressing current demands or general spending temptations instead of being saved for the future. For instance, when respondents in a survey at Hyderabad were asked to list if there were any expenses they would like to cut down, 28% of the poor named at least one item they would like to cut down on. Alcohol and tobacco topped the list (44%) followed by sugar, tea, and snacks (nine percent), festivals (seven percent), and entertainment (seven percent) (Banerjee, Abhijit V 2007). The discretionary expenditure is not gender neutral. Men are more likely to spend on tobacco, alcohol and tea than women. Within the household not everyone enjoys equal power and influence in the financial decision making process. Depending on the family structure, the woman may be subordinated to the mother-in-law or her husband. The woman may thus not be able to exercise her authority on the savings at home. It can be taken away by the husband, son or the mother-in-law (Rutherford, Stuart 2009). One may also feel compelled to lend cash on-hand to a neighbor or friend who needs cash urgently.

Given the vulnerable homes of the urban poor, the money stored at home is prone to theft and likely to be lost during police raids, floods, fires or other disasters that may befall the slums. The possibility of theft has been documented in previous research, though there is no data to illustrate how much of a concern it is (Banerjee, Abhijit V 2007) , (Rutherford, Stuart 2009). In a qualitative study done by tracking the financial lives of poor in diaries by Collins et al, a participant reported cash worth ₹2800 ($56) stolen from his hut (Daryl, Collins 2009) A simple Google news (India edition) search for ‘slums + fires’ returned at least 10 instances of small or big fires in urban slums across the country during the last year. There is also a possibility of more fires that went unreported or did not make it to the search results.

Gold: Savings in the form of gold are inefficient from a macro perspective. A high proportion of gold savings in India are in the form of jewelry and other artifacts. Savings in the form of gold lock up national resources as these cannot be invested and put to a productive use. Incentivizing households to monetize their savings in the form of gold will increase the FDI available for investment, it will also free up foreign exchange reserves to import other resources of priority such as crude oil.

There are disadvantages to the individual investor as well. For instance, savings in the form of gold will not earn the investor interest and there is some value loss when it is liquidated. Despite these disadvantages, poor households save in the form of gold because they have easy access to it (Desai, Meghnad 1989) (Panikar, PGK 1961).[3] Since gold is saved in the form of women’s jewelry, the women are likely to have more bargaining power in decisions involving buying and selling gold.

[3] Both Desai and Panikar speak mainly in the rural context.

Gold is considered both a symbol of wealth as well as a form of investment in India.[4] Anyone who has money can go and buy it, so it is popular among all segments of the society. There is no contract that needs to be guarded. It is common for individuals to save as much as possible and then purchase the quantity of gold they can with it. In recent years gold deposit schemes have also become popular. Several jewelry stores have cropped up in the urban slums. These shops allow customers to pay a fixed amount every month for a year. In the last month, the jeweler adds the monthly amount to the client's account and the clients can buy gold or a piece of jewelry equal to the amount accumulated in their account. These gold deposit schemes give the urban poor an opportunity to save in a disciplined way and keep their deposit safe albeit for just a year. A report released by the RBI in February 2013 acknowledges the role of gold in accumulating savings but it speaks mostly in the rural context. There is no data about how widespread gold savings are in the urban slum areas.

Unlike the cash hidden under the mattress, accumulating savings in the form of gold or jewelry protects it from inflation. Also in the long run, accumulating gold can help tide over one of the biggest expenses that a household has to incur during its life time – the children's wedding expenses. In South Asia marriage expenditure is a substantial component of the household budget even for the poorest families (Daryl, Collins 2009). Marriage expenses include both logistical expenses such as cost of the location, food and rituals as well as the gifts (including gold jewelry) given to the bride and groom and other relations.

Since the gold saved in the form of jewelry is owned by the woman, she has more authority on it. Her voice is likely to weigh in more on decisions pertaining to selling or pawning gold.  Unlike cash that can be spent easily, the transaction costs involved in liquidating gold and

[4] India is the world's largest importer of gold and imported $58 billion worth of gold in the fiscal year ending March 31, 2012.

the emotional value attached to it safeguards it from temporary temptations and secures the investment for the long term.

In the short term, pawning gold or using it as collateral to borrow from the informal market during times of need can help tide over short liquidity crunches. Pawning gold involves a transaction cost in the form of the time and money spent to visit a pawn broker. There is also value loss because neither the jeweler can sell the piece of jewelry, nor will he lend the individual money equal to the value of the jewelry pawned. Pawn broking helps eliminate costs associated with information asymmetry; because individuals usually pawn it with the jeweler they purchase it from. Besides, the jeweler most likely lives in the same slum as the individual and he knows the reason for the cash emergency, he is thus in a position to judge the risk associated with the transaction. The popularity of gold as collateral has also resulted in the mushrooming of several loan-against-gold companies in the recent years however the estimates of how widespread this practice is are unavailable (Rao, K.U.B February 2013).

2. *Borrowing from friends and family*

The informal agreement between community members to lend to each other during times of trouble is possible because everyone is more or less aware of each other's finances and repayment capacities. The poor harness the collective saving power of their network by securing interest free loans from their friends and family. This is one of the most common sources of credit used by the poor (Daryl, Collins 2009), (Demirgüç-Kunt, Asli 2012). Since these loans are taken and given out of goodwill, there is an unwritten understanding that the loans will be reciprocated with future loans when necessary. They are thus a form of social investment (Guyer, Jane 1997). The loans depend to a great extent on the relationship between the borrower and the lender, their earlier transaction history and the negotiation skills of the borrower. To the borrower, the informal loans help meet a credit crunch, to the lender, the informal loans are a form of savings. By loaning out money to someone who needs it more than they do at the moment, the lender saves the money for future exigencies. It also helps keep the money secure as leaving it idle at home is unsafe.

Low monetary transaction costs: Although loans taken from friends and family generally do not have an exorbitant interest, they come with other transaction costs. For instance, the time invested in securing the useful amount is high as the borrower may have to connect with several potential lenders and present his need before they agree to lend. The borrower thus spends considerable time visiting and speaking to several people. Since the potential lenders are often people from the borrower's socio-economic class, they may not always have the ability to lend even if they are willing. Another difficulty is that one borrower may obtain small amounts of their overall loan from many lenders. So the borrower has to remember the sums borrowed from several different people. It also brings along the risk of making their personal financial life a public gossip topic.

Just like several other mechanisms employed by the poor to manage their finances, the informal loans obtained from friends and neighbors are also not given out for profits. As mentioned above all the costs associated with the loans are non-monetary, thus the loans are not very expensive to obtain in terms of money. The low cost of the loans makes them affordable. Secondly, the loans are secured from people who know the borrower outside the financial transaction. The lender is familiar with the borrower, his / her family, native place, and other pending credits and so on. Thus the lender is able to judge the repayment capability of the borrower. Unlike a bank, they don't need to rely on credit history.

Social norms help to ensure contract enforcement: Transactions in the informal sector are based on implicit understandings and unwritten norms or contracts that are respected for several reasons. Usually these are multilateral contracts where individuals maintain informal relations with several other individuals who are familiar with each other (Jagannathan, N V. 1987). When the loans are taken within the community, both the lender and the borrower know that the lender is going to need the money back as desperately as the borrower needed it when the loan was secured. Not returning the money will mean that the borrower will not be able to borrow money again from that lender or most likely from anyone else familiar to the lender because the news of the loan default will pass through informal information channels and people will be unwilling to lend to the borrower fearing they may lose the money forever.

Alternatively, the urban poor's high risk of default results in higher interest rates in the formal financial market. The formal markets are based on the principle of reward the rule-abiding and punish the defaulters (Daryl, Collins 2009). While informal markets are also organized on similar mechanisms guaranteed by the social contacts, there is more possibility of dire circumstances being taken into account. For instance, if someone absolutely cannot repay a loan obtained from friends and family, it is more likely to be forgiven than a loan obtained from a microfinance institution. Contracts are informal and are negotiated and renegotiated frequently depending on the needs of both the borrower and lender and their re/payment ability. This flexibility does not exist in the profit making arena that relies on rigid rules to ensure that their business does not fail.

*3. ROSCA/ Chit funds/ Savings groups*

Savings groups are an informal yet organized arrangement that give women a platform that goes beyond financial matters. The mechanism relies on the group members to generate a pool of resources to dip into and use their knowledge to minimize the risk. Savings groups or Rotating savings and credit association (RoSCAs) are called chit funds in India. A group is formed and each member of the group contributes a predetermined amount of money that is taken home by one member of the group at each meeting. After every member has taken his / her turn at taking home the lump sum, the group may dissolve or proceed with another cycle. The order in which the group members take the funds may be predetermined or determined by a lottery system. Chit funds are very useful to accumulate a lump sum and help to inculcate a savings habit. One problem with these chit funds is given their predetermined or unpredictable cycles the time of the payout cannot be dictated by the individual member. So, the participant cannot match the inflow of cash with the outflow. The money saved may not be available when it is required.

The formal sector equivalent of a chit fund is a recurring deposit. Every month a fixed amount is deducted from the bank account and at the end of the tenure, the amount with the interest is cashed back in to the account. Since the bank has access to credit histories and other documents, the contract between the account holder and the bank is a simple bilateral contract that is kept secret. The structure of RoSCAs helps to eliminate several market imperfections and the costs associated with them.

<u>Social relations help reduce information asymmetry:</u> RoSCAs are based on mutual trust. Entry into a chit fund group is highly restricted / monitored. New members sometimes need an existing member to vouch for them. This ensures that the group does not tack on members who are ‘high risk.’ Group members are likely to come from the same social circle, neighborhood or occupational group. The members who come together to create a group are acquainted with each other outside the chit fund and share other social ties. They are aware of the risk appetite and finances of the other members and can judge the creditworthiness of the other members. This

helps ensure there is close to perfect information and makes up for the lack of credit scores or reports.

Contract Enforcement: Selection mechanisms associated with RoSCAs also solve the problem of enforcing contracts. Because the participants are engaged in complex multilateral contracts with several other members of the group at different levels, there is an obligation to respect the contract, keeping in mind the information channels that will reduce their ability to access credit in the future in case of a default. The poor are eager to keep their credit avenues open in case of future emergencies and hence go out of their way to respect contracts. This is evident from the good repayment rates that MFIs have enjoyed.

Low transaction costs: Since RoSCAs are organized for the people by the people, there is rarely an outside manager who charges fees; thus the transaction costs are low. The cost of intermediation is absent since the money passes directly from the lenders to the borrower (Rutherford, Stuart 2009). The opportunity cost of time to the group members is also low as all transactions are done near home. The members can just drop off their share with the manager a day or so before the due date. If it is a lottery system, participants will often send their share with someone else, if their name has already been drawn.

Since RoSCA members have a binding obligation to contribute their share every month, it is easier for the women to justify and save their share of payment. This allows them to diligently put aside money routinely. Some RoSCAs also sanction loans for specific purposes. This could help women check the misuse of the funds by their husbands or other family members and increase their control over their savings.

The biggest transaction cost of RoSCAs and savings groups is the time spent in attending group meetings -to sanction loan disbursal- which takes considerable time. The opportunity cost of these meetings is significantly high for women. However, gathering for meetings also provide a forum to women to discuss common issues that may require collective action such as approaching authorities; taking up issues as a group instead of individually increase their bargaining power and visibility.

## *Policy Implications*

Although the poor have adapted the existing products and services to suit their needs and / or developed ingenious informal mechanisms to cope with their needs, they see a value in accessing formal institutions due to various reasons. Informal systems and even the existing formal systems come with a cost or inconvenience that can be avoided if better products and services are introduced. Developing policies that balances risk and promoting access would help institutions reach out to the 'bottom of the pyramid'.

1. *Unique Identification (UID) Project*

The concept of a unique identification number for every permanent resident of India was first conceived in the mid 2000s and the first UID number - a 12 digit alpha-numeric number called Aadhaar- was issued in 2010. The project has high potential to facilitate access to formal services as the UID will enable people to produce authentic identity proof, the project is likely to give a big boost to financial inclusion. There is also potential to link credit histories to the UID number to facilitate lending to the urban poor. As of today, according to a press release issued by the Unique Identification Authority of India (UIDAI), 230,000,000 residents have enrolled for the Aadhaar number, 21,000,000 Aadhaar numbers have been allocated, and over 150,000 Aadhaar enabled bank accounts have been opened in the country but evaluations of their usage have not yet been done (Unique Identification Authority of India 2012). The project is still in a nascent stage, but has tremendous potential.

2. *More inclusive policy*

It is important for regulators to put in place a policy that will enable mobilization of savings. The Reserve Bank of India (RBI) does not allow non banking financial companies (NBFC) to collect deposits. Since reliable micro finance institutions (MFIs) that do not have a banking license are not allowed to collect deposits as they are classified as NBFCs, the poor are pushed to use options that are more riskier to safe keep their money (Daryl, Collins 2009). The government faces a trade-off between implementing stringent policies to ensure the safety of depositors' money at the cost of lenient policies that will make it easier for financial service providers to penetrate the grass roots and develop services that will ease the financial lives of the poor (Wright, Graham A.N 2001). There is also a need to institutionalize existing informal frameworks to make them more reliable and incentivize urban co-operative banks (UCB), institutions that are conceptually similar to credit unions in the U.S. to take a lead.

3. *Use of facilitators*

Use of facilitators such as existing distribution channels and technology can help speed up financial inclusion in India. Innovations such as mobile banking that ride on technology can help cut costs incurred by service providers. India boasts of a very high rate of mobile penetration. While only 6% of urban households in the country own a landline, about 65% of the households own at least one mobile phone (Census of India, 2011). Getting access to a cell phone is easier than getting a landline, so those who lived without a telephone jumped on the opportunity to buy and use a mobile phone. In fact, the procedures to obtain a landline in India are quite close to the procedures to open a bank account. Technology can also be used to overcome the inflexibility and rigidity of institutions such as fixed working hours and make services more accessible and user friendly.

Allowing banks to reach out to the unbanked poor through business correspondents – agents authorized by banks to handle transactions at the client end on behalf of them - will give a further boost to financial inclusion as it will allow banks to use existing distribution channels and agents who are already established in the system and trusted by the urban poor such as *kirana* shops (mom & pop stores). Transacting through a *kirana* shop early in the morning or late in the evening is likely to be a lot easier for the urban poor than visiting banks during business hours. A doorstep banking initiative launched by Yes Bank combines the use of both technology and business correspondents. Speedy evaluations of such pilot projects so that they can be improvised, scaled and replicated would also help accelerate access to financial services.

*4. Gender Implications*

Taking into account, specific factors that would facilitate the use of banking services among women would help overcome gender disparities. Households do not operate as units, there is inequality within households (Agarwal, Bina 1997). Women are known to experience discriminated access to healthcare, education and have lesser weight in household decisions. Women are subject to social limitations unlike men and also have a lot more demand on time their time. Women are more likely to value informal mechanisms that do not have rigid office hours for transactions; and are usually a few steps away and fairly accessible. In the formal arena, mobile banking is likely to be more valuable to women for similar reasons. The transactions can usually be done discreetly by the women when visiting their friends or walking home from work with them. This minimizes interference from the husbands and also helps the women create their own stash to go back to in an exigency.

*5. Collective Action*

Using '*collective capabilities'* has helped the poor overcome several problems in the past by putting pressure on the state to enact job security legislation, a public health service, the minimum wage, public employment, state pensions, state education and training services that play a crucial role in meeting the needs of the poor in the society for a more secure and dignified working life (Bateman, Milford 2010).

Collective actions such as group lending can also address barriers that institutions face. Under group lending schemes, a group of individuals together open a bank account. One person is the point of contact with the bank on behalf of everyone. This person maintains the intra-group accounts, while the bank only has to maintain the account for the group as a whole. Besides, some transactions are intra-group and the rest are lumped together. So the transaction cost of the bank reduces. Group lending also helps ease the restrictions related to identity and address proofs. So long as one individual can produce the necessary documents to the banks satisfaction, everyone in the group gets access to a bank account indirectly. Since group members are familiar with each other, they act as guarantors or a form of collateral for each other.

Similarly, there is potential to incentivize urban co-operative banks (UCB), which are similar to credit unions in the United States. Savings groups and RoSCAs could be encouraged to graduate into UCBs on the lines of what was done in Kerela, a state in Southern India (Bateman, Milford 2010). While the micro finance movement in the rest of the country focused on connecting self help groups with banks, in Kerela, these were encouraged to formalize and thereby serve not just the founding members who were a part of the RoSCA or savings group but also others within the network.

## *Conclusion*

This paper established that financial services are valuable to the urban poor. However, their needs, challenges and profile are unique. This leads to both demand and supply side barriers. On the demand side, the high opportunity cost of accessing these services and the procedural complexities are a deterrent to accessing formal financial services. On the supply side, institutions attempting to serve the unbanked face challenges associated with regulating the clients such as information asymmetry, difficulty in monitoring and enforcing contracts. They also do not see this as a profitable segment due to the high transaction cost and scope for low profits. In India, currently several banking innovations are attempting to overcome these challenges, however, it is important for financial institutions to understand how informal mechanisms developed by the poor to meet their own needs overcome these barriers and adopt similar checks and balances to better regulate their business in this segment and make it more user friendly. Informal mechanisms rely on the social network that the communities live in to create a pool of resources they can draw out from during times of need. The social norms ensure that there is give and take and financial obligations to each other are met so as to keep the avenue open in case of a future need. However, the informal mechanisms are unreliable. Microfinance helped overcome some of these challenges, but it focused mainly on the women in the rural areas in India and was able to address only the credit need to tap into entrepreneurial opportunities. It did not address credit needs for other purposes, and the savings and remittance needs of the poor. Hence the need for formal services. The UID project is poised to solve the biggest challenge that both banks and individuals face, lack of documentation to establish the identity of potential customers. Other than that, developing products and services customized to this group, taking into account the specific needs of women and promoting postal banks and urban co-operative banks (UCBs), using facilitators and developing a more inclusive policy will help the RBI cover the last mile.

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# ***Appendix***

*Poverty line*

The latest (2009-10) poverty line for India defined by the Planning Commission was as follows ₹859.6 per month per capita for urban areas and ₹672.8 per month per capita for rural areas.[5] The poverty line in India is defined by calorie / nutritional intake and hence accounts only for food expenses.

*Small accounts*

A small account is a basic savings account that can be opened using a NREGA card or a UID number. It is a zero balance account and has certain transaction limits tied to it. Since a small account is opened using documents that do not satisfy KYC requirements, the account is valid for just a year and is closed by the bank if the necessary documentation is not provided by the client within the year. Read more here http://alturl.com/zpnbc

*No frills accounts*

A no frills account is also a basic savings account, but it is opened by fulfilling all the KYC requirements. A no frills account does not have any of the restrictions imposed on small accounts.

*Core banking services* (CBS)

CBS allows banks to connect to a network so that clients can operate their accounts, and avail banking services from any branch of the Bank on CBS network, regardless of where he maintains his account.

*PAN Card*

A PAN card or the permanent account number is issued by income tax authority in India. It is equivalent to an ITIN in the U.S. IN order to obtain a PAN card; applicants need to provide documentation to support address and identity.  Read more here: http://alturl.com/3pi6q

*Ration card*

A ration card is document that lists all members of a family, so that the household may access public distribution system (PDS) shops (fair price shops) in India to buy food and fuel if it is a low income household.

*KYC*

[5] Press Note on Poverty Estimates, 2009-10 issued by the Planning Commission, GoI on March 19, 2012

KYC or know your customer is a client identification process that the RBI requires all financial service providers to follow. In order to fulfill the KYC requirements, clients have to furnish proof of identity and address. A list of accepted document can be found here http://alturl.com/byuzq

*Dormant / Inoperative account*

A savings as well as current account is treated as inoperative / dormant if there are no transactions in the account for over a period of two years.

*Urban Areas*[6]

The data in the table on Final Population Totals are presented separately for rural and urban areas. The unit of classification in this regard is 'town' for urban areas and 'village' for rural areas. In the Census of India 2001, the definition of urban area adopted is as follows: (a) All statutory places with a municipality, corporation, cantonment board or notified town area committee, etc. (b) A place satisfying the following three criteria simultaneously:

i) a minimum population of 5,000;
ii) at least 75 per cent of male working population engaged in non-agricultural pursuits; and
iii) a density of population of at least 400 per sq. km. (1,000 per sq. mile).

For identification of places which would qualify to be classified as 'urban' all villages, which, as per the 1991 Census had a population of 4,000 and above, a population density of 400 persons per sq. km. and having at least 75 per cent of male working population engaged in non-agricultural activity were considered. To work out the proportion of male working population referred to above against b) (ii), the data relating to main workers were taken into account.

An Urban Agglomeration is a continuous urban spread constituting a town and its adjoining urban outgrowths (OGs) or two or more physically contiguous towns together and any adjoining urban outgrowths of such towns. Examples of OGs are railway colonies, university campuses, port areas, etc., that may come up near a city or statutory town outside its statutory limits but within the revenue limits of a village or villages contiguous to the town or city. Each such individual area by itself may not satisfy the minimum population limit to qualify it to be treated as an independent urban unit but may deserve to be clubbed with the town as a continuous urban spread.

For the purpose of delineation of Urban Agglomerations during Census of India 2001, following criteria are taken as pre-requisites: (a) The core town or at least one of the constituent towns of an urban agglomeration should necessarily be a statutory town; and (b) The total population of all the constituents (i.e. towns and outgrowths) of an Urban Agglomeration should not be less than 20,000 (as per the 1991 Census). With these two basic criteria having been met, the

[6] Census of India 2001

following are the possible different situations in which Urban Agglomerations would be constituted: (i) a city or town with one or more contiguous outgrowths; (ii) two or more adjoining towns with their outgrowths; and (iii) a city and one or more adjoining towns with their outgrowths all of which form a continuous spread.