# Economic Watch
## Financial Inclusion

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Economic Analysis

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# The Financial Inclusion Law in Uruguay

On 24 April Uruguay passed the Financial Inclusion Law, which requires wages and pensions to be paid into an account (or debit card) in the formal financial system. This will bring about a major increase in both access levels and use of formal financial services.

The key reforms introduced by the law are[1]:

- Mandatory payment of wages and pensions through financial institutions
- Opening and free maintenance of accounts for workers and SMEs
- Granting of "payroll loans" to be subtracted from wages
- Reduction in value added tax for payments by card
- Restrictions on payments in cash
- A savings programme for housing

Uruguay enjoys one of the highest per capita incomes in the region, but nevertheless has relatively low levels of bank usage. Access to formal financial services, as well as access to education and healthcare, is a key ingredient contributing to greater wellbeing and increased prosperity. Passing this law, which will come into force in August, will have a major impact on financial inclusion. Its principal aims are: to improve the population's access to financial services (saving, credit and payment instruments), to reduce the use of cash as a payment instrument, to encourage saving by young people and to support the growth of the formal economy[2].

The purpose of this paper is to report on the economic environment in Uruguay at the time of the passing of the Financial Inclusion Law. By calculating related indicators, we endeavour to present the country's current situation in terms of financial inclusion in the light of the future law, in order to show empirical evidence that can be used for subsequent analysis and evaluations. We have used micro data from the Global Findex (2011) survey carried out by the World Bank.

1: For a detailed description of the Financial Inclusion Law, see the legal text.
2: Taxes and rentals will also be paid using bank accounts.

## Bank accounts

Uruguay has a bank usage penetration rate of around 24% of the adult (older than 15) population and only a little more than half of these banked individuals use a bank account to receive their wages. The proportion of people receiving their incomes through a bank account varies considerably by income level, from 39% in the poorest income quintile, to 67% for the richest quintile. It is interesting to note that there are no differences by gender when it comes to having a bank account, but that there are variations in the percentage of people who use them to draw their wages. 57% of men receive their remuneration from work in their bank account while for women the percentage is 50%. This difference is not very significant if we compare it with other developing countries. As to the reason for opening these accounts, 72% state that they did so for personal reasons, while only 0.4% did so for business purposes, and 11% for both motives.

## Credit

The immediate effect of this new law will undoubtedly be seen in high numbers of new customers and an increase in local currency financing, generated by new deposits. The simple existence of this type of account will improve access to credit by making it easier for banks to provide "payroll loans". Having better information means that risk is significantly reduced. In this way, banks will be able to offer loans at lower rates than other types of consumer credit, while preserving asset quality.

Reducing credit risk is particularly helpful in a banking system where prudential issues are key when granting credit. Between 2010 and 2011, only 15% of individuals in the country had a loan, with the proportion evenly distributed between men and women (16% and 14% respectively).

## Barriers to financial inclusion

The law prevents this type of account for workers from charging commissions, which will mean banks having to make an extra effort, on top of the high operating costs they already support[3,4]. These costs may be offset by an increase in providing low risk loans which, together with the increase in potential demand, will mean that the overall amount of money out on loan will expand[5]. High maintenance and opening costs of bank accounts are the main obstacles perceived by that part of the population that is excluded from the financial system (without considering those individuals excluded for having no money!). 26% of the non-banked claim that they do not get involved in the formal financial system because financial services are too expensive.

## Deposits

The law will also contribute to an increase in banking deposits. Specifically, there will be an increase in national currency deposits over dollar deposits. The latter are a reflection of the lack of trust that individuals have in the national currency. The percentage of people declaring they have saved money in the last year is only 17%, equally distributed between men and women. Only 34% save in a formal manner and 13% do so in savings clubs, or ROSCAS (Rotating Savings and Credit Associations), which are considered to be in the informal sector.

The increase in deposits will represent a new source of financing in the local currency, with favourable conditions for banks. This measure, as well as reducing exchange rate risks, enables banks to increase their peso-denominated loans.

3 The law requires banks to authorise unlimited balance consultations, as well as a minimum of five withdrawals in the network free of charge a month; in the case of accounts in financial intermediation institutions, eight transfers free of charge a month to the same institution or another local bank.
4 See IMF (2011) for a detailed analysis of the causes of low profitability in the Uruguayan financial system.
5: To compensate for this increase in costs for banks, the law will grant them compulsory retention of wages and pensions.

Historically, this final issue has hindered banking growth and this has translated into a very low credit intermediation rate (25% of GDP in the last decade). In recent years, growth has focused on financing consumer operations, in the form of credit cards and personal loans.

## Payment instruments

Another interesting aspect to the law is that it encourages the creation of incentives to keep one's money in deposits, in preference to cash. This is designed to drive debit card payments, which will be treated in exactly the same way as cash payments. This preference for payment by debit card will be incentivised with a reduction in the value added tax which will be charged on payments made using this type of card. In Uruguay, only 16% of the adult population has a debit card, with the proportion being the same for men and women. Nevertheless, the number of individuals with a credit card is nearly double this (27%). The percentage of women with this kind of product is slightly higher than men, 30% compared to 24%. For both kinds of card, debit and credit, the percentage of holders goes up significantly in line with income level.

## Concluding remarks

The coming into force of the Financial Inclusion Law represents a great opportunity for both the financial sector and for households. The former is going to benefit from a significant increase in bank usage, better information for risk assessment, an increase of deposits in the national currency and greater use of credit cards. In this new scenario it will be the individual who chooses the financial institution into which the wage will be paid; formerly it was the company which chose. As a result, fierce competition is expected between banks to attract these linked accounts.

In this new scenario, designed by law, there is an opportunity for product innovation for the financial sector. The use of new technologies, which enable new products to be created incurring lower costs and better adapted to their customers' needs, will be key in the race towards banking penetration. Those financial institutions which offer ample access to financial services as well as differentiated products, and which are able to communicate the usefulness of these products, will have an important advantage.

When it comes to private individuals, these will benefit from the advantages offered by financial products, such as greater security, access to credit in better conditions, smoothing out of cycles which cause irregular income and which impact on consumption, better tools for dealing with unexpected events (health problems), as well as long-term saving and education funding, among other areas. This is likely to provoke a change in the behaviour of those individuals who have previously been excluded from the formal financial system. This change will take place principally in areas related to payment execution, planned savings and in the way in which these individuals manage risk. The new law is particularly helpful for the most vulnerable groups in society, at especially high risk of financial exclusion (young people, individuals with low income or limited education, women and those living in country areas).

Nevertheless, there are certain risks which must be borne in mind. Access *en masse* to financial services and the ease of obtaining credit may mean that individuals who do not have the necessary financial skills could take irrational decisions which end up harming them. This type of decision involves choosing between consumption and saving, and judging which levels of debt are appropriate so as not to forego future consumption unnecessarily. Financial education is the key to responsible consumption of these types of services, and so that both individuals and banks can profit from the advantages that financial inclusion brings. Policies designed to encourage financial inclusion should not seek the use of financial services at any cost, but rather guarantee access to these services in suitable conditions and promote their responsible use.

# Bibliography

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