FINANCIAL INCLUSION

The Fundamentals of Financial Inclusion: an Overview

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1. Introduction

Unprecedented rates of economic growth in middle income and developing countries over the past decade have raised more than 1 billion people out of poverty (United Nations, 2013). A central element that has fueled this progress is the development of the financial institutions and infrastructure within these countries that has enabled many to access savings, payments, and risk management instruments to support their participation in a modern market economy. While impressive in the outcomes that have been achieved, in the eyes of many, the development of financial sectors and the associated process of "financial inclusion" remains in its' infant stage with considerable potential for growth in the years to come.

The object of this paper is to summarize relevant issues on financial inclusion and its impact on the global society. The document discusses topics such as the barriers to financial inclusion, financial literacy, consumer protection and regulation. It also presents efforts from developing countries to foster financial inclusion through collaboration and specific agreements. This overview of recent advances in financial inclusion would be a good point of departure for in-depth studies in this field. In addition, it may be useful for non-expert readers to have an idea of current, relevant financial inclusion topics.

Many countries and development institutions are moving toward a focus on achieving financial inclusion in their strategies for growth and poverty alleviation. Extending financial inclusion to all corners of the globe has caught the attention of those committed to sustainable development. The G20 has established the Global Partnership for Financial Inclusion (GPFI) to develop principles and share experience in achieving these goals. The GPFI, a joint venture of the Alliance for Financial inclusion (AFI), Consultative Group to Assist the Poor (CGAP), and the International Finance Cooperation (IFC), seeks to enhance "peer learning, knowledge-sharing, policy advocacy and coordination on financial inclusion" (G20 Financial Action Plan). The World Bank's 2014 Global Financial Development Report (2013) indicated that over "2\3 of regulatory and supervisory agencies are now charged with enhancing financial inclusion". Also, the World Bank's president, Jim Yong Kim, stated the goal of achieving universal financial access by 2020. A variety of emerging research supports the case for growth through broader participation in the formal financial sector and is beginning to illustrate how this participation benefits individuals. According to CGAP, low income groups benefit from financial inclusion the most due to their lumpy consumption and the lack of an effective safety net to manage unexpected economic shocks (Deb and Kubzansky, 2012).

Effective public policy and real progress in this area require consensus and clarity of the relevant concepts and pathways of change. A strong business case for financial institutions involvement in promoting financial inclusion is also evident, providing a role for the private sector. There are however, innumerable barriers to achieving a more inclusive financial environment. Obstacles range from issues of geography to a lack of coordination, from the tangible to the intangible, and from the international level to the individual level. Some of the hurdles are a result of the lack of knowledge of financial concepts and instruments in an underdeveloped environment, while others are associated with patterns of behavior resulting from cultural and psychological tendencies. Some interventions seem easily obtainable, such as the promotion of savings accounts through reduction in bank fees, while others face the more complex task of changing behavioral tendencies that have persisted for centuries and may be deeply embedded in human nature.

One of the first steps to continued progress in this area is to achieve some clarity on concepts and terminology to enable a common vocabulary to support the development of goals, a paradigm for change and creation of measures for the evaluation of progress. Key issues in achieving this are the concepts and definition of financial inclusion, financial capability, and financial education, along with the development of a model for change that provides an understanding of the distinctions among these terms and how they combine to achieve the outcomes of development, growth, and enhanced individual well-being.

2. Defining Financial Inclusion

The term financial inclusion has taken on a multitude of meanings and is too often perceived as an outcome by itself, rather than a means to an end. To some, it is simply conceived as access to a local bank branch, while to others it has expanded to encompass a wide variety of measurements hinging on the psychological tendencies and patterns of behavior of each individual. There is no accepted or unified definition in the global community, and each entity seems to support and push for their own characterization. There are three major schools of thought surrounding the definition, each weighting measures of “inclusion” differently. The original definition is shallow and therefore outdated as it is only concerned with broad density indicators such as ATMs per capita or accessibility of bank branches (World Bank, 2013). The term subsequently evolved to incorporate a variety of indexes and indicators, with financial inclusion moving toward a definition as “the share of the population that uses formal financial services” (Demirgüç-Kunt and Klapper, 2013). However, others have moved well beyond this to far more comprehensive concepts that define financial inclusion as the combination of financial access, financial capability and engagement with the financial system (Deb and Kubzansky, 2012).

The international community has yet to successfully develop a metric that focuses on the demand side of the equation. The leading reports and surveys reveal extensive data on outputs, but have been unable to synthesize a technique that can incorporate the behavior of individuals. Furthermore, the lack of a definition is a product of the challenges in achieving cooperation and agreement among the various institutions that are engaged in the effort. Recently, this challenge was addressed with the creation of the Alliance for Financial Inclusion, and its seminal Maya Declaration.

3. Barriers to Financial Inclusion

There are a plethora of barriers that have been identified as impediments to achieving these general goals. Demirgüç-Kunt and Klapper (2013) mapped out many of the factors that have led to individuals not having accounts in formal financial institutions. The most prominent, and possibly the most troubling, are indicated in their findings from the Global Findex Survey that revealed that 65% of unbanked claim that they did not possess enough money to open an account, while 25% claimed that holding a bank account was too expensive; the “costs of having an account outweigh its benefits” (Demirgüç-Kunt and Klapper 2013). These individual greatly desire to have access to an account, but are prevented by impediments restraining supply. This clearly represents a failure in the market, as there is a shortage in supply. Demirgüç-Kunt and Klapper (2013) also discovered other impediments to consumers that desired to open an account. These included lack of access as a consequence of large distances to the nearest bank branch, and the lack of necessary documentation to open an account.

Both of these findings indicate the challenges to achieving progress on financial inclusion. Banks will be reluctant to incur the fixed costs to build a brick and mortar branch in rural areas where potential accounts are small, providing little financial incentive on the supply side. Banks are also wary of the escalating requirements to address money laundering and limit the potential sources of financing for terrorism, which can impose legal complications for expansion into underserved area and impose threats to their brand image. Financial institutions have begun implementing the more stringent Know Your Customer (KYC) regulations in an attempt to curb potentially illegal behavior. However, an unintended consequence of this is that it may prevent many rural inhabitants from accessing financial institutions and services, as many do not have the required identification.

The lack of documentation poses another hurdle to inclusion. Without a reliable way to track individual's credit, banks will only lend with the higher subprime rates as they have no assurance of repayment (World Bank, 2013). Furthermore, when creating loan policies banks often require set collateral, something many low income consumers are unable to provide. Not only do these unbanked individual lack collateral, they often also don't have access to the technology to effectively engage with the quickly developing banking industry, especially with the emergence of various types of correspondent and non-branch banking innovations. Today, a large portion of banking in previously underserved locales (as well as higher income areas) utilizes recent technological developments (computers, cell phones, etc.), possessions many of the unbanked cannot afford (Atkinson and Messy, 2013).

All of these barriers represent impediments on the supply side. There is more than enough demand to satisfy the amount of financial services that banks and other financial institutions are providing. More often than not, the business case for firms to adjust to higher demand, using the current banking structure, is weak because the marginal profits are clearly exceeded by costs and perceptions of risks. Many nations are now addressing this imbalance through intervention by the public sector and efforts to stimulate innovations in technology to allow greater access to the customer. This has assuaged some of the risk concerns of the banks, and subsidies to banks that have made efforts to become more inclusive have spurred growth in this area. Such innovations include the introduction of "tester" loans as an initial measure to determine credit worthiness, as well as efforts to develop shared credit databases (World Bank, 2013). On the technological side, the innovative payment systems, such as mobile money, have broken down many of the previous barriers. In Kenya, Safaricom's M-PESA has opened the door to many of the previously unbanked, who can now transfer, receive, and store money in a comparatively safe, dependable, and inexpensive process (Jack and Suri, 2011).

In contrast to the extensive data, documentation, and analysis on supply side barriers, there is considerably less analysis available on demand side obstructions, which potentially provide more useful insights into viable solutions. This is in part a result of the challenges inherent in understanding the behavioral and psychological tendencies of the consumers and the complex influence of culture and setting. Stimulating demand for financial products and willingness to engage with financial service providers has been a dilemma that financial institutions have struggled with for years, learning it cannot be addressed by simply offering a new product or lowering rates. In their survey, Demrigüç-Kunt and Klapper (2013) narrowed down their findings to three main reasons for lack of demand in financial accounts: a member of the family is already "banked", distrust with the banking system, and religious reasons. Women tended to not open an account because a member of their family already holds a shared account, a product of overlying societal norms. Another cultural phenomenon that constrains demand is Islam's irreconcilability with certain financial products. Yet, a lack of trust with financial institutions is the most problematic of the demand barriers. Decades of being turned away by banks and the experience of several major financial crises resulting in the failure of financial institutions has created an aura of uncertainty and a lack of confidence (Demirgüç-Kunt and Klapper 2013). Consumers are wary of many financial institutions and remain very reluctant to trust institutions they perceive as unreliable.

4. Financial Education

4.1 Financial Literacy and Financial Capability

The traditional avenue to address demand side limitations has been formal financial education, yet the effectiveness of these programs remains controversial. An overwhelming majority of low wage workers have never had any formal or informal training in interactions and interpretations of the financial infrastructure or market. Citi group estimates that of the five to eight hundred million adults in abject poverty who have "financial access", only between one hundred ten and one hundred thirty million have had any form of financial education (Deb and Kubzansky, 2012). This is in part a consequence of the high costs associated with formal financial education. Citi also calculated the costs of educating just those 110-130 million individuals and estimated the cost to be in the $7-10 billion range. A number they claim is in reality much higher as it is calculated under the premise that all will be "financially educated" after only one session.

More importantly, the capacity of financial education to achieve sustainable results requires a clear definition of objectives and the understanding of the pathways of change. The traditional types of classroom education or seminars in the workplace assume that knowledge translates directly into behavior, when in fact there is extensive evidence that it is only one of a range of factors that influence decisions about the use of money and the way that people engage with financial products. Cole and Fernando (2008) published a study that found that there is no concrete link between any contemporary financial education models and measureable results; "While many organizations have provided documentary evidence suggesting that financial literacy education is effective, there is surprisingly little rigorous, academic evidence" (Deb and Kubzansky, 2012).

These limitations have led to the emergence of a more complex formulation that introduces the concept of "financial capability", a notion that seeks to advance beyond the knowledge oriented goal of "financial literacy" to developing objectives directed toward attitudes and behavior. This approach is based on the principle that knowledge is an important, but not always necessary, input to behavioral change, and that the outcome of relevance is how individuals behave in relation to financial products rather than what they know about them. An early version of the concept underlies the measurement effort of the Financial Services Administration (2006) in the UK to define and measure behavior and attitudes to inform public policy development. This posited several key domains of behavior in relation to managing financial resources and making decisions about products rather than simply measuring knowledge.

The concept has since been advanced in a variety of way to develop a more complex formulation of how financial inclusion can be developed. This approach suggests that improving knowledge is only one of several key pathways that will enhance the capability to achieve financial inclusion, and that education is one of a much broader range of instruments that can enhance an individual's capability. At this juncture, the effort to develop this new framework and a consensus definition of "financial capability" is just emerging. According to Johnson and Sherraden (2007), financial capability is more than being financially literate, instead it is the development of not only financial knowledge and skills, but also the acquisition of "financial instruments and institutions". Holzmann et al. (2013) have categorized financial capability as "a composite of skills, not a single skill that could be measured by a single score". A project to develop methods to measure the concept of financial capability, undertaken by the World Bank, suggests a definition and framework of financial capability that is organized around four key domains of knowledge, skills and behavior: (1) managing money and household budgets, (2) planning for the future, (3) making choices among products and services, and (4) keeping informed by obtaining information and help. Through surveys in a range of lower income countries the study found that these key topics that were developed in the UK and validated in other high income settings were also relevant to other environments. The effort however concluded that it is not possible to consolidate the measure of these components into a single score or measure of capability (World Bank, 2013).

The Organization for Economic Co-operation and Development (OECD) has retained the older terminology of financial literacy but has broadened it to include the additional behavioral concepts. Atkinson and Messy (2013) conclude that being financial literate is not only comprehending and being aware of products, but also knowing how to use these tools in one's best interest and according to the socioeconomic environment. Atkinson and Messy define financial literacy as "a combination of awareness, knowledge, skill, and behavior necessary to make sound financial decisions and ultimately achieve individual financial wellbeing" (OECD/INFE, 2013a).

This is where financial education comes to a cross roads. There are so many different definitions of financial literacy, that the "specific objective of the financial literacy component can range from improved awareness, confidence, knowledge and understanding of consumers and investors on financial issues to making savvier financial decisions" (OECD/INFE, 2013b). Without a specific goal, it is hard to compare and determine the impact of different education initiatives as they are directed toward different targets.

The existing surveys that measure financial inclusion focus on four main components: Access, Quality, Usage, and Welfare (AFI, 2010). None of these metrics can accurately measure the effectiveness in which a person is using financial products, only if they are aware of the products and if they are using them. Furthermore, an individual can be financially literate and capable according to many definitions, but chooses not to or is unable to use a financial service due to other barriers, a sentiment echoed by Kempson et al. (2013): "people can be very capable even without using formal financial products". Yet, in Johnson and Sherraden's definition the presence of financial literacy without access does not constitute financial capability. It is truly difficult to capture this data as it relies on human behavior and attitudes, concepts that cannot be quantified as easily as the number of bank accounts per thousand people. Also, when testing for financial literacy, it is hard to compare results from country to country, as relevant information in one country (i.e. how to use M-PESA in Kenya) is not pertinent in others.

4.2 Financial Education Initiatives: Relative Successes and Failures

Currently there are three primary means that have achieved widespread use to promote financial capability and inclusion: mass marketing, individual training, and group based training (Deb and Kubzansky, 2012). Presently, the majority of financial capability education is classroom-based, a version of group training. Yet, individuals often lack the interest and motivation to attend these classes. A World Bank report in Indonesia revealed that when classes contained monetary incentives, individual's proclivities to attend were considerably higher (World Bank, 2013). In addition, these are most often one-off classes and only provide short term training with no follow up. Participants in the classes insist that without repetition of the education, retention is considerably lower and is quickly forgotten (Deb and Kubzansky, 2012). More often than not, individuals exhibit change in financial behavior only in the short term. This is due to a "one size fits all" approach that typically provides general information rather than a customized, focused approach intended to achieve a specific behavior change.

This very general mode of teaching often fails to address the demographic groups that have the greatest needs. Atkinson and Messy have advocated for a focus on women and children, citing the fact that when our youth reach the age when they must make independent financial decisions, our markets are most likely to be more complex and will require higher financial capability (OECD/INFE, 2013c). Women also need more extensive financial education because their life expectancy is much longer, heightening the chances they will experience a "financial hardship" (OECD/INFE, 2013c). To accomplish the education of these segments, a unified effort must emerge, bringing together entities from different sectors. This often means the creation of a "National Strategy", a plan shaped by both the private and public sector, aimed at the construction of an integrated front to attack the lack of financial capability (OECD/INFE, 2013b)

Facilitating change in financial behavior has proven to be much more common when implemented during what has become known as a teachable moment, a time "when people may be especially motivated to gain and use financial knowledge and skills and are able to put this knowledge to work" (World Bank, 2013). The Citi group has funded extensive research on the use of teachable moments, and has classified the types of education into five distinct groups: induction training, supplemental training, delinquency management, star performer and transaction intercept (Deb and Kubzansky, 2012). All are classroom based, except for transaction intercept, but are each targeted at very different segments. Although induction, supplemental, and delinquency training target the most vulnerable individuals, according to Deb and Kubzansky (2012) the teaching was found to be the least effective

Perhaps the most innovative strategy to date has been the use of "entertainment education". Studies using widely disseminated radio and TV programs have revealed definitive effects in altering behavior and inclination towards financial inclusion. These programs reach a large audience, and consumers enjoy watching these programs, making participation much more likely. In South Africa the show *Scandal!* effectively altered a control group of viewers' decisions to gamble, borrow for consumption, and lowered desire to take out high interest, long term financing (World Bank, 2013). The use of the show *Nuestro Barrio* has also proved reliable in promoting aspects of financial inclusion. The show was able to reach illegal immigrants in the United States and provided images suggesting that banks were trustworthy. This is significant as illegal immigrants are unlikely to attend any classroom based initiatives or trust banks as they are more concerned about their legal status (Atkinson and Messy, 2013).

Unfortunately, entertainment education has some short fallings. Spader et al. (2009) find strong corollaries to the outcomes of classroom based training, awareness is raised, but in depth knowledge is not. The shows were "successful in raising viewer's awareness and changing attitudes, although knowledge did not increase as a result of watching the program" (Atkinson and

Messy, 2013). Evidence suggests that once the entertainment moves to different story lines and programs, the change in behavior steadily drops off, and individuals slowly regress to previous tendencies.

5. Consumer Protection and Regulation

How do you ensure that predatory financial institutions do not take advantage of the unbanked? Inclusion should be a national initiative, conducted in a responsible, sustainable manner. Unbanked individuals generally have limited wealth and do not have large incomes. Irresponsible financial inclusion will be more detrimental to the livelihoods of the poor, and erode the perception of financial institutions. For a successful, inclusive environment to emerge, education and other capability enhancement initiatives will need to be complemented with consumer protection regulations. With trust comes confidence and therefore greater inclination to join the financial world. This requires a delicate balance between promoting inclusion, maintaining a competitive environment, and providing basic protections to ensure the safety and reliability of the financial system. Since financial inclusion conditions are different in every nation, there is no universal proposal that can create the necessary atmosphere in which both parties feel protected and have avenues for redress from inappropriate behavior. In addition, recently developed technology requires dynamic regulation adjusted to fit the globally-connected world.

Consumer protection is a sweeping topic that is not easy to define, as measures to address it are different on a case to case basis. The basis of every established financial service is the existence and promotion of private property and implementation and regulation of shareholder and creditor rights (Levine, 1998, 1999). The government of a nation provides the groundwork for this, championing “inclusion, stability, integrity, protection” (World Bank, 2013). Then, the question becomes, how do we measure if this consumer protection has taken hold? Perotti et al. (2013) have asserted that this is accomplished through a survey which measures an individual’s trust and perception of regulators, if they believe they have a legitimate form of redress, and if they can successfully resolve disputes.

If corporations and individuals share trust in the system, financial inclusion becomes increasingly apparent. 13% of individual interviewed for the Global Findex claim that they do not have a bank account due to lack of trust with financial institutions (Demirgüç-Kunt and Klapper, 2013). The more confidence that there is in the system, the more lenders expand who they lend to, including more frequent loans to opaque borrowers who have little to no credit history (Haselmann and Wachtel, 2010). Much of this can be attributed to legislation by governments enacting measures like a credit sharing system, or courts to handle disputes. More often the not, these policies are to protect consumers from financial institutions. However, government actions can often overstep their boundaries and enact policies with unintended consequences.

Regulation needs to reside in a place that promotes change, but does not completely overhaul the system, representing a “tradeoff between the need for conservatism and the need for enabling” (Ashta, 2010). Many blame the “great recession” on the overextension of mortgages to subprime borrowers in the US. Most of the culpability can be attributed to the greed of large financial corporations, yet congress unexpectedly accentuated this decline by attempting to be more financially inclusive. Fannie Mae and Freddie Mac lowered their standards for loans as a response to new congressional directives; “the decline in underwriting standards was at least partly a response to mandates that required Fannie Mae and Freddie Mac steadily to increases the mortgages…they issued to target low income or minority borrowers” (World Bank 2013). Know

Your Customer (KYC) laws can also result in unintended consequences. As Demirgüç-Kunt and Klapper (2013) note, around one fifth of people they interviewed could not open an account due to lack of necessary documentation. Yet, if these standards become too lax, money laundering, tax evasion, and funding of terrorist activity becomes increasingly easy. Governments must find middle ground in these situations, a place that is distinct to every nation.

The G20 has recently taken the position that consumer protection is the most relevant issue moving forward in financial inclusion. The leaders of the G20 have released a statement indicating their belief "that integration of financial consumer protection policies into regulatory and supervisory frameworks contributes to strengthening financial stability" (G20-OECD taskforce, 2013). The G20's approach focuses on three major initiatives: to promote transparency, to require reasonable forms for redress, and to ensure responsible behavior by financial institutions. They believe that it is in these situations where unbanked consumers will be the most vulnerable and the most exploited. This decree calls for a set of universally recognized principles such as companies always providing information on the "fundamental benefits, risks, and terms of the product", and also that "redress mechanism and internal complaint handling redress are provided free of charge or for a nominal fee to the consumer" (G20-OECD taskforce, 2013). With the support of the G20, consumer protection has moved to the forefront in the fight for a more inclusive society. With the advent of mobile financial service, regulators are forced to reevaluate the systems which have governed their financial sectors for years.

6. Maya Declaration

Following the Alliance for Financial Inclusion's Global Policy Forum in 2011, numerous nations and financial institutions enacted and signed the groundbreaking Maya Declaration. This collective agreement attempts to "not only raises the profile of a major global issue but also provides the public visibility needed to ensure that policy makers are held accountable for their commitments and make tangible progress" (AFI, 2011). Currently, organizations in over 90 countries have pledged their support for this initiative, and each year new members join the cause to end financial exclusion.

This pledge is an agreement to improvement in four major areas of financial inclusion, the issues deemed to be the highest priorities articulated in the subsequent G20 Principles for Innovative Financial Inclusion. These topics are: the advancement in innovative technology to combat exclusion, policies that create cooperation across all the fields of financial inclusion, the promotion of consumer protection and empowerment, and the commitment to the application of data towards policy (AFI, 2011).

However, this declaration addresses only principles and aspirations rather than establishing specifics actions or outcomes. No signee is mandated to provide any type of financial capability training or real evidence of progress (Deb and Kubzansky, 2012). This is a result of the flexible approach of the AFI that views all countries' situations as unique, so each is allowed to fashion their own goals. This creates a wide variety of promises, ranging from the State Bank of Pakistan's sweeping statement to "take financial inclusion beyond the frontiers of commitment to a walk of life", to the direct initiatives of the Bank of Uganda to "increase percentage bank accounts to adult population from 32.8% in 2013 to reach 39.5% in 2017".

Although this declaration has no measure of the progress of its signatories, it does provide resources to aid financial inclusion in its member institutions. The Maya Declaration created the first universal database to gather the research and data of those involved. Furthermore, it creates a support network from the institutions in the financially developed countries for nations with nascent global emergence (AFI, 2011). Coordination and assistance to reach nation's pledges is headed by multiple GPFI Subgroups. These subgroups, Principles and Standard Setting Bodies, SME Finance, Financial Inclusion Data and Measurement, and Financial Consumer Protection and Literacy, all work together to provide and pool resources within the GPFI and AFI. The Maya Declaration may not be able to hold its members accountable for progress, but it creates the necessary framework to promote a change in agenda setting toward greater financial inclusion.

7. Conclusion

The objective of this report is to highlight the importance and relevance of financial inclusion. It compiles current studies on financial inclusion, focusing on the areas of defining inclusion, the barriers to implementation, the role of financial education, protection of consumers, and the formative Maya Declaration. It also summarizes the progress in promoting financial inclusion, as well as presenting the challenges that lie ahead. Financial inclusion is a comprehensive matter, and this report aims to provide an overarching outline of central themes and focuses.

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