



**FINANCIAL INCLUSION,
REGULATION, AND
EDUCATION**

Asian Perspectives

EDITED BY NAOYUKI YOSHINO AND PETER J. MORGAN

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Preface

Since the late 2000s, inclusive growth has become one of the world's most important policy goals, and has been recognized as such in global forums like the Group of 20. Governments, development institutions, and economists are promoting a broad agenda of inclusion in economic and social life, including universal access to education, health care, social security, clean water, and sanitation. Financial inclusion has come to be seen as an important part of this agenda. This reflects the view that individuals, households, and firms cannot take full advantage of available opportunities for economic and social development if they lack adequate and appropriate access to financial products and services. Nonetheless, many Asian economies still have relatively low rates of financial access, especially in rural areas.

Financial inclusion has come to refer to not just any form of financial access, but access to financial products and services that are convenient, affordable (taking into account relevant costs and risks), appropriate for the user's circumstances, and accompanied by legal and supervisory safeguards, including consumer protection, deposit insurance, and regulatory and supervisory frameworks. Moreover, it is increasingly recognized that consumers of financial products and services need adequate financial education in order to make informed decisions about important financial matters. This is particularly important because, due to pressure on fiscal resources and the aging of many populations, the responsibility for long-term financial planning is shifting increasingly from governments to households.

This book focuses on the nexus of financial inclusion, regulation, and education. Existing financial supervisory and regulatory frameworks have largely been shaped by the environment of traditional commercial banking, and this environment has not proved conducive for increasing financial inclusion. In many cases, efforts and policies to expand financial access have involved innovations in areas such as types of financial institutions (e.g., microfinance and crowd financing), borrowing regimes (e.g., mutual responsibility loans), service access (e.g., mini-branches), types of products (e.g., microcredit, microdeposits, and microinsurance), delivery channels (e.g., mobile phone banking, e-banking, and representative banking), and identity requirements (e.g., biometric identification). Such innovations often involve the adoption and adaptation of new technologies. Financial inclusion efforts must also deal with problems such as a lack of adequate financial data and/or collateral for lending.

Thus, regulatory and supervisory frameworks must be reviewed, extended, and adapted to cover these developments. New institutions must also be developed, such as nationwide credit databases for households and small and medium-sized enterprises. Because trust is essential to encourage financial participation, consumer protection frameworks also need to be expanded.

Governments are increasingly recognizing the need to develop policies to promote financial education, but so far efforts in this regard have tended to be fragmentary and inadequate. Such efforts confront numerous hurdles, such as low levels of literacy (including computer literacy), inadequate access in rural areas, a lack of coordination among relevant institutions, and a lack of basic data about levels of financial education. Separate programs should be developed to target different groups, including schoolchildren of various ages, farmers, and the elderly. Moreover, there is still relatively little reliable evidence about the effectiveness of financial literacy programs relative to their costs.

This book focuses on the experience of six Asian economies—Bangladesh, India, Indonesia, the Philippines, Sri Lanka, and Thailand. It also examines the experience of Germany and the United Kingdom to identify issues associated with financial inclusion, regulation, and education in advanced economies. The chapters were written by country experts, and the papers were presented at two separate conferences, held in Tokyo and Bangkok in 2014.

By comparing country experiences among different areas, circumstances, and income levels, this book aims to identify lessons regarding best practices and important innovations that would be useful for other countries. Such lessons include (i) the importance of crafting a national strategy that includes all major stakeholders; (ii) the need for a coordinated approach that includes financial education, consumer protection, regulation, and supervision to build trust as well as knowledge; (iii) the need to promote financial access in ways that are aligned with economic returns and consistent regulation; (iv) the desirability of regulating microfinance entities “proportionately” in line with financial system risk; (v) the need to promote new delivery technologies and credit databases; and (vi) the need for national financial literacy data and financial education strategies.

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Abbreviations

ABI	Association of British Insurers
ADB	Asian Development Bank
ADBI	Asian Development Bank Institute
ARCM	Asian Resource Center for Microfinance
ASEAN	Association of Southeast Asian Nations
BAAC	Bank for Agriculture and Agricultural Cooperatives
BaFin	Federal Financial Supervisory Authority (<i>Bundesanstalt für Finanzdienstleistungsaufsicht</i>)
BBA	British Bankers' Association
BIS	Department for Business, Innovation and Skills
BKB	Bangladesh <i>Krishi</i> (Agricultural) Bank
BKD	village credit institutions (<i>Badan Kredit Desa</i>)
BMTs	<i>Koperasi Baytul Maal wat Tamwil</i> (savings and credit cooperatives)
BMZ	German Federal Ministry for Economic Cooperation and Development (<i>Bundesministerium für wirtschaftliche Zusammenarbeit und Entwicklung</i>)
BOT	Bank of Thailand
BPD	bank pembangunan daerah
BPR	Bank Perkreditan Rakyat
BPRS	Bank Pembiayaan Rakyat Syariah (Islamic Rural Bank)
BPS	National Agency for Statistics (<i>Badan Pusat Statistik</i>)
BRI	Bank Rakyat Indonesia
BSBDA	basic savings bank deposit account
BSP	Central Bank of the Philippines (<i>Bangko Sentral ng Pilipinas</i>)
CAR	capital adequacy ratio
CBO	community-based organization
CBSL	Central Bank of Sri Lanka
CDD	Community Development Department
CDFA	Community Development Finance Association
CDFI	community development finance institution
CEPS-ECRI	Center for European Policy Studies-European Credit Research Institute Brussels
CFDI	Community Finance Development Institution
CGAP	Consultative Group to Assist the Poor
CIC	Credit Information Corporation
CMA	Competition and Markets Authority

CPIP	Credit Policy Improvement Project
CRB	Co-operative Rural Bank
CSES	Centre for Strategy and Evaluation Service
CTF	Child Trust Fund
DCP	directed credit program
DFI	development financial institution
DMI	German Microfinance Institute (<i>Deutsches Mikrofinanz Institut</i>)
DOF	Department of Finance
DSGV	German Savings Banks Association (<i>Deutscher Sparkassen- und Giroverband</i>)
EFLP	Economic and Financial Learning Program
e-KTP	Kartu Tanda Penduduk Elektronik
ESCAP	Economic and Social Commission for Asia and the Pacific
EU	European Union
FCA	Financial Conduct Authority
FCB	foreign commercial bank
FCP	financial consumer protection
FIN	Financial Identity Number
FRS	Family Resources Survey
FSA	Financial Services Authority
FSMP	Financial Sector Master Plan
GDP	gross domestic product
GFD	Global Financial Development
GSB	Government Savings Bank
HCSTC	high-cost, short-term credit
HMT	Her Majesty's Treasury
IBank	Islamic Bank of Thailand
ICT	information and communication technology
IDRA	Insurance Development and Regulatory Authority
IFAD	International Fund for Agricultural Development
iff	<i>Institut für Finanzdienstleistungen e.V.</i>
IRHP	interest rate hedging product
IMF	International Monetary Fund
IPS	Institute of Policy Studies of Sri Lanka
ISA	individual savings account
Jamkrindo	Perusahaan Umum Jaminan Kredit Indonesia
km ²	square kilometer
KTB	Krunghthai Bank
KUD	village unit credit (<i>Kredit Unit Desa</i>)
KUPEDES	Kredit Umum Pedesaan
KUR	<i>Kredit Usaha Rakyat Kecil</i> (business credit for the poor)

LBG	Lloyds Banking Group
LCB	licensed commercial bank
LDKP	Lembaga Dana Kredit Perdesaan
LPD	Lembaga Perkreditan Desa
LSB	licensed specialized bank
MAP	Making Access Possible
MAS	Money Advice Service
MBA	mutual benefit association
MBO	microbanking office
MDGs	Millennium Development Goals
MFIN	Microfinance Institutions Network
MFI	microfinance institution
MGNREGA	Mahatma Gandhi National Rural Employment Guarantee Act
MOF	Ministry of Finance
MRA	Microcredit Regulatory Agency
MSEs	micro and small enterprises
MSMEs	micro, small, and medium-sized enterprises
MUDRA	Micro Units Development and Refinance Agency
NBFC	nonbank finance company
NBFI	nonbank financial institution
NCB	National Credit Bureau
NCC	National Credit Council
NESDP	National Economic and Social Development Plan
NGO MFI	nongovernment MFI
NGO	nongovernment organization
NPL	nonperforming loan
NSO	National Statistical Office
OECD	Organisation for Economic Co-operation and Development
OFT	Office of Fair Trading
OJK	Financial Services Authority of Indonesia (<i>Otoritas Jasa Keuangan</i>)
ONS	Office for National Statistics
OSMEP	Office of Small and Medium Enterprises Promotion
P2P	peer-to-peer
PCA	personal current account
pfeg	Personal Finance Education Group
PKSF	Palli Karma Sahayak Foundation
PMJDY	Pradhan Mantri Jan Dhan Yojana
POCA	Post Office card account
ProMiS	Promotion of the Microfinance Sector
RBI	Reserve Bank of India

RBS	Royal Bank of Scotland Group
SAVE	<i>Sparen und Altersvorsorge</i>
SBS	Samurdhi banking society
SES	Socio-Economic Survey
SFI	specialized financial institution
SGP	savings group for production
SME Bank	Small and Medium Enterprise Development Bank of Thailand
SMEs	small and medium-sized enterprises
SMRJ	Organization for Small and Medium Enterprises and Regional Innovation of Japan
TA	technical assistance
TCCS	thrift and credit cooperative society
TCGC	Thai Credit Guarantee Corporation
TCRB	Thai Credit Retail Bank
UK	United Kingdom
UN	United Nations
US	United States
UU	Undang-undang

1

Overview of Financial Inclusion, Regulation, and Education

Peter J. Morgan and Naoyuki Yoshino

1.1 Introduction and Purpose of the Study

Financial inclusion is increasingly receiving attention for its potential to contribute to economic and financial development while fostering more inclusive growth and greater income equality. In 2010, leaders from the Group of 20 nations approved the Financial Inclusion Action Plan and established the Global Partnership for Financial Inclusion¹ to promote financial access. Further, the Asia-Pacific Economic Cooperation Finance Ministers' Process has a forum dedicated to considering financial inclusion issues,² and the implementation of the Association of Southeast Asian Nations' Framework on Equitable Economic Development has made the promotion of financial inclusion a key objective (Association of Southeast Asian Nations 2014). Development organizations have also been responsive; for example, the Asian Development Bank (ADB 2012) has approved 121 projects (totaling \$2.59 billion as of 2012) to support microfinance in Asia and the Pacific. Many individual Asian economies have also adopted financial inclusion strategies as an important part of their overall strategies to achieve inclusive growth.

One key indicator of household access to finance is the percentage of adults who have an individual or joint account at a formal financial institution, such as a bank, credit union, cooperative, post office, or microfinance institution (MFI), or with a mobile money provider. According to the Global Findex database for 2014, which is based on survey interviews, the worldwide average for this indicator is 62%,

¹ Global Partnership for Financial Inclusion. <http://www.gpfi.org/>

² The annual forum was held most recently in the Philippines in March 2015 (Asia-Pacific Economic Cooperation 2015).

and the total number of adults without accounts is about 2.0 billion, a figure that, while having decreased substantially from 2.7 billion in 2011, remains high. Asia's statistics show that more must be done to facilitate access to finance, as East Asia, the Pacific, and South Asia combined account for 55% of the world's unbanked adults, the majority of whom live in India and the People's Republic of China (Demirgüç-Kunt et al. 2015).

Within emerging economies in Asia, the percentage of residents with accounts varies widely, from nearly 100% in Singapore and the Republic of Korea, to less than 20% in Afghanistan, the Kyrgyz Republic, Pakistan, and Tajikistan, and less than 2% in Turkmenistan (Demirgüç-Kunt et al. 2015). A similarly wide range can be found for other indicators of financial inclusion, such as having a loan from a formal financial institution or the share of small firms having a bank loan.

This study aims to (i) survey advanced and developing countries to assess factors affecting the ability of low-income households and small firms to access financial services, including financial literacy, financial education programs, and financial regulatory frameworks; and (ii) identify policies that can improve their financial access while maintaining financial stability. In particular, it aims to identify successful experiences and lessons that can be adopted by other emerging economies. The countries examined are Germany, the United Kingdom (UK), Bangladesh, India, Indonesia, the Philippines, Sri Lanka, and Thailand.

1.2 Definitions of Financial Inclusion

Financial inclusion broadly refers to the degree of access of households and firms, especially poorer households and small and medium-sized enterprises (SMEs), to financial services. However, important variations in term usage and nuance exist. The World Bank (2014: 1) defined financial inclusion as “the proportion of individuals and firms that use financial services,” while ADB (2015: 71) defined it as “ready access for households and firms to reasonably priced financial services.” Atkinson and Messy (2013: 11) defined it as:

the process of promoting affordable, timely and adequate access to a wide range of regulated financial products and services and broadening their use by all segments of society through the implementation of tailored existing and innovative approaches including financial awareness and education with a view to promote financial well-being as well as economic and social inclusion.

The Alliance for Financial Inclusion (2010: 6) has “four commonly used lenses through which financial inclusion can be defined, in order of complexity: access...quality...usage...welfare”; and the Consultative Group to Assist the Poor (CGAP) (2013: 4) envisages “a world where everyone can access and effectively use the financial services they need to improve their lives [that] does not mean developing separate financial markets for the poor.” Finally, Chakraborty (2011) defined financial inclusion as “the process of ensuring access to appropriate financial products and services needed by vulnerable groups such as weaker sections and low income groups at an affordable cost in a fair and transparent manner by mainstream institutional players.”

The World Bank definition focuses on the actual use of financial services, while the other definitions focus more on potential ability to use such services. Moreover, “access” does not mean any kind of access, but implies access at a reasonable cost and with accompanying safeguards, such as the adequate regulation of firms supplying financial services, and laws and institutions to protect consumers against inappropriate products, deceptive practices, and aggressive collection. Of course, it is difficult to define “reasonable cost” in cases where the amounts involved are small or information asymmetries exist. Therefore, a key question involves the extent to which governments should subsidize such services or intervene in the market. This perspective also highlights the need for adequate financial education, as consumers cannot take proper advantage of access to financial services if they do not understand them properly.

The CGAP definition alludes to the issue of “mainstreaming,” that is, access to mainstream financial institutions. The positive effects of financial access may be limited if poor households are limited to specialized institutions and financial products, such as MFIs, that have unique aspects such as group responsibility and rigid payment schedules, but do not necessarily provide a stepping stone to more conventional financial access.

Access to financial services has many dimensions reflecting the range of possible financial services, from payments and savings accounts to credit, insurance, pensions, and securities markets. Another important dimension is the actual usage of such products and services; for example, campaigns to increase the number of bank accounts fail if those accounts ultimately are rarely or never used.

Finally, the concept of financial inclusion also implies financial exclusion, also known as being “unbanked.” Financial exclusion is defined as not using any financial services or products of formal financial institutions, including MFIs. However, it is important to distinguish between those who, for whatever reason, do not wish or need to use

such services and products, and those who wish to use them but cannot do so due to insufficient funds, poor access, high costs, ignorance or a lack of understanding, a lack of trust, or identity requirements.

1.3 Rationale for Financial Inclusion

There are various arguments in favor of greater financial inclusion. As poor households are often severely cash-constrained, innovations that help them manage cash more efficiently and smooth their consumption can significantly impact their welfare. A reliance on cash-based transactions entails many costs and risks; for example, many transactions may require the carrying of large amounts of cash, possibly over long distances, raising issues of safety. Many studies have also found that the marginal return to capital for SMEs is large when capital is scarce, suggesting that SMEs could reap sizable returns from greater financial access (Demirgüç-Kunt and Klapper 2013). This is particularly important in Asia where SMEs contribute significantly to total employment and output.

Greater financial inclusion can also help reduce income inequality by raising the incomes of the poorest quintile (Beck, Demirgüç-Kunt, and Levine 2007). It may also contribute to financial stability by increasing the diversity of bank assets, thereby decreasing their risk, and by increasing the stable funding base of bank deposits (Khan 2011; Morgan and Pontines 2014). Greater financial access can also help governments shift from wasteful subsidies to cash transfer programs, and the greater transparency associated with electronic funds transfers can help reduce corruption.

A growing body of evidence suggests that access to financial services can reduce poverty, raise income, and promote economic growth. However, in some cases, these conclusions remain tenuous, as many earlier studies relied on macro data, which were subject to numerous issues, such as endogeneity and missing variables.³ While much research has also been done on the impacts of microfinance (McKernan 2003; Pitt et al. 2003; Kaboski and Townsend 2005), the reliability of many study results suffers from possible selection bias (Karlan and Morduch 2009). More reliable studies with randomized control trials or natural experiments are rare. Some found evidence that increased numbers of bank branches reduced poverty and raised income and employment

³ See Honohan (2004); Beck, Demirgüç-Kunt, and Levine (2007); and World Bank (2008).

levels (Burgess and Pande 2005; Bruhn and Love 2013). In a recent survey of the literature on the subject, the World Bank (2014: 3) concluded that

Considerable evidence indicates that the poor benefit enormously from basic payments, savings, and insurance services. For firms, particularly the small and young ones that are subject to greater constraints, access to finance is associated with innovation, job creation, and growth. But dozens of microcredit experiments paint a mixed picture about the development benefits of microfinance projects targeted at particular groups in the population.

As the literature has placed such a heavy emphasis on microcredit, this assessment suggests caution in this area.

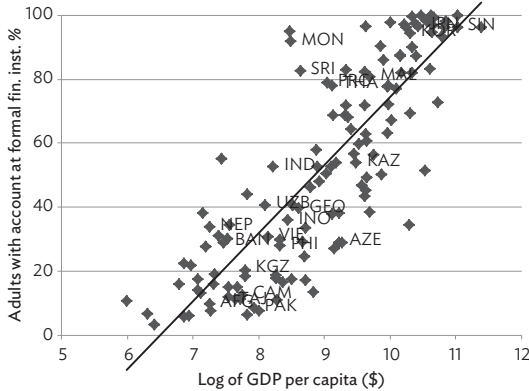
1.4 Status of Financial Inclusion in Asia

1.4.1 Households

The financial access of households tends to rise with per capita gross domestic product (GDP), as expected; Figure 1.1 implies that countries with a per capita income of over \$30,000 have nearly full financial inclusion. However, huge variations across countries remain, implying that factors other than income—including overall financial development and regulatory, institutional, social, and geographic factors—play important roles. For example, deposit penetration in Bangladesh is much higher than in Afghanistan or Nepal, despite these countries' similar per capita income levels. India lies on the trend line, but Indonesia and the Philippines are considerably below it, and Sri Lanka and Thailand are above it. More importantly, the majority of Asian economies for which data are available—Afghanistan, Azerbaijan, Bangladesh, Cambodia, Georgia, India, Indonesia, Kazakhstan, the Kyrgyz Republic, the Lao People's Democratic Republic, Nepal, Pakistan, the Philippines, Tajikistan, Uzbekistan, and Viet Nam—have less than 55% penetration.

In contrast, Figure 1.2 shows that the relationship between per capita GDP and the share of adults obtaining loans from formal financial institutions is negatively sloped. The relative positions of emerging economies are similar to those in Figure 1.1; however, high-income countries, such as Japan, Malaysia, the Republic of Korea, and Singapore, have relatively low ratios, which may reflect access to other forms of credit in those countries, such as credit cards. Borrowing rates for India,

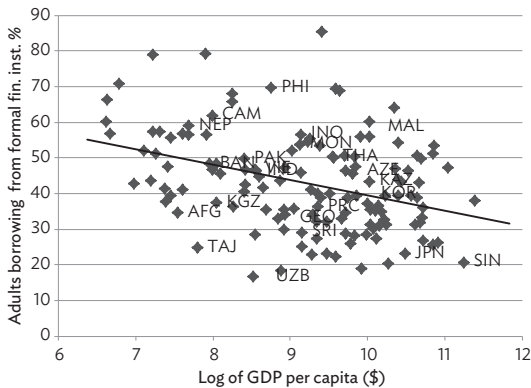
Figure 1.1: Relation of per Capita Gross Domestic Product to Deposit Penetration for Adults, 2014



AFG = Afghanistan, AZE = Azerbaijan, BAN = Bangladesh, CAM = Cambodia, PRC = People's Republic of China, GEO = Georgia, GDP = gross domestic product, IND = India, INO = Indonesia, JPN = Japan, KAZ = Kazakhstan, KGZ = Kyrgyz Republic, KOR = Republic of Korea, MAL = Malaysia, NEP = Nepal, PAK = Pakistan, PHI = Philippines, SIN = Singapore, SRI = Sri Lanka, TAJ = Tajikistan, THA = Thailand, UZB = Uzbekistan, VIE = Viet Nam.

Source: World Bank, Global Findex. <http://www.worldbank.org/en/programs/globalindex> (accessed 15 June 2016).

Figure 1.2: Relation of per Capita Gross Domestic Product to Loan Penetration for Adults, 2014



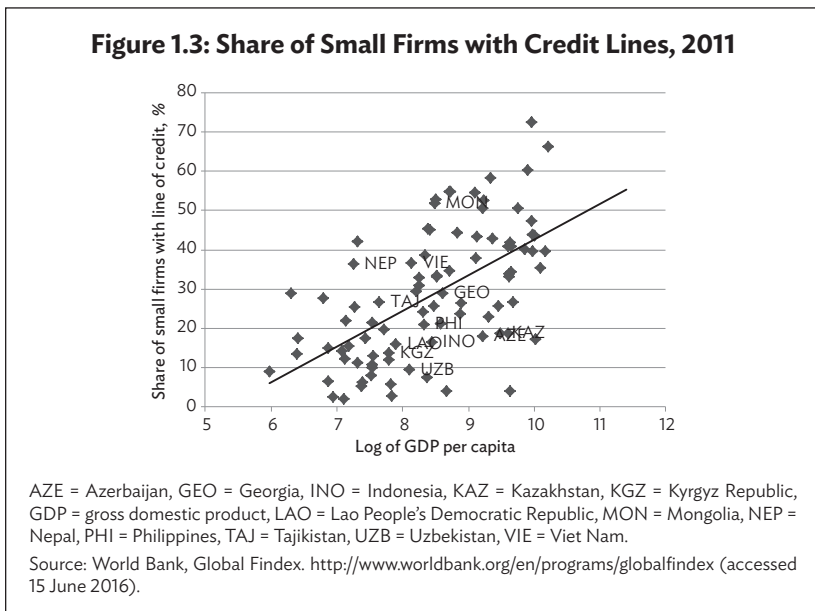
AFG = Afghanistan, BAN = Bangladesh, CAM = Cambodia, PRC = People's Republic of China, GEO = Georgia, GDP = gross domestic product, IND = India, INO = Indonesia, JPN = Japan, KAZ = Kazakhstan, KGZ = Kyrgyz Republic, KOR = Republic of Korea, MAL = Malaysia, NEP = Nepal, PAK = Pakistan, PHI = Philippines, SIN = Singapore, SRI = Sri Lanka, TAJ = Tajikistan, THA = Thailand, UZB = Uzbekistan, VIE = Viet Nam.

Source: World Bank, Global Findex. <http://www.worldbank.org/en/programs/globalindex> (accessed 15 June 2016).

Indonesia, and Viet Nam are fairly close to the trend line, while that for the Philippines is relatively high.

1.4.2 Firms

Figure 1.3 shows a fairly strong overall relationship between per capita GDP and the share of small firms' credit lines, but the pattern among emerging Asian economies again shows a high degree of variation. Compared to the data available for household financial access, data for small firms' credit lines are available for considerably fewer countries. Borrowing rates for Indonesia and the Philippines (around 20%) are relatively low compared to the trend line. Data are not available for the other emerging Asian economies in this study.



1.5 Barriers to Financial Inclusion

Barriers to financial inclusion can be classified as either supply-side or demand-side. Supply-side barriers reflect limitations on the financial sector's capacity or willingness to extend financial services to poorer households or SMEs. These barriers can be further subdivided into three

categories: market-driven factors, regulatory factors, and infrastructure limitations.

Market-driven factors include aspects such as (i) relatively high maintenance costs associated with small deposits or loans, (ii) high costs associated with providing financial services in small towns in rural areas, (iii) a lack of credit data or usable collateral, and (iv) a lack of convenient access points. The provision of financial services in rural areas can pose particular problems in archipelagic countries, such as Indonesia and the Philippines; this highlights the need to focus on innovative delivery technologies that can break down transport-related barriers. Further, the lack of credit data and reliable financial records worsens the problem of information asymmetry, which discourages banks from lending to poorer households and SMEs.

Regulatory factors include capital adequacy and supervisory rules that may limit the attractiveness of small deposits, loans, or other financial products for financial institutions. Strict requirements regarding the opening of branches or ATMs may also decrease the attractiveness of doing so in remote areas. Identification and other documentation requirements are important with respect to know-your-client requirements as well as the monitoring of possible money laundering and terrorist-financing activities; however, these can pose problems for poor households in countries that do not have universal individual identification systems. Regulatory requirements, such as restrictions on foreign ownership and inspection requirements, can also restrict the entry of MFIs. Regulatory requirements must be calibrated to be commensurate with the systemic financial risks posed by various financial institutions, and the trade-off of financial stability with greater financial inclusion.

Infrastructure-related barriers include (i) a lack of access to secure and reliable payments and settlement systems, (ii) the limited availability of either fixed or mobile telephone communications, and (iii) the limited availability of convenient transport to bank branches or ATMs. Again, these can pose particular problems in archipelagic countries. Numerous studies have identified a lack of convenient transport as an important barrier to financial access.⁴

Demand-side barriers include a lack of funds, lack of knowledge of financial products (i.e., financial literacy), and lack of trust. A lack of trust can be a significant problem when countries do not have (i) well-functioning supervision or regulation of financial institutions, (ii) consumer protection programs requiring adequate disclosure, (iii) collection procedure regulations, or (iv) dispute resolution systems.

⁴ See, for example, chapter 9 of this volume.

1.6 Approaches to Promote Financial Inclusion

Financial inclusion strategies can be implemented at the national level, as well as by central banks, financial regulatory agencies, private institutions, and nongovernment organizations (NGOs). The UK and Germany have both implemented extensive policy interventions to promote financial inclusion, with varying degrees of success. Among Asian countries, Indonesia, the Philippines, and Thailand are relatively advanced in developing broad national strategies for financial inclusion. Efforts to promote SMEs in Thailand are progressing well and are organized through the SMEs Promotion Master Plan.⁵ Although South Asian countries, such as Bangladesh, India, and Sri Lanka, are lagging in the area of national strategy, their central banks have been active in this area.

Financial inclusion strategies encompass the following broad areas: (i) the promotion of inclusion-oriented financial institutions, (ii) subsidized funding, (iii) the development of innovative products and services, (iv) the development of innovative delivery technologies, and (v) the development of innovative systems to enhance access to credit (Table 1.1).

1.6.1 Inclusion-Oriented Financial Institutions

Inclusion-oriented financial institutions include MFIs, state-owned banks, post offices offering financial services, credit cooperatives, and community organizations. Among advanced economies, Germany has a long history of developing such institutions, including cooperative, promotional, and regional public savings banks (Neuberger, chapter 2). India and Indonesia have also been active in this area. India has operated mainly through state-owned agricultural banks and local banks, such as local area banks, regional rural banks, and united community banks (Barua, Kathuria, and Malik, chapter 5).

Indonesia has established financial institutions aimed at expanding financial inclusion, including Bank Pembangunan Daerah, Bank Perkreditan Rakyat, and Bank Rakyat Indonesia (Tambunan, chapter 6). Thailand has also established a number of specialized financial institutions that operate as banks and cater to lower-income households and smaller firms, including the Bank for Agriculture and Agricultural

⁵ Current promotion policies for SMEs are detailed in the third master plan, which came into effect in 2012 and covers a 5-year period ending in 2016 (Tambunlertchai, Chapter 9).

Table 1.1: Elements of Financial Inclusion Strategies

Country	Inclusive Financial Institutions	Subsidized Funding	Innovative Financial Products and Services	Innovative Delivery Technologies	Innovative Systems to Enhance Credit Access
Germany	Public savings banks, cooperative banks, guarantee banks		Guaranteed access to accounts with basic payment services	Internet, mobile phone banking	A credit database, loan guarantee programs
United Kingdom	Credit unions, community development financial institutions		“Basic” bank accounts to make and receive payments and withdraw cash	Internet, mobile phone banking	A credit database, loan guarantee programs
Bangladesh	Cooperative societies, postal savings bank, Grameen Bank, licensed NGO MFIs, agricultural development banks	Palli Karma Sahayak Foundation for MFIs, refinancing of bank loans to small and medium-sized enterprises	Microdeposits, microloans, Taka 10 bank accounts for farmers, school banking program	Mobile phone banking	
India	Regional rural banks, united community banks, local area banks, NBFC MFIs	Micro Units Development and Refinance Agency Bank	No-frills bank accounts (with additional services to be added), business correspondents	Telephone bill-paying	Stock-exchange platforms for small and medium-sized enterprises, credit bureaus, credit guarantee programs
Indonesia	Bank Perkreditan Rakyat, Bank Pembangunan Daerah, Bank Rakyat Indonesia		Grameen Bank-style microcredit products, Islamic microfinance products	Telephone banking, e-money	Loan guarantee programs
Philippines	Rural banks, cooperatives, credit cooperatives, credit NGOs		Microdeposits, microloans, and microinsurance products; agents for insurance, e-money, and payments	Telephone banking, e-money	

continued on next page

Table 1.1 *continued*

Country	Inclusive Financial Institutions	Subsidized Funding	Innovative Financial Products and Services	Innovative Delivery Technologies	Innovative Systems to Enhance Credit Access
Sri Lanka	Cooperatives, NGO MFIs, community-based organizations, Samurdhi, rotating savings and credit associations			Telephone banking via point-of-sale terminals, e-remittance services	
Thailand	State financial institutions, cooperatives and occupational groups, savings groups for production, Village Funds			Telephone banking, e-money	Loan guarantee programs, a credit database (in development)

MFI = microfinance institution, NBFC = nonbank financial company, NGO = nongovernment organization. Sources: Compiled by authors from Asian Development Bank Institute (2014); Boston University Center for Finance, Law and Policy (2014); and chapters in this volume.

Cooperatives, Government Savings Bank, and Small and Medium Enterprise Development Bank of Thailand. In addition, in Thailand, there are three main types of semiformal institutions: cooperatives and occupational groups, savings groups for production, and Village Funds (Tambunlertchai, chapter 9).

Several types of MFIs exist in the Philippines: cooperatives, credit cooperatives, credit NGOs, and rural banks (Llanto, chapter 7). Inclusive financial institutions in Sri Lanka include (i) semiformal institutions (e.g., community-based organizations, cooperatives, and NGO MFIs); (ii) state programs (e.g., Samurdhi); and (iii) informal sources of finance (e.g., rotating savings and credit associations). The post office was also upgraded to provide banking and financial services, and banks employ mobile banking units to reach rural areas (Kelegama and Tilakaratna, chapter 8).

MFIs are also active in most emerging Asian economies, although their status and regulation differ significantly across countries. Problems of access and coverage also exist. For example, Tambunan (chapter 6) noted that the key microfinance providers in Indonesia—Bank Rakyat Indonesia units and Bank Perkreditan Rakyat—tend to cover mostly the upper levels of micro, small, and medium-sized enterprises in district

capitals, subdistrict towns, and economically active regions, while coverage is thinner elsewhere.

1.6.2 Innovative Products and Services

Innovative products and services include various microproducts, such as no-frills bank deposits, microcredit and microinsurance, agent banking, and microbranches. India saw an impressive rollout of 150 million no-frills accounts by mid-April 2015. However, 85 million of these contain no funds, and many of those with funds are basically dormant (*Economist* 2015). Indonesia has introduced Grameen Bank-style credit products and also offers three types of Islamic microfinance products, including a profit-and-loss-sharing approach for credit and savings, Grameen-model Islamic microfinance, and Islamic-style microinsurance (Tambunan, chapter 6). In the Philippines, regular insurance companies and mutual benefit associations have begun to provide microinsurance and similar products to help low-income sectors deal with vulnerability risks and catastrophic events (Llanto, chapter 7).

In Europe, the European Commission has mandated that consumers be guaranteed access to basic payment services, including the facility to place funds and withdraw cash. To include unbanked vulnerable consumers, payment accounts with basic features must be offered free of charge or for a reasonable fee. European Union member states must implement these new rules into national law. However, as the rules do not include the right to an overdraft, consumers are not protected from illiquidity risks. The Government of the UK has persuaded its major banks to introduce basic bank accounts that allow people to make and receive payments and withdraw cash; however, these also omit an overdraft facility.

The use of agents or correspondents can help overcome problems of distance and branch shortages. India has been promoting business correspondents who can provide connectivity for financial services in remote and underbanked locations; however, business correspondents largely facilitate payments and play a limited role in deposit opening or lending. Barua, Kathuria, and Malik (chapter 5) argued that this service mix skew reflects a fundamental problem of the model, which is that the business correspondents are bank agents, but have no capital invested of their own. This makes banks reluctant to allow correspondents to facilitate loans on their behalf. They also cited evidence that over 75% of accounts opened with business correspondents in rural areas and over 25% of those opened in urban areas are dormant. The Philippines allows agents in the areas of insurance, e-money, and payments, but not in banking.

1.6.3 Innovative Delivery Technologies

Innovative delivery technologies, such as mobile phones, e-money, and internet banking, can also help bridge distances and save time. Telephone banking has great potential due to the rapid expansion of mobile phone ownership in many emerging economies, and has enjoyed substantial success in the Philippines (United Nations Economic and Social Commission for Asia and the Pacific 2014). On the other hand, the share of the population using mobile phones to pay bills in India remains limited at only about 2%; this is much lower among the rural poor (Barua, Kathuria, and Malik, chapter 5). Similarly, in Sri Lanka, although bank representatives can visit rural homes and use point-of-sale electronic devices to connect to mobile phone networks to take deposits and provide instant electronic confirmations, the use of telephone banking remains extremely limited (Kelegama and Tilakaratna, chapter 8).

The development of e-money can substantially reduce the cost and inconvenience of making payments. Llanto (chapter 7) noted that the number of e-money accounts and transactions has increased significantly in the past few years in the Philippines. For example, the number of registered e-money accounts increased by 34% from 19.9 million in 2010 to 26.7 million in 2013. Also, as of 2013, 10,620 active e-money agents were performing “cash-in, cash-out” transactions. However, issues exist with regard to the identification and monitoring of money laundering and possible terrorism-related transactions. In Sri Lanka, commercial banks have introduced e-remittance services to capture large-scale inward remittance flows, although it is difficult to gauge their penetration of this market (Kelegama and Tilakaratna, chapter 8).

Regarding internet banking, Lewis and Lindley (chapter 3) cited data that around half of all adults in the UK now bank online, up from 30% in 2007.

1.6.4 Innovative Systems to Enhance Credit Access

Informational asymmetries, such as the lack of credit data, bankable collateral, and basic accounting information, often discourage financial institutions from lending to SMEs. Innovations to provide more information in this area, such as credit databases, credit guarantee systems, and rules to expand eligible collateral, can ease these asymmetries and increase financial institutions’ willingness to lend. Financial education for SMEs can also encourage them to keep better records. Finally, the development of new investment vehicles, such as

venture capital, specialized stock exchanges for SMEs and new firms, and hometown investment trusts, can expand SMEs' financing options.

Some Asian economies have been actively expanding and consolidating credit databases on households and SMEs; however, most of these efforts are still at an early stage, while in other economies such efforts have not yet begun. Tambunlertchai (chapter 9) noted that the existing credit database of the National Credit Bureau of Thailand provides little credit information on low-income individuals or microenterprises. The issue of establishing a credit database for SMEs in Thailand has been raised in the current SME Promotion Master Plan, and dialogues, training sessions, and workshops have taken place in preparation for establishing one for the implementing agencies, such as the Thai Credit Guarantee Corporation, Bank of Thailand (BOT), and Office of Small and Medium Enterprises Promotion.

There is no formal credit bureau in Indonesia to monitor the risk of over-indebtedness in areas of strong credit growth (Tambunan, chapter 6). Llanto (chapter 7) also cited the slow implementation of a credit information system in the Philippines. Similarly, in Sri Lanka, membership in the Credit Information Bureau of Sri Lanka is mandatory only for formal financial institutions, such as commercial banks, licensed specialized banks, leasing companies, and finance companies; and most MFIs are unintegrated (Kelegama and Tilakaratna, chapter 8).

While credit guarantees can also ease access to finance for SMEs, these face several problems, mainly moral hazards and high costs due to nonperforming loans. In Thailand, the Thai Credit Guarantee Corporation offers credit guarantee products that help SMEs obtain commercial bank loans (Tambunlertchai, chapter 9). Under a program for individual or community business credit in Indonesia, two insurance companies, Asuransi Kredit Indonesia and Perusahaan Umum Jaminan Kredit Indonesia, and other companies that have voluntarily joined the program guarantee 70% of the value of loans to micro, small, and medium-sized enterprises (Tambunan, chapter 6). The Philippines does not have a credit guarantee program.

Some governments have introduced measures to help SMEs access equity-related financing, which is often a challenge for SMEs. India has established dedicated platforms for SMEs in both the national and Bombay stock exchanges, and Thailand has similar programs. An alternative means of financing local projects is the development of hometown investment trust funds.⁶ Cambodia, in particular, is actively promoting such trusts as an alternative source of finance.

⁶ Described in Yoshino and Kaji (2013).

1.7 Strategies for Financial Inclusion

Strategies are needed to set priorities and coordinate overall approaches to expanding financial inclusion. National strategies are most desirable, followed by strategies at the level of the central bank, ministries, and/or financial regulatory bodies. Table 1.2 shows the range of approaches used in the subject countries. Among Asian countries, the Philippines and Thailand have the most well-articulated financial inclusion strategies, which are incorporated into their national economic planning strategies. Bangladesh, India, Indonesia, and Sri Lanka have long-standing policies to promote financial inclusion through devices such as loan quotas for priority sectors, but no articulated national strategies exist.⁷ At the regulatory level, Thailand's Master Plan for SME Promotion stands out, along with the Philippines' Credit Policy Improvement Project.

Table 1.2: Strategies for Financial Inclusion

Country	National	Central Bank	Ministries and Regulators	Private Sector
Germany	Legal basis for promotional and guarantee banks, microloan fund to fund start-ups, European Commission directive on universal account access			
United Kingdom	Money Advice Service, automatic enrollment in company pension funds, subsidies for community development financial institutions		Her Majesty's Treasury, which sets voluntary targets with banks; the Financial Conduct Authority for consumer protection	
Bangladesh	No national strategy, legal basis for Grameen Bank, establishment of the Microcredit Regulatory Authority	Taka 10 account for farmers, expansion of rural bank branches, refinancing, mobile banking, SME financing, school banking		Microcredit Regulatory Authority and Insurance Development and Regulatory Authority

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⁷ Indonesia does have the well-articulated National Strategy for Financial Inclusion, maintained jointly by Bank Indonesia and the Ministry of Finance.

Table 1.2 *continued*

Country	National	Central Bank	Ministries and Regulators	Private Sector
India	Priority sector lending targets, Prime Minister's People Money Scheme bank account strategy, biometric identification program	Rural branch opening rules, establishment of innovative bank types, promotion of no-frills bank accounts, business correspondents, financial education		
Indonesia	Subsidized credit and bank lending targets for micro, small, and medium-sized enterprises and farmers; establishment of Grameen-type banks and other microfinance institutions	National Strategy for Financial Inclusion (with the Ministry of Finance), payment system infrastructure, financial education, credit-related information, supporting regulation, campaigns, consumer protection	Ministry of Finance	
Philippines	Aspects of the Philippine Development Plan 2011–2016 to increase confidence in the financial system, including expanded offerings of financial products and financial education	Lead government institution to formulate specific financial inclusion strategies, numerous circulars	Department of Finance-National Credit Council's Credit Policy Improvement Project	
Sri Lanka	A 10% bank loan target for agriculture, creation of Samurdhi banking societies	Branch opening regulations		Commercial bank campaigns to attract savings, and provide services for overseas workers
Thailand	Aspects of the 11th National Economic and Social Development Plan, including a focus on SME finance and financial education		Ministry of Finance's National Strategy for Financial Inclusion; Office of SMEs Promotion's Master Plan of SME Promotion	

SME = small and medium-sized enterprise.

Sources: Compiled by authors from chapters in this volume.

1.8 Regulatory Issues for Financial Inclusion

While efforts to promote financial inclusion create many challenges for financial regulators, creative responses to these challenges can help promote financial inclusion. Traditionally, regulators have been skeptical of financial inclusion due to higher credit risks and a lack of documentation associated with small borrowers. Khan (2011) cited a number of ways in which increased financial inclusion can negatively impact financial stability. The most obvious example of this is if an attempt to expand the pool of borrowers lowers lending standards.⁸ Banks can also increase their reputational risk if they outsource various functions, such as credit assessment, to reach smaller borrowers. Finally, if MFIs are not properly regulated, increased lending by that group can dilute the overall effectiveness of regulation in the economy and increase financial system risks.

However, more recent literature has focused on the positive implications of financial inclusion for financial stability. Khan (2011) suggested three ways in which greater financial inclusion can contribute positively to financial stability. First, greater diversification of bank assets as a result of increased lending to smaller firms can reduce the overall riskiness of a bank's loan portfolio. This would reduce both the relative size of any single borrower in the overall portfolio, and its volatility. Adasme, Majnoni, and Uribe (2006) found that nonperforming loans of small firms have quasi-normal loss distributions, while those of large firms have fat-tailed distributions, implying that the former have less systemic risk. Morgan and Pontines (2014) found evidence that an increased share of lending to SMEs tends to reduce measures of financial risk, such as bank Z-scores or nonperforming loan ratios. Prasad (2010) also observed that a lack of adequate access to credit for SMEs and small-scale entrepreneurs adversely affects overall employment growth, since these enterprises' operations tend to be much more labor-intensive than those of larger firms.

Second, increasing the number of small savers would increase both the size and stability of the deposit base, reducing banks' dependence on noncore financing, which tends to be more volatile during a crisis. Third, greater financial inclusion can also contribute to a better transmission of monetary policy, also contributing to greater financial stability. Hannig and Jansen (2010) argued that, as low-income groups are relatively immune to economic cycles, including them in the financial sector

⁸ This was a major contributor to the severity of the 2007–2009 subprime mortgage crisis in the United States.

will improve the stability of the deposit and loan bases. This view is supported by Han and Melecky (2013), who found that a 10% increase in the share of people with access to bank deposits can reduce deposit growth drops (or deposit withdrawal rates) by 3–8 percentage points. Therefore, regulators should strive to provide a fertile environment for providers of financially inclusive services, while guaranteeing the stability of the financial system and protecting consumers.

Table 1.3 summarizes the major features of regulations related to financial inclusion in the subject countries, including regulatory agencies, identification-related measures, the regulation of MFIs, the regulation of lending (mainly interest rate caps), and consumer protection. Two broad conclusions emerge: (i) programs to promote financial inclusion must be aligned with financial incentives to avoid facing great difficulties while pursuing their targets; and (ii) the regulation of microfinance must be proportionate to the financial stability risks involved therein.

Table 1.3: Financial Inclusion Regulatory Measures

Country	Regulatory Agencies	Identification-Related Measures	Regulation of Microfinance Institutions	Lending Regulations	Consumer Protection
Germany	Federal Financial Supervisory Authority		Not licensed, but accredited, trained, and monitored by the German Microfinance Institute	MFIs act as agents only and do not lend directly	Federal Financial Supervisory Authority, Federation of German Consumer Organisations
United Kingdom	Prudential Regulation Authority, Financial Conduct Authority		Community finance development institutions regulated by the Financial Conduct Authority		Financial Conduct Authority
Bangladesh	Bangladesh Bank, Microcredit Regulatory Authority, Insurance Development and Regulatory Authority		Licensing of MFIs over a certain size to enable them to take deposits	Interest rate cap, deposit rate floor	
India	RBI, Micro Units Development and Refinance Agency Bank	Aadhaar biometric identification program linked to access to micro-accounts	Most MFIs regulated by the RBI; they can apply to change their regulatory status to that of a small bank	Lending rate caps for banks and nonbank MFIs, although gradually disappearing	RBI's grievance redressal mechanism in banks, banking ombudsman system

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Table 1.3 *continued*

Country	Regulatory Agencies	Identification-Related Measures	Regulation of Microfinance Institutions	Lending Regulations	Consumer Protection
Indonesia	Bank Indonesia, OJK, and others		Multiple regulatory entities	Interest rate caps of 22% on a non-collateralized credit scheme for micro, small, and medium-sized enterprises (KUR), and 5%–7% for agriculture and energy programs	National Consumer Protection Agency, Consumer Dispute Settlement Board, Credit Information Bureau
Philippines	BSP, Insurance Commission	Easier identification requirements in cases where documentation is lacking	BSP regulates most entities; only rural banks and credit cooperatives can accept deposits	Disclosure rules only	BSP Consumer Affairs Group, Securities and Exchange Commission, National Credit Council and National Anti-Poverty Council Microfinance Consumer Protection Guidebook
Sri Lanka	Central Bank of Sri Lanka		Nongovernment organization MFIs can register under various acts; not licensed; only cooperative societies and Samurdhi banking societies can take deposits		Consumer Affairs Authority, voluntary financial ombudsman system, Consumer Affairs Council, Credit Information Bureau of Sri Lanka
Thailand	BOT, Ministry of Finance, and others		Various agencies, depending on the type of MFI; some are entirely unregulated	Interest rate caps of 28% for specialized financial institutions, and 15% for nonformal lenders	BOT Financial Consumer Protection Center

BOT = Bank of Thailand, BSP = Central Bank of the Philippines (*Bangko Sentral ng Pilipinas*), KUR = Credit for Businesses (*Kredit Usaha Rakyat*), MFI = microfinance institution, OJK = Financial Services Authority of Indonesia (*Otoritas Jasa Keuangan*), RBI = Reserve Bank of India.

Sources: Compiled by authors from chapters in this volume.

1.8.1 Need for Financial Inclusion Strategies to Be Aligned with Economic Returns

The performance of state-owned banks and government financial programs has been mixed, and a gradual learning process has shifted the emphasis away from specialized, state-owned lenders—often operating with subsidies—to more market-based solutions. Barua, Kathuria, and Malik (chapter 5) observed that many small local banks in India have been unviable, partly due to their vulnerability to capture and concentration risk owing to the localization of their operations and political influence. Tambunan (chapter 6) argued that the supplied, subsidized microcredit programs initiated by the Government of Indonesia have not created a conducive environment for sustainable microfinance providers, and that the government should shift resources from subsidized program credits to building the capacity of existing MFIs for expanded outreach and sustainability.

Llanto (chapter 7) noted that the Government of the Philippines recognized the failure of subsidized or directed credit programs to reach their intended targets—mostly small farmers and other small-scale clients—in a sustainable manner. Further, reforms pursued by the government and regulators in collaboration with private stakeholders led to a greater private sector role, chiefly on the part of MFIs, in providing credit, deposit services, and other services to low-income sectors. In the UK, Lewis and Lindley (chapter 3) argued that community development finance institutions—small-scale social enterprises that lend money to businesses and individuals who cannot obtain financing from larger banks—are not financially viable. On the other hand, in Germany, Neuberger (chapter 2) pointed out that the system of municipal public savings banks, public promotional banks, and guarantee banks using the “housebank” model, together with financial consumer protection and credit reporting regulations and institutions, has achieved high levels of financial inclusion.

India is also promoting the “bank in a bank” model, where a commercial bank establishes a microfinance subsidiary. Barua, Kathuria, and Malik (chapter 5) noted that this has successfully furthered financial inclusion in several countries, and the limited experiments in India have been remarkably successful.

1.8.1.1 Regulatory Measures to Promote Access

Governments have relied on a number of different measures to promote financial access, with varying degrees of success. India sets minimum lending quotas for banks in so-called “priority sector loans,” such as for agriculture and SMEs. The Prime Minister’s Task Force on Micro, Small

and Medium Enterprises also stipulated a 20% credit growth target to micro and small enterprises on a year-on-year basis (Barua, Kathuria, and Malik, chapter 5). In the Philippines, banks are required to allocate at least 8% of their loan portfolio to micro and small enterprises, and at least 2% to medium-sized enterprises (Llanto, chapter 7). In Sri Lanka, the banking sector is required to allocate 10% of credit to agriculture, and the central bank requires banks to open two branches in rural areas for every branch opened in a metropolitan area (Kelegama and Tilakaratna, chapter 8). However, banks will not meet such targets without adequate incentives, as they tend to choose customers within target groups and leave poorer segments unserved. For example, in the Philippines during 2008–2014, only rural banks consistently achieved the required 8% target.

In Thailand, banks receive various incentives to increase lending to lower income groups. These efforts, which are part of broader financial reforms, are outlined in the various Financial Sector Master Plans, the most recent of which covers the period 2012–2016. The reforms include increasing the yearly interest rate cap to 28% (i.e., interest and fees) for unsecured personal and microfinance loans, and issuing further guidelines to enable commercial banks to approve microfinance loans (Tambunlertchai, chapter 9).

The Reserve Bank of India (RBI) also proposed convenient access guidelines, which stipulate that the number and distribution of electronic payment access points must be such that every resident is within a 15-minute walk from such a point anywhere in the country by January 2016. It also set a target of opening 80,000 new rural bank branches in 2013–2016 (Barua, Kathuria, and Malik, chapter 5). However, these targets appear very difficult to achieve.

1.8.1.2 Interest Rate Caps

Table 1.3 shows that many countries impose caps on loan interest rates. In India, the charge on all bank loans is linked to their base rate (except for farm loans, which are capped at 7%). However, the costs of making small loans to poor households and firms are inherently high due to a lack of economies of scale and information, and access costs in remote areas. If such limits restrict supply, they can be counterproductive. For example, in examining the experience of 30 countries, CGAP (2004) found that interest rate ceilings impede the penetration of microcredit. In April 2014, the RBI took a major step by removing the 26% price cap on loans advanced by nonbank MFIs, the only lenders eligible to lend through the microfinance channel (Barua, Kathuria, and Malik, chapter 5).

Traditional moneylenders remain an important source of credit for low-income households and SMEs; however, in most cases, they lie

outside the range of formal financial institutions, including banks and MFIs, and pose a number of regulatory issues. In the Philippines, the Central Bank of the Philippines (*Bangko Sentral ng Pilipinas* [BSP]) does not currently impose interest rate caps on moneylenders, relying on disclosure requirements alone.

1.8.1.3 Insufficiency of Relying on Banks Alone

Conventional banks are not motivated to provide financial services to the unbanked due to high costs associated with maintaining small deposits and loans, especially in remote areas, and information asymmetries. On the other hand, NGO MFIs have shown that their business models can achieve satisfactory investment results, as long as the risks and costs of servicing their customer base are adequately reflected in the rates that they charge. Policies should therefore aim to maximize the potential benefits of MFIs by providing affordable and efficient financial services.

1.8.2 Proportionate Regulation

The observation that loans to poorer households and SMEs have less systemic risk than loans to large firms is the basis for the concept of “proportionate regulation,” that is, that financial institutions should be regulated in a way commensurate with their potential benefits and financial systemic risks. Of the countries in the region, the Philippines has perhaps implemented this concept most thoroughly. The General Banking Act of 2000 and National Strategy for Microfinance provided a regulatory framework for the proportionate regulation and risk-based supervision adopted by the BSP for microfinance (Llanto, chapter 7). This legislation, in turn, provided the basis for BSP regulations that sought to enhance MFIs’ capacity to provide financial services to small-scale clients without jeopardizing financial stability.

Llanto (chapter 7) noted that proportionate regulation requires a cultural change on the part of financial regulators, because the regulatory norms for banks frequently do not meet the needs of MFIs. Proportionate regulation means taking into account the features of the microlending methodology used by MFIs and adjusting prudential norms accordingly, including (i) reduced capital and documentation requirements; (ii) loan appraisals based on personal contact rather than scoring; (iii) more emphasis on overall risk management practices as opposed to collateral; and (iv) the development of appropriate microproducts such as microdeposits, microenterprise loans, micro-agriculture loans, housing microfinance, and microinsurance. It also means being open to new delivery technologies and other systems to enhance access to credit. For

example, microbanking offices have become important financial service access points in areas where regular branch banking is not available.⁹

Finally, proportionate regulation also paved the way for the adoption of innovative delivery technologies, such as telephone banking (Llanto, chapter 7). Llanto observed that proportionate regulation has worked for the microfinance sector, but cautioned that, as the coverage and diversity of financial products and services offered to low-income clients increases, it is becoming necessary to understand more fully, and find ways of managing, the risks inherent to “light-touch” regulation.

1.8.3 Regulatory Coordination and Regulation of Microfinance Institutions

A consistent financial inclusion policy requires a coordinated regulatory approach. Compared with banks, MFIs typically face greater restrictions on their activities. Therefore, they tend to be regulated separately and more lightly than banks, which are typically supervised by the central bank or financial regulator. However, having a variety of lenders can spawn a multitude of regulatory frameworks and lead to inconsistencies and gaps. Table 1.3 shows that this is particularly the case for Indonesia, Sri Lanka, and Thailand. For example, Tambunan (chapter 6) argued that too many kinds of MFIs in Indonesia with overlapping regulations, coverage, and responsibilities make it difficult for the monetary authority and Government of Indonesia to evaluate and control the development of microfinance in the country. Tambunan also noted that many semiformal and informal institutions have an unclear legal status in the financial system.

In Sri Lanka, the current regulatory framework for MFIs is weak and fragmented, as different institutions are regulated by different departments, ministries, and laws (Kelegama and Tilakaratna, chapter 8). In Thailand, semiformal financial institutions are not regulated by financial authorities, such as the BOT or Ministry of Finance (MOF), and many operate under nonprudential regulations or no regulations at all (Tambunlertchai, chapter 9). For example, the Cooperative Audit Department within the Ministry of Agriculture and Cooperatives oversees cooperatives. Informal community financial institutions are typically not subject to regulatory controls.

⁹ Microbanking offices are scaled-down branches that perform limited banking activities, such as accepting microdeposits and releasing microloans to microfinance clients.

Table 1.3 shows that many countries, including India, Indonesia, and Sri Lanka, do not allow many MFIs to accept deposits; in the Philippines, only rural banks and credit cooperatives are allowed to accept deposits (Llanto, chapter 7). Bangladesh allows MFIs of a certain size to be licensed and take deposits, a development found to improve the MFIs' efficiency and attractiveness to customers (Khalily, chapter 4). The proposed Microfinance Act in Sri Lanka provides for the establishment of the Microfinance Regulatory and Supervisory Authority, which will be responsible for licensing, regulating, and supervising all NGO MFIs and cooperatives engaged in microfinance. Importantly, under the act, licensed and registered MFIs will be allowed to accept deposits from their members. This is expected to have significant positive effects for the development of Sri Lanka's microfinance sector (Kelegama and Tilakaratna, chapter 8). Thus, it appears that more countries should consider a similarly explicit MFI licensing regime to promote efficiency in the sector.

1.8.4 Identification Requirements

Banking transactions are normally subject to strict requirements regarding identification, both in view of know-your-client prudential norms and the need to monitor possible cases of money laundering or terrorist financing. However, proof of identification is often difficult to obtain in poorer rural areas. The two main approaches to this problem are (i) relaxing identification requirements, and (ii) establishing a national identification system. As shown in Table 1.3, the Philippines has moved in the direction of relaxing identification requirements when such evidence is difficult to obtain. On the other hand, India has implemented an ambitious program of rolling out a unique biometric identity card, or Aadhaar, as the sole document for both account opening and access to other microfinance products. These cards have already been created for 850 million individuals (*Economist* 2015). However, evidence as to the effectiveness of this program is still lacking.

1.8.5 Development of Regulatory Frameworks for Mobile Phones and e-Money

New delivery technologies, such as mobile phones and e-money, hold promise for promoting financial inclusion, but require appropriate regulatory frameworks to achieve this while remaining consistent with financial stability and other regulatory requirements. It is difficult to achieve a consistent approach because in many cases service providers

are not banks. In India, 27 private prepaid instrument providers are currently allowed to offer digital wallets capable of holding a maximum of Rs50,000. However, as these payment systems pose many risks with regard to the identification and monitoring of money laundering and terrorism financing, it has been suggested that these prepaid instrument providers should be converted to payment banks, which would give mobile wallets the status of deposits (Barua, Kathuria, and Malik, chapter 5).

In the Philippines, the BSP has helped develop the regulatory framework of e-money schemes for both bank and nonbank companies. It regulates e-money as a service independent from the e-money issuer's legal character, while still imposing conditions to mitigate risks presented by nonbank e-money issuers. The regulations effectively created a level playing field between banks and nonbanks, ultimately enabling the entry of a greater number of firms and products with the potential to promote financial inclusion (Ehrbeck, Pickens, and Tarazi 2012).

1.8.6 Consumer Protection

Consumer protection programs are seen as a necessary support for financial inclusion efforts, together with financial education and the effective regulation and supervision of financial institutions. Consumer protection can help address the issue of trust as a demand-side barrier to financial inclusion. Consumer protection programs are at various stages of development. In the UK, the Financial Conduct Authority regulates consumer credit, and requires strict affordability checks to ensure that consumers can afford repayments, have protection from misleading advertisements, and benefit from a robust authorization regime. However, in general, micro, small, and medium-sized enterprises do not have the same level of consumer protection as do retail consumers in the UK (Lewis and Lindley, chapter 3). In Japan, the Financial Services Agency established a consumer hotline for consumer protection that has proved to be a valuable source of information for the regulator. The BOT, which has the power to monitor consumer protection in Thailand, opened its Financial Consumer Protection Center in 2013 to (i) inform consumers about their rights and responsibilities as consumers of financial services, (ii) keep consumers from falling prey to fraudulent practices, and (iii) facilitate informed consumer decision-making. India, Indonesia, and the Philippines have less well-developed consumer protection programs.

1.9 Financial Literacy and Education¹⁰

In the aftermath of the global financial crisis, financial literacy and education are receiving increasing attention. Sobering lessons include the way in which the mis-selling of financial products directly contributed to the severity of the crisis, both in developed economies and in Asia. This can be partly attributed to inadequate financial knowledge on the part of individual borrowers and investors.

Financial education can be viewed as a capacity-building process taking place over an individual's lifetime resulting in improved financial literacy and wellbeing. Financial education is also necessary to prepare for old age. Collecting an SME database can be a good source of financial education for SMEs, which is also important. As a result of Japan and Thailand beginning to collect SME databases, SMEs have begun to keep their books; this has led them to become more aware of their daily revenues and expenses, and some have begun to think long term. At the same time, asset management by SMEs has become vital. For example, since SMEs must prepare pension contributions for their employees, they are accumulating pension reserve assets, which they must know how to manage.

1.9.1 Current Situation of Financial Literacy in Asia

Mapping the current status of financial literacy (or financial capability) in Asia presents challenges to researchers and policymakers alike, as this is a new area with limited data. The available surveys have assessed a limited number of Asian economies and target groups within them, and have produced widely varying results due in part to inconsistent methodologies. Although financial literacy is clearly related to per capita income, the relative rankings of economies vary significantly across different studies. Greater coverage of target groups (e.g., students, seniors, SMEs, and the self-employed) is needed. International organizations, such as the Organisation for Economic Co-operation and Development, World Bank, and ADB, should sponsor surveys using the same kind of questionnaires and methodologies to establish a meaningful basis for international comparisons.

Table 1.4 shows a compilation of financial literacy surveys. The first column shows the survey's overall ranking based on responses to three

¹⁰ This section is based on Yoshino, Morgan, and Wignaraja (2015). See also the extensive discussion of issues related to financial education in Yoshino, Messy, and Morgan (2016).

Table 1.4: Selected Financial Literacy Survey Results from around the World

Country (year of survey)	Overall Ranking ^a	Q1: Compound Interest	Q2: Inflation	Q3: Risk Diversification	Survey Sample (number)
High-Income					
United States (2009)	60	65	64	52	1,488
Italy (2006)	48	40	60	45	3,992
Germany (2009)	74	82	78	62	1,059
Sweden (2010)	64	35	60	68	1,302
Japan (2010)	57	71	59	40	5,268
New Zealand (2009)	65	86	81	27	850
Netherlands (2010)	71	85	77	52	1,324
Upper Middle-Income					
Russian Federation (2009)	33	36	51	13	1,366
Romania (2010)	34	24	43	–	2,048
Azerbaijan (2009)	46	46	46	–	1,207
Chile (2006)	25	2	26	46	13,054
Lower Middle-Income					
Indonesia (2007)	56	78	61	28	3,360
India (2006)	38	59	25	31	1,496
West Bank and Gaza (2011)	58	51	64	–	2,022

– = no data, Q = question.

^a Calculated as the average of questions 1, 2, and 3.

Source: Xu and Zia (2012).

questions regarding (i) the understanding of compound interest, (ii) the impact of inflation, and (iii) the understanding of risk diversification. Germany ranks highest overall, while Japan and Indonesia rank highly among Asian economies. However, since the results come from different surveys, they should not necessarily be regarded as comparable.

Table 1.5 shows the results of another survey, the MasterCard Index of Financial Literacy (MasterCard 2013), which also illustrates the comparability problem. The index is based on a survey of over 7,000 individuals aged 18–64 on three aspects of basic financial literacy: money management, financial planning, and investment. The table ranks New Zealand at the top and Japan at the bottom. The surprisingly low ranking of high-income Japan, below less-developed economies like Bangladesh and Myanmar, may reflect the fact that the survey focuses on credit cards, which are not prevalent in Japan.¹¹

Table 1.5: MasterCard Index of Financial Literacy Report, 2013

Rank	Economy	Overall Financial Literacy Index
1	New Zealand	74
2	Singapore	72
3	Taipei, China	71
4	Australia	71
5	Hong Kong, China	71
6	Malaysia	70
7	Thailand	68
8	Philippines	68
9	Myanmar	66
10	People's Republic of China	66
11	Bangladesh	63
12	Viet Nam	63
13	Republic of Korea	62
14	Indonesia	60
15	India	59
16	Japan	57
Average for Asia and the Pacific		66

Source: MasterCard (2013).

¹¹ Surveys based on certain groups of people may not be representative, and different surveys can produce very different results due to different survey forms and methodologies. It is thus clear that an internationally coordinated survey effort is needed to compare results across economies.

1.9.2 Benefits and Costs of Financial Education

The conclusions of the empirical literature as to the impacts of financial education on savings and other financial behavior are decidedly mixed.¹² However, financial education will prompt households to take longer-term investment perspectives and make increased use of life insurance products and pension funds that enhance the wellbeing of individuals in retirement. SMEs will increasingly consider how to finance their businesses, and start-ups may find it easier to receive funds from households or financial institutions. These developments can also support higher economic growth.

Since many Asian economies have rapidly aging populations, pension funds are becoming increasingly important. For example, with a 401K-type defined-contribution pension scheme, people must decide what percentage of their money to allocate to risky and safe assets. Pension funds and life insurance plans are important for self-protection after retirement. In Asia, pension fund and insurance company assets can be a very important source of financing for infrastructure investment. Given such investment's critical role in supporting long-term and sustainable growth in Asian countries, the promotion of these savings can contribute significantly to this growth.

A simple macroeconomic model illustrates how financial education can potentially contribute to economic growth by expanding the funds available for investment in the economy, and improving the allocation of those funds (Figure 1.4). Equation 1 represents household after-tax income, which is distributed between savings and consumption. Savings consist of increases in deposits and securities (i.e., the capital market). Equation 2 shows aggregate supply, where Y is output, N is labor, and K is capital. Labor demand depends on the real wage rate. In equation 2, the aggregate supply curve is expressed as the expected price minus the actual price, and L represents bank loans producing capital. B is the money from the stock market. Investment (K) consists of $L + B$ in equation 2. Equation 3 represents the aggregate demand curve. Aggregate demand depends on consumption, capital investment, government spending, and net exports. Since equation 3 is a reduced form equation, investment comes from bank loans and the capital market. Equation 4 shows the expected output, which is a function of the expected loans and capital from the capital market, plus a shock term, u , together with government spending and net exports.

¹² See, for example, Mandell and Klein (2009) and Braunstein and Welch (2002).

Figure 1.4: Macroeconomic Impacts of Financial Education**(1) Households' Asset Allocation (Diversification)**

$$Y - T = S + C = (D + B) + C$$

Y = GDP, T = Tax, S = Savings, C = Consumption, D = Deposits, B = Capital Investment

(2) Aggregate Supply Curve (SME and corporation)

$$Y = F(N, K) = a_1(P - P_e) + a_2L + a_3(B + u)$$

F(.) = Production function, N = labor, L = Loan, P_e = Expected Price, P = Price, u = shock term

(3) Aggregate Demand Curve

$$Y = b_1 + b_2L + b_3(B + u) + b_4G + b_5NX$$

L = Bank loan, B = Capital Investment, G = Government spending, NX = Net Exports

(4) Increase of Expected Output

$$E(Y) = a_2E(L) + a_3E(B + u)$$

Aggregate Supply

$$E(Y) = b_1 + b_2E(L) + b_3E(B + u) + b_4E(G) + b_5E(NX)$$

Aggregate Demand

(5) Volatility

$$V(Y) = a_3V(u) \quad \text{Aggregate Supply}$$

$$V(Y) = b_3V(u) \quad \text{Aggregate Demand}$$

GDP = gross domestic product, SMEs = small and medium-sized enterprises.

Source: Authors.

Funds between bank loans and the capital market can be best allocated if financial education is implemented well. As shown in equation 4, the capital market, in principle, will then seek a higher rate of return on capital, increasing investment much more than would be expected if banks were to remain the dominant financial institutions. Equation 4 shows that expected output will increase if financial education is implemented, developing the capital market further. However, equation 5 shows the negative side of financial education, as the volatility of output will rise higher than it otherwise would if bank loans were to remain dominant.

Thus, more efficient allocation of household assets should be encouraged, enabling households to provide more risk capital. Financial education can also promote start-up businesses and SME financing, which can enhance economic growth. However, the increased volatility of asset allocation will also increase the volatility of economic growth.

1.9.3 Current Policies and Gaps in Financial Education in Asia

Many policy gaps remain in the areas of financial literacy and education in Asia. A variety of programs exist, as summarized in Table 1.6, which shows (i) national strategies; (ii) the roles of central banks, regulators, and private programs; and (iii) the channels and coverage of such programs. The starting point for financial education programs is to have a national strategy; however, only India, Indonesia, Japan, and the Philippines have established and implemented such strategies in Asia thus far. Indonesia and the Philippines are comparatively strong in this area.

Financial education comprises national, school, and SME levels. For example, the Philippines is in the process of finalizing its national financial education policy. Central banks active in this area include the RBI, Bank Indonesia, the BSP, and the BOT. Financial regulators active in this area include the Financial Services Authority of Indonesia (*Otoritas Jasa Keuangan* [OJK]). In Sri Lanka, however, measures to enhance financial literacy have been rather ad hoc in nature, and there is no national financial education policy.

Indonesia's financial education program is particularly well-developed, including cooperative efforts by the MOF, Bank Indonesia, and OJK. These entities have developed a variety of programs both at the national level and targeting specific groups, including students and youth, migrant workers, fishers, communities in remote areas, and factory workers. One notable development is the *TabunganKu* (My Savings) program established jointly by the MOF and Bank Indonesia, which has helped promote savings in bank accounts. Through this program, the Government of Indonesia established a no-frills savings account with no monthly administration fees and a low initial deposit of Rp20,000 for commercial banks and Rp10,000 for rural banks. As of April 2014, the number of *TabunganKu* accounts reached 12 million (Bank Indonesia 2010; World Bank 2014). This shows the importance of having financial products that meet the demands raised by financial education programs.

Financial education programs are carried out through schools and the media. Bank Indonesia, in cooperation with all commercial and rural banks, conducted a series of campaigns, including the national "Let's Go to the Bank" campaign from 2008 onwards, to improve consumer understanding of financial services, products, planning, management, and literacy. The OJK has also created a National Financial Literacy Strategy program (Tambunan, chapter 6).

In India, the Financial Stability and Development Council launched the National Strategy for Financial Education in 2012. The RBI's financial literacy program has developed teaching materials that are promoted through schools for a variety of target groups, including students, women, the rural and urban poor, and the elderly. Private banks have also developed literacy centers to work with MFIs (Myrold 2014).

Table 1.6: Policies and Programs for Financial Education in Asia

Country	National	Central Bank	Other Regulators	Private Sector	Coverage	Channels
Germany	Courses on the public pension system	None	None	Nonprofit organizations, the financial services industry	Schools	None
United Kingdom	Money Advice Service; financial education required in schools	None	None		Schools	
Bangladesh	None	Policy statement on financial literacy, but no specific strategy	None	Member group meeting of microfinance institutions	Schools	None
India	National Strategy on Financial Education launched by the Financial Stability and Development Council	Financial literacy project to enhance financial literacy among target groups; standardized literacy material	None	Bank literacy centers that work with microfinance institutions	Schoolchildren, senior citizens, military personnel	Schools
Indonesia	Financial education as one pillar of the National Strategy for Financial Inclusion organized by Bank Indonesia and the Ministry of Finance, the TabunganKu (My Savings) program (2010)	Financial education, "Let's Go to the Bank" campaign (2008)	Financial Services Authority (Otoritas Jasa Keuangan): National Financial Literacy Strategy	None	Students, children and youth, migrant workers, fishers, communities in remote areas, factory workers	Schools, media

continued on next page

Table 1.6 *continued*

Country	National	Central Bank	Other Regulators	Private Sector	Coverage	Channels
Philippines	Included in the Philippine Development Plan (2011–2016) and National Strategy for Financial Inclusion	Economic and Financial Learning Program to promote public awareness of economic and financial issues	None	None		None
Sri Lanka	None	Some activities	Some activities	Some activities	None	None
Thailand	None	Financial education programs for individuals, small and medium-sized enterprises	Government “Debt Doctor” program, Office of Small and Medium Enterprise Promotion	Civil society groups, commercial banks, Bank of Agriculture and Agricultural Cooperatives, independent organizations, nonprofit organizations	Generally small-scale programs, except “Debt Doctor”	Media

Sources: Compiled by authors from Asian Development Bank Institute (2014); Boston University Center for Finance, Law and Policy (2014); and chapters in this volume.

In the Philippines, the BSP has been actively developing financial education strategies, and has issued several circulars in this regard. Its primary focus is the Economic and Financial Learning Program, which promotes awareness of economic financial issues. The program targets specific audiences, such as schoolchildren, secondary and tertiary students, overseas Filipino workers, and microfinance clients. It is also implementing the Credit Surety Program, a trust fund financed by contributions from provincial governments and cooperatives in the same province to encourage financial institutions to lend to micro, small, and medium-sized enterprises in that province, using the surety cover as a collateral substitute. The Consumer Affairs Group of the BSP oversees consumer protection programs, and the Monetary Board approved the adoption of the Financial Consumer Protection Framework to institutionalize consumer protection as an integral component of banking supervision in the country (Tetangco 2014). In addition, the National Credit Council and Insurance Commission oversees financial education covering microinsurance in collaboration with the National Anti-Poverty Commission (Llanto, chapter 7).

In Japan, the Central Council for Financial Services Information, sponsored by the Bank of Japan, has created an ambitious matrix of

goals for implementing financial education at all levels of primary and secondary education. Major topics include:

- (i) financial life planning and household expense management, including money management and decision-making, the significance of savings and effective use of financial products, understanding the importance of life planning and obtaining the skills for it, and providing against accidents, natural disasters, and illness;
- (ii) mechanisms of finance and the economy, including understanding the functions of money and finance, business cycles, the need for economic policies, and economic problems;
- (iii) rights of and risks to consumers and the prevention of financial difficulties, including acquiring basic skills for independent and appropriate decision-making to live better lives, and preventing consumer trouble related to financial transactions and multiple debt problems; and
- (iv) career education, including understanding the significance of work and occupational choices.

Most financial education programs in Asia tend to be small and to target individual groups rather than the broad population. Only Japan actually includes financial education in its school curriculum, but its program has many problems, including a lack of experienced teachers, time, and student motivation. The experience of financial education in Japan was studied using a survey of 4,462 junior high and high schools sponsored by the Japan Securities Dealers Association (Study Group on the Promotion of Financial and Economic Education 2014). The survey found that 74.2% of junior high schools taught zero hours of financial education in the first year. This figure was only slightly better for high schools, and 34.5% of high schools taught zero hours in the second year. Although many teachers recognized that financial education was required, they actually allocated much less time than necessary. The survey also showed that teachers do not know the subject well, and textbooks contain only short statements about financial education.

Moreover, most junior high and high school teachers in Japan lack an appropriate background for the subject. Of the surveyed teachers, 27% had a background in education and 29% had a background in home economics, while only 13% had a background in economics and business. Students reported that the subject was difficult to understand and had nothing to do with daily life; they also noted the lack of textbooks on the subject.

Few programs in Asia address the financial education needs of senior citizens or SMEs. In many countries, financial education programs are conducted independently from one another. Japan has been consolidating financial education programs, and a coordinated system has been created to eliminate duplication.

A national strategy for financial education should include the activities of private groups also engaged in this area. For example, ADB (2013) advocated establishing an oversight mechanism to operationalize a national financial education strategy, promote continuous learning among the various stakeholders, and serve as a point of contact for engagement with international initiatives to support financial education and consumer protection. It also recommended creating an innovation fund to encourage both private and public organizations to conduct research, innovate, and pilot new financial education approaches that are appropriate to local contexts.

The process of developing financial education programs must address a complex set of interrelated questions, such as those articulated by Braunstein and Welch (2002):

- (i) What is the targeted audience and that group's informational needs?
- (ii) When should individuals be exposed to both general and specific information about financial issues and options?
- (iii) Where should financial literacy education be provided to reach the broadest audience?
- (iv) How can financial literacy education be effectively delivered?
- (v) How can the effectiveness and impact of financial literacy programs be measured?

1.10 Conclusions and the Way Forward

Numerous arguments support increased financial inclusion, and a large body of evidence shows that this can significantly reduce poverty and boost shared prosperity; however, efforts to this end must be well-designed. Increased household access to financial services can help smooth consumption, ease cash shortages, and increase savings for retirement and other needs. The evidence for microfinance is less positive. Similarly, increased access can allow SMEs to take greater advantage of investment projects with potentially high returns and participate in international trade. Greater financial access may also provide side benefits, such as greater financial stability and more efficient monetary policy. Governments can also benefit from greater

financial access, which enables them to rely on cash transfer programs and reduce corruption and money laundering.

Nonetheless, there are numerous barriers to financial inclusion on both the supply and demand sides. On the supply side, the high costs of handling small deposits and loans in physically remote areas, together with information asymmetries and a lack of documentation and collateral, deter financial institutions from extending financial services to lower income households and SMEs. Regulatory restrictions on capital adequacy, identification requirements, and branch openings, as well as inadequate infrastructure for transport and payment systems, have a similar effect. On the demand side, the chief barriers are a lack of cash, ignorance of financial products and services, and a lack of trust.

As a result, financial inclusion in many emerging Asian economies remains relatively low. In many countries, the percentage of adults with an account at a formal financial institution (the most widely used measure of financial inclusion) was less than 55% as of 2014. Levels of financial literacy are also generally low, contributing to demand-side barriers to financial inclusion.

The following major policy categories can help address supply-side barriers to access: (i) the establishment of inclusive financial institutions, such as MFIs, credit cooperatives, special-purpose state banks, post offices, and agents; (ii) borrowing subsidies; (iii) low-cost and innovative financial products and services, such as no-frills accounts and microinsurance; (iv) innovative technologies, such as mobile phone banking and e-money; (v) innovative ways to increase credit access, such as credit databases, broader ranges of collateral, credit guarantee programs, and innovative financing vehicles; and (vi) innovative regulations, including proportionate regulation and national identification schemes.

Demand-side barriers can be addressed by (i) measures that directly increase the funds available to low-income households, such as cash transfer programs; (ii) effective supervision and regulation of financial institutions, including MFIs and moneylenders, to increase the general level of trust; (iii) the implementation of strong consumer protection programs to ensure the sale of appropriate products and services, adequate disclosure, and the prevention of aggressive collection practices; and (iv) financial education programs for both households and SMEs to enable them to make wiser choices related to financial products and services, as well as maintain better financial records to increase their bankability. These measures clearly require a high degree of government capacity, an area that requires more attention.

Financial literacy levels in Asia are generally low. While Asia's experience in financial education remains limited, there are significant

potential gains to be made from more concerted policy efforts in this area. First, more national financial literacy surveys using consistent and internationally comparable methodologies are needed, particularly in poorer Asian countries. Second, effective national financial education strategies include four key elements: (i) coordination among major stakeholders, including regulatory authorities and educational, financial, and civil society institutions; (ii) an emphasis on customer orientation and addressing demand- and supply-side gaps; (iii) the combination of broad-based functional interventions, such as in-school curricula and targeted programs for vulnerable groups according to resource availability; and (iv) the adoption of a long-term, flexible timeline that can respond to changing needs.

Third, the monitoring and evaluation of national financial education strategies is vital to analyze experience and adapt programs appropriately. Appropriate incentives can enable think tanks and universities to support these efforts. Finally, since government support programs alone cannot provide adequate financing, the private sector, such as life insurance firms, must supply long-term financial products suitable for self-protection. Long-term household asset allocation can support infrastructure and other investments requiring long-term finance.

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2

Germany

Doris Neuberger

2.1 Introduction

Financial inclusion plays an important role in supporting economic welfare and sustainable economic development. Broader access to financial services for households and firms makes it easier to finance profitable investment projects, alleviating poverty and spurring economic growth. Access to finance may even be considered a basic need (Peachy and Roe 2006), and financial inclusion “can be broadly defined as an economic state where individuals and firms are not denied access to basic financial services based on motivations other than efficiency criteria” (Amidžić, Massara, and Mialou 2014: 5). Financial exclusion, in contrast, refers to difficulties accessing or using financial services that are appropriate to the needs of individuals and “enable them to lead a normal social life in the society in which they belong” (European Commission 2008). Exclusion may be voluntary if people do not use financial services because they do not—or think they do not—need them, or for cultural or religious reasons. If due to financial illiteracy, financial exclusion is a consequence of a failure of the education system. Involuntary exclusion may result from efficiency criteria (e.g., insufficient income or high credit risk) or from market or government failures such as discrimination, lack of information, bad products, high prices, or weak contract enforcement (Amidžić, Massara, and Mialou 2014; World Bank 2014).

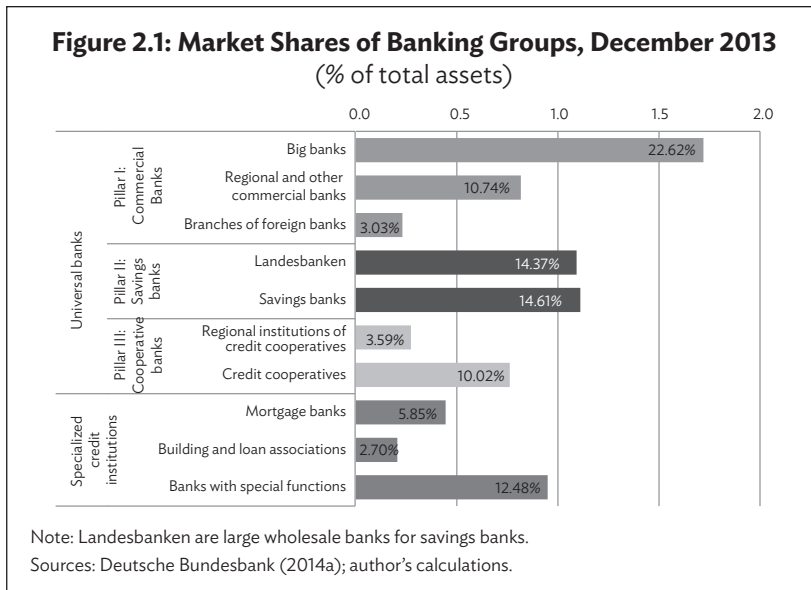
From a policy perspective, appropriate financial inclusion does not require that all individuals or firms have access to all products, but that they are able to access products that deliver real benefits. The experience of the global financial crisis, microfinance crisis, and sharp increases in the number of over-indebted individuals in many countries has shifted the policy focus of German and international development cooperation away from increasing access to finance at any cost, to responsible

finance (Gross 2014). Responsible finance means “coordinated public and private sector interventions that encourage and assist financial services providers and their clients in improving their understanding and approaches, practices, and behaviors to create more transparent, inclusive, and equitable financial markets balanced in favor of all income groups” (German Federal Ministry for Economic Cooperation and Development, Consultative Group to Assist the Poor, and International Finance Corporation 2011: 1). It encompasses fair service delivery to enterprises and consumers. The primary measures for achieving responsible finance for consumers are the regulation and supervision of financial consumer protection (FCP), self-regulation of the industry, and financial education (German Federal Ministry for Economic Cooperation and Development, German Agency for International Cooperation, and International Finance Corporation 2013). Following the guideline of a “human social market economy,” the Government of Germany aims to provide all citizens with equal opportunities for a good life through freedom, rule of law, political stability, economic strength, and justice. These efforts will be based on the belief that a policy that moves humans onto center stage must make every effort to ensure that no financial actor, product, or place remains inadequately regulated (Merkel 2014).

2.2 Overview of the German financial system

The German financial system is bank-based. Bank credit to the private sector represented 103.80% of gross domestic product (GDP) in 2011 (versus 52.62% in the United States [US]), and stock market capitalization represented 43.38% of GDP in 2012 (versus 114.92% in the US) (Global Economy 2014). The German financial system is based on the original three-pillar structure of universal banks, comprising private commercial banks, public savings banks, and cooperative banks. The share of public banks is much higher in Germany than in other European Union (EU) countries: in December 2013, private commercial banks accounted for 36.4% of total assets, public savings banks 29.0%, and cooperative banks 13.6% (Figure 2.1). The commercial bank pillar—comprising big banks, regional and other commercial banks, and branches of foreign banks—is dominated by four big stock corporation banks, which account for 26.3% of the total assets of the entire banking market.¹

¹ While Deutsche Bank, Unicredit Bank, and Commerzbank are highly internationalized and focus on large corporate customers and wealthy individuals, Postbank is oriented toward retail customers.



The savings bank pillar comprises nine Landesbanken owned by federal states and savings banks, and 417 municipal savings banks owned by cities and local authorities. Landesbanken are large wholesale banks for the savings banks. While their traditional role was to finance regional development and the international business of SMEs, today they are universal, profit-oriented banks active in international markets. The municipal savings banks are subject to the regional principle, which restricts them to their local communities. They focus on retail customers, and their public mission is the provision of safe and interest-bearing investment opportunities and access to loans to local populations and small and medium-sized enterprises (SMEs). Although state guarantees of German savings banks were abolished in 2005, these banks are still publicly owned. The savings bank pillar cooperates as a group and ensures depositor safety through its joint liability scheme.

The cooperative bank pillar comprises 1,081 credit cooperatives and two central institutions. Credit cooperatives are oriented toward local retail customers, following the nonprofit mission to serve the interests of their members (usually farmers or small businesses). Like the savings banks, they cooperate as a group and ensure depositor safety through a mutual guarantee system.

The remaining specialized credit institutions account for 21% of total assets and comprise 17 private mortgage banks, 22 public and private building and loan associations, and 21 banks with special functions (public and private promotional banks). Banking statistics exclude 18 public guarantee banks (Deutsche Bundesbank 2013) and 35 microfinance institutions (MFIs) without banking licenses (Bendig, Unterberg, and Sarpong 2014).

Table 2.1 shows that retail banking markets are dominated by public savings banks, which provide 35% of all branches, 41% of consumer deposits, 31% of consumer loans, 43% of current accounts, 45% of customer bank cards, 42% of loans to domestic enterprises, and 42% of loans to the self-employed. Figure 2.2 summarizes the various ways that savings are channeled to capital users through bank or microloans.

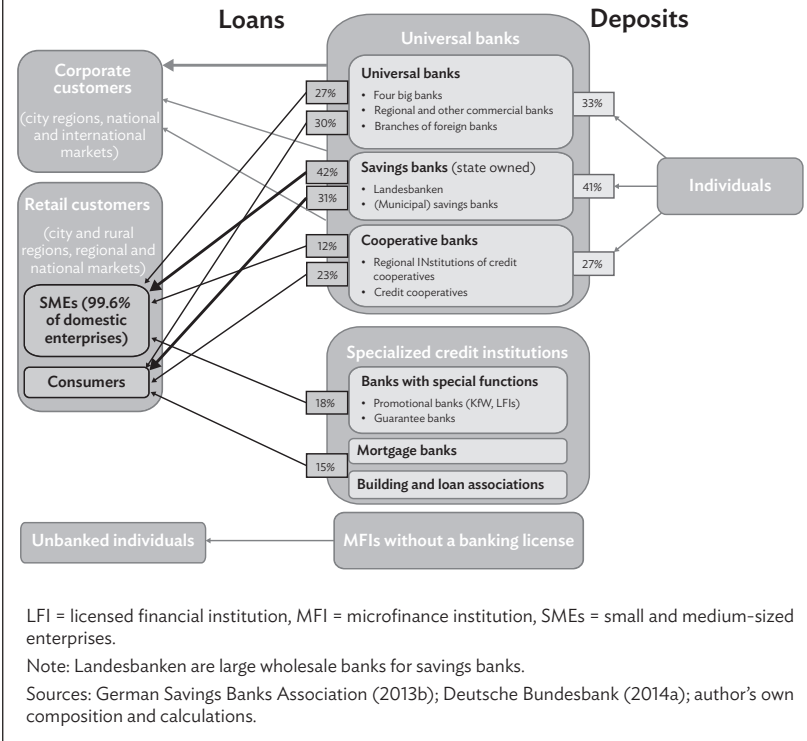
Table 2.1: Market Shares of Banking Groups, December 2013
(% of total number of branches and retail banking volumes)

	Pillar I: Commercial Banks	Pillar II: Savings Banks	Pillar III: Cooperative Banks	Specialized Credit Institutions
Branches	27	35	33	5.0
Deposits from individuals	33	41	27	0.4
Loans to individuals	30	31	23	15.0
Current accounts	29	43	28	0.0
thereunder online	38	34	28	0.0
Customer bank cards	28	45	27	0.2
Loans to domestic enterprises	27	42	12	18.0
Loans to the self-employed	19	42	31	8.0

Note: Individuals are economically dependent individuals and other private persons.

Sources: German Savings Banks Association (2013b); Deutsche Bundesbank (2014a, 2014b); author's calculations.

Figure 2.2: Financial Intermediation through the German Banking System



2.3 Financial Inclusion

Financial inclusion has been measured by three dimensions—outreach, usage, and quality of financial services (Amidžić, Massara, and Mialou 2014: 8). Usual outreach indicators are geographic or demographic penetration (Beck, Demirgüç-Kunt, and Martinez Peria 2007), such as the number of branches per 1,000 square kilometers or 1,000 adults. Usual usage indicators are the percentage of adults with at least one type of regulated deposit account, loan account, or insurance policy; and the percentage of enterprises with bank loans. Quality indicators may include financial literacy, disclosure requirements, dispute resolution, and usage costs (Amidžić, Massara, and Mialou 2014: 10).

Table 2.2 shows demographic branch penetration and usage of deposits, loans, current accounts, and customer bank cards by adults

as well as loan usage by domestic enterprises and the self-employed. SMEs represent 99.6% of all domestic enterprises (Institut für Mittelstandsforschung 2014).

Table 2.2: Demographic Branch Penetration and Usage of Banking Services at the Three Banking Pillars, December 2013

	Pillar I: Commercial Banks	Pillar II: Savings Banks	Pillar III: Cooperative Banks	Total
Number of branches per 1,000 adults	0.15	0.20	0.19	0.54
Deposits from individuals per 1,000 adults (€) ^a	8,159,923	10,218,734	6,628,368	25,007,025
Loans to individuals per 1,000 adults (€) ^a	4,741,870	4,940,952	3,594,531	13,277,353
Current accounts per 1,000 adults	420.31	623.14	400.64	1,444.08
thereunder online	303.38	274.21	220.81	798.40
Customer bank cards per 1,000 adults ^a	420.81	675.22	399.14	1,495.17
Loans to domestic enterprises per domestic enterprise (€)	65,742	101,754	29,154	196,649
Loans to self-employed persons per self-employed person (€)	16,926	37,047	27,116	81,088

^a Statistics for the number of adults are from 2012.

Note: Individuals are economically dependent individuals and other private persons.

Sources: Statista (2012); German Savings Banks Association (2013a); Deutsche Bundesbank (2014a, 2014b); Institut für Mittelstandsforschung (2014); author's calculations.

Branch penetration, usage of consumer loans, and deposits in Germany are above the EU and eurozone averages.² In 2011, the percentage of current bank accounts, life and non-life insurance, shares,

² Number of branches per inhabitant: 0.45 in Germany, versus 0.39 in the EU and 0.49 in the eurozone (Deutsche Bundesbank 2014a; European Central Bank 2014; World Bank 2015; author's calculations). Average annual deposit amount per inhabitant: €21,012 in Germany, versus €18,434 in the eurozone (German Savings Banks Association 2013b; European Banking Federation 2013; Statista 2014; World Bank 2015; author's own calculations). Average annual consumer loans per inhabitant in 2013: €2,766 in Germany versus €2,098 in the EU (Crédit Agricole 2014; author's own calculations).

bonds, and investment funds used was above the EU average, while the use of credit cards, mortgages, and personal loans was below the EU average (European Commission 2012: 13). In 2012, each adult had on average 1.3 life insurance policies, above the EU average, and 5.4 non-life insurance policies (Gesamtverband der Deutschen Versicherungswirtschaft 2013a, 2013b; Statista 2014; author's calculations).³

The percentage of bank nonperforming loans to total gross loans was 2.7% in 2013, indicating the high quality of lending by German banks (World Bank 2015). The German banking sector's high outreach can be attributed to local savings and cooperative banks, which provide higher branch penetration than commercial banks. Of the three banking pillars, savings banks provide the most even regional branch distribution (Bresler, Größl, and Turner 2007; Conrad, Neuberger, and Schneider-Reißig 2009). A comparatively high branch penetration in less wealthy regions helps to reduce regional economic disparities. Both savings and cooperative banks ease access to retail banking services by maintaining a large number of branches per inhabitant in less densely populated regions (Conrad, Neuberger, and Schneider-Reißig 2009). The nationwide presence of public savings banks increases the quality of financial inclusion by ensuring banking group competition in each region.

The importance of bank branch penetration has declined due to the increasing use of online banking. In 2013, 42% of bank account transactions were performed online.⁴ However, 48% of the German population did not carry out financial transactions online due to security concerns, versus 42% of the EU (European Commission 2009: 18). In 2013, only 35% of Germany's population used mobile banking, compared to 60% in the People's Republic of China, 55% in India, and 48% in Thailand (Bain & Company 2013: 22). Germany, the largest smartphone market in Europe, shows the lowest use of mobile banking (Comscore 2011). In 2013, 23% of Germans used their smartphones to access bank accounts, 16% did so to make electronic payments, and 9% did so to use credit cards (Statista 2013). The comparatively low rates of mobile banking adoption in developed countries seem to reflect the high risk of online transactions due to cybercrime. In Germany, the number of cybercrime cases has been rising. Customer losses through phishing in online banking reached €16.4 million in 2013, around €240,000 per adult,⁵ and mobile phones are especially attractive targets (Bundeskriminalamt

³ In 2012, the number of life insurance contracts to total population ratio was 109% in Germany and 89% in the EU (Insurance Europe 2014).

⁴ Deutsche Bundesbank (2014b), author's calculation.

⁵ Statista (2012); author's calculations.

2013). Peer-to-peer lending platforms may provide cheaper loans to professionals and self-employed individuals in particular than do banks (Stiftung Warentest 2013). However, the loan volumes and number of users of these platforms are small. The need for “social lending” is smaller in Germany than in other countries because the consumer loan market functions comparatively well.⁶ As much as 88% of the German population (versus 81% of the EU) does not engage in peer-to-peer file sharing with unknown persons due to security concerns (European Commission 2009: 18).

The above statistics reveal that relatively few individuals are excluded from financial services. Using the new Household Finance and Consumption Survey across European countries, Le Blanc et al. (2014) found that in Continental Europe,⁷ 11.6% of households do not have a credit card or credit line, 8.2% have been turned down or discouraged from asking for a loan, and 46.0% are likely to be credit constrained due to low assets. In Germany, the KfW start-up survey found that business start-ups, low-income families, and small borrowers encounter difficulties in accessing loans. In 2013, 17% of business start-ups were financially constrained (KfW 2014a). The likelihood of financial constraints was highest for start-ups out of unemployment, which typically have low equity and collateral (KfW 2008). In 2014, a fifth of enterprises that applied for loans did not receive them, and 28% of small enterprises (having sales of up to €1 million) reported difficulties in accessing loans, a percentage nearly four times as high as that reported by large companies (having sales of more than €50 million). Enterprises younger than 6 years old complained of increased difficulties in accessing loans. The main barriers appear to be the banks’ higher demand for information on investment projects and business data, as well as higher collateral requirements. KfW (2014b) found that 60% of small enterprises and 69% of young enterprises are likely to be denied credit. The venture capital market remains underdeveloped compared to France, the United Kingdom (UK), and the US, as it constrains innovative SMEs from accessing equity capital (Organisation for Economic Co-operation and Development [OECD] 2014: 28).

In 2009, 670,000 (1%) of Germans aged 15–79 lacked access to a bank account. Germany’s high level of bank account penetration puts these consumers at risk of financial exclusion (Centre for Strategy and Evaluation Services 2010: 17). Access to bank services is

⁶ In the US, peer-to-peer lending is mostly used to refinance credit card loans. This is not necessary in Germany because consumers have access to installment loans (Ertinger and de la Motte 2013).

⁷ Austria, Belgium, France, Germany, Luxembourg, and the Netherlands.

related to households' level of over-indebtedness and socioeconomic characteristics. The share of over-indebted individuals⁸ without a current account decreased from 22.1% in 2004 to 10.5% in 2013; this seems to be due to the introduction of the so-called attachment protection account⁹ in 2010 (Knobloch et al. 2014). Entrepreneurs with an immigration background are denied credit more often than natives (Bruder, Neuberger, and R athke-D oppner 2011). Young entrepreneurs have to pay higher loan rates than older entrepreneurs due to their limited liquidity and smaller businesses (Neuberger and R athke-D oppner 2015). Female entrepreneurs apply less often for bank loans due to a fear of rejection and are denied credit more often than male entrepreneurs (Stefani and Vacca 2015). However, the evidence for discrimination is weak because these differences can be largely explained by differences in risk factors.

2.4 Financial Regulation and Supervision

Government interventions are justified by market imperfections such as monopoly power, incomplete information, and transaction costs. Monopoly power excludes consumers by reducing quantities and raising prices. Incomplete and asymmetric information in credit markets causes credit rationing, to small and opaque enterprises in particular. Microloans may not be provided because they are not profitable due to the fixed costs of screening and monitoring borrowers. A lack of transparency of product characteristics and inadequate consumer financial literacy impair the use of high-quality financial products. Financial inclusion in Germany is fostered by a variety of regulations, institutions, and public programs, the most important of which are discussed in the following section.

2.4.1 Regulatory and Supervisory Authorities

Banks and insurance companies are supervised by the Federal Financial Supervisory Authority (*Bundesanstalt f ur Finanzdienstleistungsaufsicht* [BaFin]), which is responsible for their safety and soundness. BaFin also plays a leading role in implementing and enhancing FCP. The German

⁸ Over-indebtedness is concentrated around middle-aged consumers with below-average levels of education, language skills, income, or assets (Knobloch et al. 2014: 23, 50).

⁹ This *Pfandungsschutzkonto* account is exempted from the attachment of wages.

central bank (Deutsche Bundesbank) focuses on price and financial system stability on a macro level, but is also responsible for cash supply, cashless payments, and banking supervision. Whereas BaFin and Deutsche Bundesbank operate at the national level and supervise the big financial providers, the local commercial regulatory authorities (*Gewerbeaufsichtsämter*) control the work of financial services intermediaries with respect to admission requirements, reliability, and professional competences (Tiffe and Clerc-Renaud 2014).

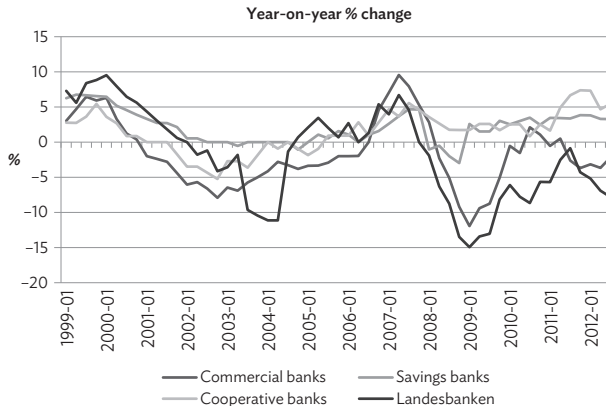
2.4.2 Public Savings Banks

Public savings banks, which dominate retail markets, ensure high bank outreach and competition among the three banking groups in all regions (section 3). The benefits of relationship lending provided by such local banks arise from the use of soft information over time (Boot 2000). In Germany, enterprises usually maintain a close and long-term relationship with one main bank, which provides them with long-term loans. Empirical studies show that relationship lending according to this German “housebank” model helps to reduce financing constraints, especially for opaque SMEs, by increasing credit availability, reducing loan rates and collateral requirements, and providing a kind of liquidity insurance over time.¹⁰

Small local banks stabilized the German economy during the 2008 financial crisis by increasing their long-term lending (Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung 2008; *The Economist* 2012). In 2008–2009, commercial banks and Landesbanken sharply reduced loans to domestic enterprises and the self-employed, while savings and cooperative banks increased them (Figure 2.3). Although local savings banks are in public hands, they seem to perform better than private banks (Zimmermann and Schäfer 2010: 150). The largest losses during the financial crisis accrued to the Landesbanken, a special state bank, and a large private mortgage bank. The local savings banks show high levels of efficiency. Even if their mission of providing financial services to all regions has its costs in terms of efficiency losses, these seem to be outweighed by increased banking group competition (Conrad, Neuberger, and Trigo Gamarra 2014). Therefore, they should remain in public hands. However, the Landesbanken require restructuring, including privatization and an increased focus on their traditional role as central banks for the savings banks (OECD 2014).

¹⁰ See Elsas and Krahen (1998); Harhoff and Körting (1998); Lehmann and Neuberger (2001); Stein (2015); and Neuberger and Rähke-Döppner (2015). For a literature review, see Degryse, Kim, and Ongena (2009).

Figure 2.3: Loans to Domestic Enterprises and Self-Employed Individuals (Without Securities)



Note: Landesbanken are large wholesale banks for savings banks.

Sources: Deutsche Bundesbank (2013); author's own calculations.

2.4.3 Promotional Banks

Promotional banks pursue economic, structural, and sociopolitical goals, like supporting SMEs, agriculture, infrastructure, housing, and urban development. They are completely or partly state-owned and often backed by state guarantees. There are two federal public promotional banks (the KfW development bank and Landwirtschaftliche Rentenbank) and 17 regional promotional banks (*Landesförderinstitute*). A comprehensive system of public support programs aims to compensate for market failures, providing credit, mezzanine, and equity capital at favorable terms and conditions to consumers (e.g., home finance, student loans, and educational loans) and enterprises, in particular start-ups and SMEs.

The business model of promotional banks is organized as follows (Association of German Public Banks 2014; Schäfer and Zimmermann 2008):

- (i) Promotional banks are credit institutions subject to the German banking law and a public mission.
- (ii) According to the housebank principle, promotional banks conduct most of their lending by refinancing their customers' business banks, which assess customer creditworthiness and maintain customer relationships. This ensures that

promotional activities are subsidiary and neutral for competition, and that the benefits of relationship lending by local banks are maintained. The housebank must bear at least part of the credit risk. Promotional banks' direct investments in equity capital are conditioned on the equal participation of private equity funds acting as lead investors.

- (iii) Customer access to finance at favorable terms and conditions is reached both through state guarantees, which reduce promotional banks' refinancing costs in capital markets, and state subsidies within special programs.

Promotional bank loans include microloans below €25,000 provided within specific microloan schemes, as well as general business promotion programs and KfW's StartGeld program (Bendig, Unterberg, and Sarpong 2012: 66). Empirical evidence shows the positive effects of promotional banks' activities on access to finance for SMEs and self-employed professionals, economic production, employment, and growth. Despite possible windfall gains or crowding-out effects, their net benefits appear positive (Schäfer and Zimmermann 2008; Centre for Strategy and Evaluation Services 2012). The German Council of Economic Advisors has recommended increasing the use of public promotional banks along the German model, and the cooperation of such banks across countries to foster SME finance in Europe (Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung 2013: 223). However, improving access to funding for start-ups and innovative SMEs requires not only financial support, but also better exit possibilities for venture capitalists (OECD 2014: 28).

2.4.4 Guarantee Banks

To prevent profitable investment projects from not being realized due to insufficient collateral or equity, guarantee banks support credit and equity financing of enterprises and professionals by granting sureties and equity guarantees. They were created as self-help institutions for SMEs more than 60 years ago and are sponsored by industry associations, banks, and insurance companies. Today, 17 guarantee banks subject to the German banking law operate at the federal state level. By taking on securities to collateralize loans and guarantees and reduce the risk of equity investments, they make it easier for normal banks and private equity companies to finance SMEs. The default risk is limited by counter securities and guarantees from the federal government and the respective federal state, which cover up to 80% of the risk (Verband Deutscher Bürgschaftsbanken 2014).

Empirical studies show the positive effects of German guarantee banks on GDP, employment, firm growth, and the state's net financing position. Guarantees have less distortionary effects than investment grants and subsidies (Schmidt and van Elkan 2006, 2010; Neuberger and R athke-D oppner 2008).

2.4.5 Microfinance Institutions

Microloans are provided by promotional banks, local employment agencies (job centers), and MFIs. Although there is some overlap, promotional banks target bankable entrepreneurs, MFIs aim to reach unbankable entrepreneurs, and job centers target people outside the job market. MFIs operate under various legal forms at the regional or national level without a banking license due to their small size (Bendig, Unterberg, and Sarpong 2014). In 2010, the microlending fund Mikrokreditfonds Deutschland was founded to ease access to loans of up to €20,000 for start-ups, the unemployed, and the self-employed. It is based on the following cooperation model (German Microfinance Institute [*Deutsches Mikrofinanz Institut (DMI)*] 2013b):

- (i) MFIs recommend loans to banks and are responsible for all customer contact. They analyze loan requests, advise customers, monitor repayments, and realize the collateral of the loans during the duration of the contract.
- (ii) The loans are granted by a cooperating bank, which does not have any contact with the customers.
- (iii) The risk of default is shared between the MFIs and a guarantee fund, which remunerates the MFIs. The MFIs bear a first-loss liability of at most 20% of their total loan portfolio.
- (iv) The DMI accredits, trains, and monitors the MFIs to ensure high quality and responsible lending (DMI 2013a).

All partners must commit to a code of conduct based on the “Code of Good Conduct” of the European Microfinance Network and World Bank that defines the principles of responsible lending (DMI 2013a). However, these are only recommendations and are not legally binding. Bank training is not required for MFI managers.

The microloan fund started in 2010 with €100 million provided by the Government of Germany and the European Social Fund.¹¹ Until 2013, MFIs were remunerated through unit payments and an annual gratification of 10% of all repayments, minus losses. In 2014, the unit

¹¹ Its predecessor, the “Mikrofinanzfonds Deutschland,” which operated from 2006 to 2009, was worth only €2 million (Bendig, Unterberg, and Sarpong 2014).

payments were abolished and the gratification was increased to 18% of repayments. The fund guarantees that credit-granting banks do not bear any credit risk. The loan volume is usually small at the beginning of a credit relationship and increases incrementally after successful repayment. In 2013, the average loan amount was €5,700 (versus €18,000 for microloans provided by promotional banks). The duration of the loans ranges from a few months to 3 years (versus 10 years at promotional banks). The effective interest rate is fixed at 8.9%, above the 3.0%–7.0% interest rate applied at promotional banks (Bendig, Unterberg, and Sarpong 2014). The loans are collateralized.

The goal to provide 15,000 microloans by 2015 had been reached by 2013 (Bendig, Unterberg, and Sarpong 2012, 2014). Of the microloans, 50% were used for existing enterprises, 32% for start-ups out of unemployment, and 18% for other start-ups. In 2013, several MFIs had to exit the market due to high defaults (Bendig, Unterberg, and Sarpong 2014).¹² The microloan fund cooperated with *Gemeinschaftsbank für Leihen und Schenken*, a cooperative bank oriented toward social and ecological goals; however, at the end of 2014 this bank cancelled its cooperation with the fund. On 5 December 2014, microlending by MFIs stopped (Kapitalinstitut Deutschland 2015).

The microloan program's success in reducing poverty has not yet been evaluated. Even if the targeted increase in the number of microloans is reached, this may not help clients escape poverty if the loans are not used productively, or are too small or short-term. All existing evaluations of microfinance in various countries show that household outcomes remain unaffected, and microfinanced businesses often fail to grow or survive for long (Banerjee, Duflo, and Hornbeck 2014). Reviewing international developments in the growing indebtedness of MFI clients, Deutsche Bank finds that “a consensus is now emerging that problems are rooted...within the characteristics of the microfinance industry” (Deutsche Bank Research 2012: 1). Microlending outside the banking sector is generally inferior to normal bank lending for the following reasons:

- (i) By targeting the unbankable, microlending reduces the pressure to force banks to provide services to all individuals. The goal to increase the number of loans to the unbankable addresses the symptom of credit rationing rather than the cause of exclusion from bank accounts.
- (ii) Microlending does not use the benefits of relationship banking through long-term customer relationships and the

¹² The default rate varied from 3% to more than 20% across MFIs (DMI 2014).

provision of both lending and deposit services to the same customer.

- (iii) The philosophy of lending to people without a bank account neglects the important role of savings for economic development. The success of the community-based savings and loan system—which began in Germany in the late 18th century with the savings banks and later with Raiffeisen and Schulze-Delitzsch’s savings and loan cooperatives—shows that the wealth of an economy depends on the accumulation of savings to be channeled to productive investments through loans. Microlending, in contrast, is based on the myth that just providing money or property rights is a blessing for the poor (Reifner 2011: 407).

2.4.6 Financial Consumer Protection

Responsible finance for consumers includes three pillars: the regulation and supervision of FCP, self-regulation by financial institutions, and financial education. The most important pillar is FCP through an adequate regulatory framework and consumer associations. FCP, a more than 100-year-old tradition, first took form in the German Civil Code, which established standards for disclosure, advice, and protection against usury. Over the last 30 years, international (EU) consumer protection regulations have been incorporated into this law, while new codes have been established for insurance and most of the capital market regulations oriented toward all clients. A current trend driven by EU law is to set common standards for all financial services, such as standardized pre-contractual information, product explanation, extended liability of the provider in case of mis-selling, and the duty of intermediaries to have liability insurance. This helps consumers by increasing transparency and closing gaps in unregulated capital markets, for example. However, a drawback of these regulations is that they focus on the sale of financial services, that is, the time before and during the agreed contract period, while duties during the users’ entire lifetime, such as access, exploitation, cancellation, usury, debt enforcement, adaptation, and continuity, are neglected (Nogler and Reifner 2014: 41; Tiffe and Clerc-Renaud 2014). To ensure responsible finance, capital users must be protected from irresponsible lending in long-term credit contracts. To this end, the European Social Contract Declaration laid down principles of social long-term contracts in consumer credit law (European Social Contracts Group 2014), and the European Coalition for Responsible Credit (2014) has established responsible credit principles.

Regarding the institutional landscape, publicly financed consumer associations in each federal state play an important role in FCP. Organized in the Federation of Consumer Associations (*Verbraucherzentrale Bundesverband*), they offer general financial advice and legal aid for consumers, and conduct market surveillance and campaigns. If they believe that a provider's practice is against the law they can file a lawsuit. German consumer associations have launched several claims against major insurers and banks (Tiffe and Clerc-Renaud 2014).

In almost every city and region, consumers have access to public debt advisor organizations that provide free help and legal aid, in particular to over-indebted individuals. Debt advisor organizations are organized in nationwide associations that formulate demands on politicians, produce publications for prevention, and organize training for debt advisors, among other functions. Debt advisor organizations and consumer associations work closely together (Tiffe and Clerc-Renaud 2014: 23).

Consumer protection can be legally enforced through administrative enforcement and individual or collective claims against financial providers. Another good FCP practice in Germany is the active role played by state-subsidized media in providing general, neutral financial advice; conducting tests; investigating prices; publishing warnings about mis-selling practices; and explaining new technical standards to consumers; among other activities (Tiffe and Clerc-Renaud 2014).

2.4.7 Right to a Basic Bank Account

So far, banks in Germany are not bound by law to provide basic bank accounts to all citizens. Although they signed a voluntary agreement in 1995 to provide a "giro account to all," this did not prevent many individuals from being excluded from a bank account and was followed only by public savings banks in some federal states (*Handelsblatt* 2014). In July 2014, the European Council adopted Directive 2014/92/EU on the comparability of fees related to payment accounts, payment account switching, and access to payment accounts with basic features. The directive states that consumers should be guaranteed access to basic payment services, including the facility to place funds and withdraw cash. To include unbanked vulnerable consumers, payment accounts with basic features should be offered free of charge or for a reasonable fee (EUR-Lex 2014). EU member states must implement the new rules into national law by 2016. However, this will not shield consumers against liquidity risk, because they still lack the right to an overdraft and face the risk of attached assets in the case of illiquidity. Therefore, the definition of a basic bank account should be extended to

provide overdraft credit and protection from attachment of a minimum sociocultural subsistence. Governments could provide affordable bank accounts by incentivizing banks to offer such facilities either through a fund, central distribution, or advantages. A credit line insured or guaranteed by a public entity could eliminate payday or mobile phone loans (Reifner 2012).

2.4.8 Credit Reporting System

Credit reporting as a system for collecting, sharing, and using relevant data to make or manage credit agreements fosters financial inclusion by allowing creditors to evaluate risks more effectively and empowering consumers by building credit reports. It comprises individuals as data subjects, creditors as data providers, and users and credit bureaus as collectors, processors, and suppliers of data. Credit reporting has to be regulated to ensure responsible lending and at the same time respect privacy and data protection (Center for European Policy Studies—European Credit Research Institute 2013).

Germany has the highest level of credit information of any country, as well as 100% private credit bureau coverage; however, its public credit bureau coverage is only 1.3% of the adult population (World Bank 2015). It has a long tradition of private credit bureaus, which were established as self-help organizations for creditors in local markets. Only large loans (exceeding €1 million) are registered with the public German central bank, which then informs the banks about the borrowers' total indebtedness. Small loans to SMEs or individuals are registered by private credit bureaus, which do not need a license. The German association of credit bureaus (*Die Wirtschaftsauskunfteien*) comprises seven institutions (*Die Wirtschaftsauskunfteien* 2016). The market is dominated by Schufa Holding (owned by banks and trade firms), followed by Creditreform Boniversum. Their major services are providing credit scoring information, carrying out identity checks, and preventing fraud. Credit scoring is important for financial inclusion because German banks are obliged by law (Minimum Requirements for Risk Management within the Basel III framework) to base their loan pricing on credit scores.

While German credit bureaus are subject to some of the world's strongest data protection laws, their credit scorings are not transparent and are often unreliable. Consumers are entitled to receive personal credit reports, which enable them to review and verify data stored by Schufa. However, Schufa's credit scoring information tends to be flawed or incomplete. The scores are not accurate because they are based on false data, and it is unclear how they were calculated. Credit bureaus treat their scoring algorithms as business secrets. To protect consumers

from false credit scorings, which may exclude them from financial services and a normal life in society, independent or public credit bureaus are necessary (Korczak and Wilken 2009).

2.5 Financial Education

2.5.1 Necessity, Concept, and Goals of Financial Education

Consumers' need for financial education has grown due to increased market opportunities with risk-shifting to consumers. In Germany, this can be attributed to three developments: (i) the creation of a more flexible labor market; (ii) the contraction of the welfare state (e.g., through the privatization of retirement pensions); and (iii) demographic change, in particular population aging, which increases the need for private pension insurance. While increased financial opportunities may provide new chances to escape poverty, financial education is particularly crucial to enable the poor to access financial services and shield them against adverse shocks (Reifner 2006b; Reifner and Schelhowe 2010).

Financial education should provide individuals with the knowledge and skills to become questioning and informed consumers able to manage their own finances (Financial Services Authority 1999; Reifner 2006b). Its goals are financial knowledge, literacy, and capability, which should include the knowledge, understanding, and social competence necessary to evaluate financial services critically. Since poor households that cannot save can only help themselves by using credit, financial education should focus on the productive use of credit rather than savings and investments (Reifner and Schelhowe 2010). The question of the knowledge needed for financial education is highly controversial. Recent US studies have shown that financial education may fail to improve the quality of financial decision-making (Ambuehl, Bernheim, and Lusardi 2014) or lead to worse consumer decisions, because it seems to increase confidence without improving ability, as summarized in the following statement: "The search for effective financial literacy education should be replaced by a search for policies more conducive to good consumer financial outcomes" (Willis 2008: 198).

More broadly, financial education also comprises entrepreneurship education, such as providing individuals with the knowledge to write business plans and start or run a business. Since the self-employment rate in Germany is comparatively low, the need for entrepreneurship education is high.¹³

¹³ In 2013, the self-employment rate was 11.2% in Germany and 16.5% in the EU (OECD 2015).

2.5.2 Status of Financial Education

Financial literacy has been measured either by asking respondents to self-assess their financial sophistication, or by testing them on detailed and more reliable finance questions (OECD 2005a; Jappelli 2010). There is often a substantial mismatch between self-assessed and actual knowledge (Lusardi and Mitchell 2014). A representative survey of individuals in 2009 showed that only 52% of the German population self-assessed their financial knowledge as good or very good. More than a quarter of the population did not understand basic economic concepts, nearly three-quarters had difficulty understanding conversations with financial advisors, and nearly one-third did not dare to ask appropriate questions (Comdirect 2009). In a similar survey conducted in 2010, only 39% of the German population assessed themselves as well or very well informed about financial topics, 52% as partly informed, and 7% as badly informed. Only one-tenth regularly compared the prices of banking products, while more than a quarter never made such comparisons (Comdirect 2010).

Using data from the savings and pension insurance survey *Sparen und Altersvorsorge (SAVE) 2009*, which surveyed a representative German household panel, Bucher-Koenen and Lusardi (2011) found a moderate level of financial literacy, measured by answers to three simple questions regarding interest rates, inflation, and risk and diversification. Of the respondents, 37% were unable to answer at least one of the questions. Levels of financial literacy depend on age, gender, education, labor market status, and residence in East versus West Germany. Individuals with higher education levels were shown to have higher knowledge of basic financial concepts than the less educated, and financial literacy was particularly low among less educated, unemployed, and/or retired individuals in East Germany. Individuals with lower financial literacy were less likely to plan for retirement and therefore less likely to fill the gap in retirement income.

Financial literacy varies substantially across countries, as measured by senior business leaders' evaluation of the population's economic literacy from 1995 to 2008. Germany has an above-average financial literacy score, but ranks only 23rd out of 54 countries (Jappelli 2010). Levels of financial literacy depend on educational achievement (measured by Programme for International Student Assessment test scores and college attendance), the share of the urban population, and the existence of mandated savings in the form of social security contributions. Inhabitants of countries with more generous social security systems (such as Germany in the study period) are generally less literate; this is consistent with the hypothesis that incentives to

acquire financial literacy are related to the amount of resources invested in financial markets.

An online survey of adults in 12 European countries in 2013 found that Germans had the lowest levels of financial education. The share of respondents that reported never having received financial education was 53% in Germany and Spain, followed by 52% in the UK. Seventy-eight percent of Germans said that they wanted financial education at school, but only 18% received it (ING-DiBa 2013). However, the results of this study are questionable, because they relied on individuals' self-assessments of financial education, which is undefined and may be perceived differently in different cultural and educational environments.

In 2010–2011, the OECD International Network on Financial Education conducted a more detailed financial literacy survey in 14 countries across four continents, including Germany (Atkinson and Messy 2012: 6). In no country could more than 70% of the population answer at least six of eight financial knowledge questions. Only 22% of German respondents had a household budget, and 96% indicated that they had not borrowed to make ends meet (Atkinson and Messy 2012: 8). However, overall financial literacy exceeded the cross-country average (Atkinson and Messy 2012: 10). Altogether, the evidence reveals a low level of financial literacy in Germany, which is concentrated among specific population subgroups. However, these results must be interpreted with caution because financial literacy may be measured erroneously, depending on how questions are worded (Lusardi and Mitchell 2014).

The level of entrepreneurship education in Germany also seems low compared to other developed countries. Although the federal government offers support for entrepreneurship education at universities and for researchers and students to start businesses, teaching techniques must be improved. For example, according to the OECD (2014: 28), “in eastern German universities surveyed by the OECD, business plan writing is the most common learning tool, while more experience-based teaching methods—such as visits to companies, use of social media, self-learning exercises, developing prototypes, and learning about enterprise failure—are not so frequent.”

2.5.3 Financial Education in Schools

Financial services providers have market power and informational advantages over consumers, for whom financial products are complex and difficult to understand. These market failures provide a rationale for governments to act to improve financial education, which should begin in school or as early as possible in life (OECD 2005b). Schoolteachers have been identified as core gatekeepers of consumer education in society.

Of five sources of consumer education—family and friends, school, adult education, consumer organizations, and television programs—schools have been found to be the most effective and accessible form of intervention (Reifner 2006a).

So far, the teaching curricula developed by the ministries of the federal states do not explicitly stipulate the teaching of financial education. In practice, teachers partly include aspects of financial education in business administration or economics classes; however, these classes are mostly not mandatory, and appropriate teaching materials are lacking (Reifner 2006a). In 2013, the Conference of Cultural Ministers ruled that consumer education must be integrated and enforced in schools. This includes financial education about the conscious use of money, financial products and investments, types of loans, private insurance, retirement provision, marketing, and consumption. To achieve this goal, schools may cooperate with external partners such as public pedagogical institutes, consumer ministries and associations, universities, nongovernment organizations, industry associations, and enterprises. Thereby, the principle of neutrality must be obeyed. Consumer education must be integrated into at least one school subject and tailored to age and target groups (Kultusministerkonferenz 2013). These rules have begun to be implemented with various approaches at the federal state level. While an important step to improving financial education in schools, the rules are based on a market-oriented concept of consumer education, which does not take into account that pupils must learn to reflect critically on existing economic circumstances. Moreover, they allow financial companies to cooperate with schools with the commercial aim to gain pupils as future customers.

2.5.4 Providers of Financial Education

Financial education is provided by nonprofit organizations as well as the financial services industry. Consumer associations evaluate financial education material with help from independent scientists. The results are published on the Materialkompass website financed by the Federal Ministry of Agriculture, Food and Consumer Protection, which can be used to navigate the various financial school projects in Germany (Federation of Consumer Associations 2014).

The government statutory pension insurance scheme offers adult education courses on public pension systems, but fails to provide needs-based consumer education. Various welfare and consumer advice organizations engage in financial education programs to prevent over-indebtedness; however, these are critical of credit take-up, being based on the philosophy of savings. The nonprofit institute “iff” (*Institut für*

Finanzdienstleistungen) provides school projects that teach consumers to identify and meet their financial needs and be critical of the financial services market. Its basic principle is that, instead of bankers entering schools, students should enter banks to rehearse the advice sessions that they might encounter later in life and learn to pose practical questions (Reifner and Schelhowe 2010). These school projects¹⁴ have been acknowledged as successful by the OECD and evaluated as one of the best consumer education projects by the Materialkompass of the German Federation of Consumer Associations.

The financial services industry contributes a wide range of information and teaching materials for financial education. It aims to comply with the OECD's corporate social responsibility principles, in which consumer protection and education play an important part. It focuses on explaining products and their usage. Some material is based on home economics and emphasizes budgeting and savings, like the German Savings Banks Association's program. Other entities, like private commercial banks, promote the approach of economic education. Deutsche Bank offers practical economic and financial information to schools through its financial literacy initiative and employee engagement, where employees provide information about investment products and retirement funds, the global financial system, and the causes of the 2008 financial crisis (Deutsche Bank 2014). "My Finance Coach," a financial education school project financed by 30 enterprises, including large financial services companies, has already made 3,500 school visits in less than 4 years.

In 2006, 88% of 15-year-old children in Germany went to schools using teaching content influenced by commercial enterprises. All federal states welcome private suppliers to their schools. Of the largest German companies, 15 provide teaching materials beyond economic topics. While the number of free online teaching materials in Germany has reached 882,540 (Verband Bildungsmedien 2014), the total number of financial education programs is unknown. Regular evaluation through Materialkompass shows that many of these offers are ideologically biased or even contain advertising. In some cases, school materials are used directly to promote providers and their business models. Financial education initiatives by financial services providers in schools have been criticized as an unacceptable form of lobbying, as schools should be free of advertising and influence from education providers. Financial education initiatives may only be symbolic measures to avoid other forms of regulation (Tiffe and Clerc-Renaud 2014: 28). Any positive impacts on consumers remain yet to be seen.

¹⁴ *Schülerbanking* ("pupils' banking") and *Wissen rechnet sich* ("knowledge counts").

2.6 Conclusions and Policy Recommendations

Germany's bank-based financial system provides a high level of financial inclusion, as measured by average bank outreach and the use of financial services. However, it tends to exclude the most vulnerable, such as low-income, unemployed, or over-indebted individuals who need loans or bank accounts to start a business and participate in economic life, and small enterprises are often credit constrained. The quality of financial inclusion is impaired by an overall low level of financial literacy, which is also concentrated among specific population subgroups, such as the unemployed and less educated. At the same time, the need for financial education has grown due to the decline of the German welfare state.

Key lessons can be learned from Germany's experiences, particularly for less-developed countries. The German banking sector is strongly differentiated, with four big banks holding a market share of only 23% and retail markets being dominated by state-owned savings banks. A community-based system of local savings and cooperative banks, which evolved more than 200 years ago, has successfully accumulated savings and channeled them to productive investments by individuals and SMEs. The sector is based on relationship lending or the housebank model, where soft information is gathered through direct and repeated contact with the same borrower. Government interventions have proven successful in correcting market failure. The comparatively high level of financial inclusion can be attributed to municipal public savings banks, public promotional banks, and guarantee banks using the housebank model, FCP, and credit reporting regulations and institutions. Programs involving MFIs without a banking license have been stopped. The use of online and mobile banking is comparatively low due to security concerns and should not be encouraged in light of growing consumer losses due to cybercrime.

To improve financial inclusion with the aim of promoting responsible finance, the following measures are recommended:

- (i) The three-pillar universal bank system and the system of specialized promotional and guarantee banks should be preserved. Local savings banks subject to a public mission and regional principle should remain in public hands because they ensure high bank outreach, the usage of deposits and loans, and banking group competition. They contribute to equal living standards across regions and stabilized the German economy during the 2008 financial crisis. Banking regulation and supervision should take into account the diversity of bank business models and the role of local banks to improve credit access through relationship lending.

- Promotional and guarantee banks may be increasingly used to ease access to finance for start-ups and small enterprises.
- (ii) Special MFIs targeting unbanked individuals are rendered unnecessary if access to banking services for all is reached more directly by other measures, for example, (iii). They may even be harmful by increasing the over-indebtedness of the poor.
 - (iii) The right to a basic bank account must still be implemented. It should be coupled with the right to overdraft credit and protection from attachment of a minimum sociocultural subsistence. Governments could provide affordable bank accounts by incentivizing banks to offer such facilities. A credit line insured or guaranteed by a public entity could eliminate payday or mobile phone loans.
 - (iv) To protect consumers from false credit scorings by private credit bureaus, independent or public credit bureaus should be established.
 - (v) Financial education at schools should be mandatory, and should focus on the productive use of credit and providing competence to evaluate financial services critically instead of product knowledge. To ensure the high quality of financial education programs not influenced by the financial services industry, external evaluations by independent scientists must be strengthened. However, financial education is not a panacea and should not be used as a substitute for regulating financial services providers.
 - (vi) To promote entrepreneurship and access to funding for start-ups and innovative SMEs, experienced-based learning methods should be adopted in entrepreneurship education, and the venture capital market must be developed further.

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3

United Kingdom

Sue Lewis and Dominic Lindley

3.1 Introduction

The United Kingdom (UK) has a large open retail financial services sector and a strong financial conduct regulator, with a specific consumer protection mandate. While this should work well for retail and small business consumers, it has failed to deliver a fair market for them.

In recent years, UK consumers have faced increased complexity and choice in financial markets. Product innovation has been rapid, but is rarely in consumers' best interests. Despite the apparent abundance of choice, many consumers cannot find financial products that meet their needs, while some consumers are excluded altogether. Credit is more readily available, but often at very high prices, and a significant minority of the population has debt problems. Levels of financial literacy are low, particularly among the youngest, oldest, and most vulnerable members of society.

These factors have led to a dysfunctional marketplace, with widespread consumer detriment, a lack of trust in financial institutions, and weak competition among firms in most product markets. This is characterized by opaque terms and conditions, products that do not perform as expected, and pressure-selling or even mis-selling of products.

Financial inclusion is essential for individuals to participate in a modern economy. Those without a bank account usually pay more for utilities and other services. It is also more difficult for them to smooth income and expenditure without the ability to save or borrow at a reasonable cost, and to manage risks without insurance. All financial services markets exhibit a degree of exclusion. This chapter concentrates on “everyday” product markets: transactional banking, savings, loans, and general insurance. It also considers pensions, which are undergoing significant reform in the UK.

Financial exclusion is usually defined as the inability of individuals or firms to access financial products and services appropriate to their needs. However, there is growing recognition that access is not enough; products and services should be fair and affordable, and consumers should be able to use them effectively (Financial Inclusion Centre and Community Development Finance Association [CDFA] 2009).

Small firms need financial services to manage and grow their businesses, yet often have problems accessing finance.¹ Although banks treat them like business customers, they lack the financial expertise of larger firms. Although small firms are protected by regulation in some cases, they do not enjoy the same level of protection as retail consumers, although their level of financial sophistication may be similar.

3.2 Overview of the United Kingdom's Financial System

The UK banking system is large relative to the size of its economy, with total assets of around 450% of gross domestic product. Much of the system is international, with the UK hosting a large number of foreign banks and UK-owned banks having large operations abroad. Only around half of UK-owned banks' assets represent loans to nonbank customers (Bank of England 2014).

The "Big 5" banks, which dominate the UK banking system and retail financial services markets,² account for 85% of the personal current account (PCA) market (Office of Fair Trading [OFT] 2013a), 61% of outstanding mortgage lending (The Data 2014), 93% of business loans in England and Wales, and 82% of business loans in Scotland (Financial Conduct Authority [FCA] and Competition and Markets Authority [CMA] 2014). The Big 5 banks have built up their market shares through a series of mergers and acquisitions, particularly as a result of the

¹ In the UK, firm size is defined by the number of employees. The European Union (EU) definition also takes turnover into account, as outlined below.

Company Category	Employees	Turnover (EU definition)
Medium-sized	< 250	£41.0 million
Small	< 50	£8.2 million
Micro	< 10	£1.7 million
Sole trader/self-employed	0	Not defined

² Retail banks (Santander UK and LBG), and international, universal banks (RBS Group, HSBC, and Barclays).

2008 financial crisis, which also resulted in the Government of the UK acquiring stakes in Lloyds Banking Group (LBG) (43%) and the Royal Bank of Scotland Group (RBS) (84%).

There are also some smaller banks and mutually owned institutions, including cooperatives, building societies, and credit unions. Small “challenger” banks are a recent phenomenon; in 2010, Metro Bank was the first UK financial institution to be granted a full banking license in over 100 years. At the end of 2013, the British Bankers’ Association (BBA) estimated that challenger banks had £40 billion in outstanding loans, accounting for 2% of the UK market. LBG and the RBS will be required to divest a proportion of their retail banking assets as a condition for receiving state aid during the financial crisis. The resulting new banks, TSB and Williams & Glyn, will account for 6% of the PCA market (CMA 2014a). National Savings and Investments is the only state-owned deposit taker, and uses retail savings to help finance the government’s borrowing requirement.

The mutually owned sector consists of one large building society (Nationwide), one medium-sized bank (the Co-operative Bank³), around 50 smaller societies, and 375 credit unions.⁴ Mutual lenders and deposit takers have over £375 billion in total assets, £245 billion in outstanding mortgages (20% of the UK total), and £250 billion in deposits (22% of the UK total) (Building Societies Association 2013). Alongside their core activities of savings and mortgage lending, most building societies now offer a range of banking services, and mainly differ from banks in ownership structure. Building societies are restricted in their use of wholesale funding, and find it more difficult to raise additional capital than do publicly quoted banks.

Credit unions are financial cooperatives owned and controlled by their members. They aim to promote thrift, provide credit and loans at competitive rates, use members’ savings for their mutual benefit, and educate members in money management. The rate of interest that credit unions can charge for their loans is capped at 3% per month. According to Her Majesty’s Treasury (HMT 2014), in the UK there are around 1 million members of credit unions, which have just over £1 billion in total assets.

³ Following financial difficulties in 2013–2014, the Co-operative Bank is now mainly owned by hedge funds, with the parent Co-operative Group retaining only around a 30% share.

⁴ Figure for Great Britain. There are over 100 credit unions in Northern Ireland, which has a much higher number of credit unions per inhabitant than the rest of the UK.

Community development finance institutions (CDFIs) are small-scale social enterprises that lend money to businesses and individuals who cannot obtain finance from major banks. The CDFA (the membership body for CDFIs) reported that, in 2014, CDFIs lent £173 million to 50,000 businesses, social ventures, individuals, and homeowners in the UK. CDFIs are primarily a channel for distributing government funding to small businesses. They can also borrow.

Since 2010, there has been a rapid increase in “crowdfunding.” “Investment crowdfunding” is the provision of equity finance to businesses through an online platform. Peer-to-peer (P2P) lending, also known as “loan-based crowdfunding,” which connects borrowers with lenders online, has grown strongly over the past few years. Total gross lending reached £1.89 billion at the end of the third quarter of 2014 (P2P Finance Association). The UK alternative finance market is the largest in Europe, accounting for around 75% of the total European alternative finance market (Wardrop et al. 2015).

3.3 Financial Inclusion

The causes of financial exclusion are many and varied (Atkinson and Messy 2013). Some people, while not excluded altogether, are only able to access a limited range of products, often at high prices or with onerous terms and conditions. On the supply side, for example, firms might take a risk-averse interpretation of money laundering regulations or the likelihood that a consumer or small firm will be able repay a loan. They may exclude people by charging higher prices for extending credit to individuals with poor or non-existent credit records, or charging higher insurance premiums to people living in areas prone to flooding or with high burglary rates. As insurance underwriting becomes more sophisticated, there is a risk that many currently insured people will be excluded. Independent financial advisers may exclude less profitable consumers with relatively small amounts of money to invest. Exclusion may also be more subtle, in the form of high charges for “basic” accounts, barriers to opening accounts, onerous terms and conditions, or marketing activities restricted to profitable groups.

On the demand side, people may “self-exclude” from financial services because they have a low or irregular income; problems physically accessing branches or ATMs; religious or cultural beliefs that render mainstream products inappropriate for them; or an inability to understand marketing or product information due to low financial capability, low general education levels, language barriers, or the lack of informational transparency.

3.3.1 Transactional Bank Accounts

According to the BBA (2014), there are 9,700 bank branches and 1,600 building society branches in the UK. Some limited services are also available through the 11,500 local post offices, through agency agreements with the major banks.⁵ The Big 5 banks own 9,000 (92%) of bank branches in the UK (Campaign for Community Banking Services 2013).

Office for National Statistics (ONS) population statistics and BBA estimates suggest that there are about 0.19 bank branches per 1,000 adults in the UK, 0.22 if building societies are included (BBA 2014b). However, this is not a good indicator of inclusion, as it does not take geographical distribution into account. Of the around 1,800 bank and building society branches that closed between 2003 and 2012, a disproportionate number were in poorer and rural areas (French, Leyshon, and Meek 2013). This has contributed to the exclusion of those who prefer or need to use a branch, for example, the elderly and small “cash” businesses wanting to bank their takings.

Around half of all adults in Great Britain now bank online, up from 30% in 2007 (ONS 2013). In 2013, there were 534 million online banking transactions (a 64% increase since 2011), and 37% of PCA customers now use mobile banking (Mintel 2013). These changes have reduced the use of branches for transactions. The RBS, for example, has reported a 30% drop in physical customer visits in the past 3 years (BBA 2014).

The number of bank accounts is also a poor indicator of the extent of inclusion. There are 65 million “active” PCAs in the UK (CMA 2014b), or 1.28 per 1,000 adults. However, many people have more than one account; the UK’s predominant “free if in credit” model means that there is often no cost for holding multiple accounts.

Table 3.1 shows household holdings by type of account. Excluding Post Office card accounts (POCAs), 4% of households have no access to any type of transactional or savings account. However, this figure should be treated with some caution due to the high number of “don’t know” answers or refusals to answer the question (Rowlingson and McKay 2014).

⁵ A list of the agreements between the Post Office and UK banks and building societies can be found at <http://www.postoffice.co.uk/banking-services> (accessed 17 December 2014).

Table 3.1: Households with Access to Transactional and Savings Accounts

Type of Account	Households (%)
No transactional account (unbanked)	4
Personal current account	93
NS&I savings account	5
Premium bonds (zero interest savings with monthly prizes)	20
Basic bank account	6
Post Office card account	6
Individual savings account (includes “stocks and shares,” as well as cash)	39
Other bank or building society account	45
Credit union account	1

NS&I = National Savings and Investments.

Source: Family Resources Survey (2014: Table 3.2).

Households living in accommodation rented from a local council or housing association are more than three times as likely than average to be unbanked, and lone parents and single pensioners are more than twice as likely (HMT 2010), as are households in the lowest three income deciles (Family Resources Survey [FRS] 2014: Table 2.7). Lawton and Platt (2010) also reported that certain ethnic groups and people with a disability (particularly those with mental health problems) were more likely to be unbanked, although it was noted that housing tenure and income were stronger predictors.

Access is less of an issue for small businesses and the self-employed, but problems persist in the banking market for small and medium-sized enterprises (SMEs); this was subject to some competition and regulatory inquiries from 2000 to 2014.⁶ The most recent (CMA 2014b) found that the sector is as concentrated as it was in 1999, with the provision of business current accounts and business loans concentrated among the four largest banks. In the same study, SME customers reported that they believed there to be little differentiation among providers. They also experienced difficulty in comparing offers across providers, and did not shop around. This has inhibited competition between new and existing providers.

⁶ See Cruickshank (2000); Competition Commission (2002); Treasury Select Committee (2002); OFT (2007); OFT (2010); Independent Commission on Banking (2011); Treasury Select Committee (2011); and FCA and CMA (2014).

3.3.2 Savings and Pensions

Over one-third of households in the UK have no savings, and a further 13% of households have less than £1,500 put by. In general, the level of savings increases with income. However, some households on high incomes do not save at all, while others in the lowest decile do (FRS 2014: Table 2.8).

In 2012–2013, 26% of UK adults (12.9 million) were contributing to a pension. Employees have the highest pension participation rate (48%), while the self-employed have significantly lower levels of participation (17%). Participation rates for employees do not differ significantly by gender (men 47%, women 48%); however, self-employed women have much lower participation rates (12%) than self-employed men (21%) (FRS 2014: Table 6.1). Self-employed contribution rates tend to be lower as well, and only 33% of the self-employed are providing “adequately” for retirement, compared to 59% in the public sector and 41% in the private sector (Scottish Widows 2014).

3.3.3 Insurance

In 2012, the Association of British Insurers (ABI 2013) estimated that 76% of households had home contents insurance, 74% had motor insurance, 64% had buildings insurance, 20% had whole-of-life assurance, and 2% had fixed-term life insurance.

The likelihood of having home contents insurance increases with income (Rowlingson and McKay 2014). In general, older age groups are more likely to have general insurance. The groups least likely to have general insurance include adults with disabilities, particularly mental health problems, for whom affordability is the main barrier (Lawton and Platt 2010).

The self-employed are less likely than employees to have some form of insurance. For example, 79% of the self-employed have contents insurance, 11% have medical insurance, and 19% have life insurance. In comparison, 87% of lower managerial and professional workers have contents insurance, 14% have medical insurance, and 28% have life insurance (ABI 2012).

3.3.4 Unsecured Credit

Total UK outstanding consumer credit debt is currently £169.5 billion, of which £61.2 billion is credit card debt.⁷ According to the consumer

⁷ January 2015 figures from themoneycharity.org.uk (accessed 12 March 2015).

organization Which?, 79% of consumers used at least one unsecured credit product during 2013 (Which? 2014a). The fastest growing market sector is high-cost, short-term credit (HCSTC, or “payday” lending). In 2012, 1.8 million consumers took out payday loans worth £2.8 billion, up from £900 million in 2008 (CMA 2015). This type of lending has proved attractive because it allows people to borrow small amounts for a short time, and the charges are transparent. It is even preferred by some who could access bank lending. It is very expensive, however, and supplier profitability relies on the debt being rolled over and incurring additional charges, which leads many into a debt spiral (Beddows and McAteer 2014).

Bank overdrafts are also an expensive way to borrow, especially if not authorized in advance. Unlike payday loans, unauthorized overdrafts are complex and non-transparent. Which? used volunteers to calculate the overdraft costs and charges of 12 UK banks. The volunteers took 10 minutes on average to find the relevant information on the banks’ websites and only got 10 out of 72 calculations correct (Which? 2014b). Even for the cheapest accounts, dipping into an overdraft for just 2 days each month would cost £10–£20.

Table 3.2: Use of Unsecured Credit in the United Kingdom, 2013

Type of Unsecured Credit	People Who Used this Credit in 2013 (%)
Credit card	56
Authorized overdraft	28
Store card	12
Personal loan	9
Catalog finance	10
Car finance/hire purchase	7
Payday loan	5
Unauthorized overdraft	5
Home credit/doorstep loan	2
Credit union loan	1
Other	1
No credit products	21

Source: Which? (2014a).

The use of unsecured credit is closely linked to low incomes, low levels of savings, and having children at home. Lone parents are particularly likely to use payday loans. Younger and middle-aged households are more exposed than older households to relatively high levels of unsecured debt, contributing to a higher concentration of over-indebtedness and financial difficulties in these age groups (Department for Business, Innovation and Skills [BIS] 2013a).

Employees and the self-employed have similar levels of over-indebtedness, with around 6.4% of both groups finding unsecured debt a heavy burden. However, overall levels of total (secured and unsecured) debt are higher for the self-employed, as is the burden of debt repayment. More than twice as many self-employed households spend 25% or more of their income on repaying unsecured debt as do employee households, and nearly three times as many spend over half of their household income on servicing debt (Bryan, Taylor, and Veliziotis 2010).

3.3.5 Lending to Small and Medium-Sized Enterprises

Bank business loans account for 70% of funding for SMEs in the UK (FCA and CMA 2014). Overall bank lending to micro, small, and medium-sized enterprises (MSMEs) declined by 25% from the 2008 financial crisis to the end of 2013, while lending margins increased from 2.5% to 4.0% over the same period (FCA and CMA 2014).⁸ Despite the government's "Funding for Lending" scheme being re-focused to encourage lending to MSMEs, lending contracted by £0.5 billion per quarter in 2014 (Bank of England 2015). While some of this decline was due to decreased demand (BDRC Continental 2014), there is also evidence that the banks withdrew from what they saw as riskier lending. In 2011–2012, 23% of MSMEs had a loan application rejected and 19% were refused an overdraft, an increase from 2005–2007 when rejection rates were 6% for loans and 8% for overdrafts (BIS 2013b).

Lack of access to finance can be a particular problem for microbusinesses due to information asymmetries and the additional cost of providing small loans.⁹ Three-quarters of microbusinesses reported problems in obtaining finance as an obstacle to business growth (BIS 2013c). The main problem reported was that banks were "not lending," followed by concerns about the cost of finance. Over one-third of microbusinesses reported that they were "not sure where to obtain finance."

⁸ As measured by the spread between the Bank of England base rate and the loan cost.

⁹ The EU defines microcredit as loans of less than €25,000 to new or existing microenterprises.

MSMEs have also suffered from poor conduct by the major banks. One example is the widespread mis-selling of interest rate hedging products (IRHPs), which were sold to MSME customers alongside loans. The Financial Services Authority (FSA) found that banks had failed to ascertain MSMEs' attitudes to risk, failed to disclose exit costs, and even sold IRHPs larger than the size of the loan (FSA 2012c). It was also reported that some banks told MSMEs that they risked being refused credit unless they bought IRHPs (British Broadcasting Corporation [BBC] 2012).

Tomlinson (2013) found evidence that MSMEs in financial difficulty were treated poorly (e.g., increasing the pricing of business loans for struggling firms and the application of opaque and arbitrary fees. A review of Tomlinson's findings commissioned by the RBS concluded that there was "no systematic defrauding of business customers," but did find evidence of incomprehensible fees, and that banks used the threat of withdrawing an overdraft to gain leverage in negotiations with MSMEs (Chance 2014). The FCA is still investigating the Global Restructuring Group, the RBS division meant to help small businesses in financial difficulty.

3.4 Financial Regulation and Supervision

The first priority of national authorities following the financial crisis was to stabilize financial systems. More recently, financial services regulators in developed economies have turned their attention to conduct regulation, that is, looking at the way firms do business and how this affects consumer outcomes. The UK has been at the forefront of these developments.

3.4.1 Regulatory and Supervisory Authorities

The UK has had a "twin peaks" model of financial services regulation since the single regulator, the FSA, was disbanded in 2013. The Prudential Regulation Authority is responsible for the safety and soundness of the financial system, and the FCA is responsible for ensuring that financial services markets work well for consumers. The FCA has three statutory objectives: to secure an appropriate degree of consumer protection, to protect and enhance the integrity of the UK financial system, and to promote effective competition in the interests of consumers (Government of the UK 2012).¹⁰

¹⁰ The definition of consumers includes the self-employed and other business customers purchasing regulated financial products.

The FCA supervises the conduct of larger financial services firms on a relationship basis; for smaller firms (for example, independent financial advisers and consumer credit firms) it carries out thematic reviews intended to identify and remedy systematic issues causing consumer detriment. CDFIs are only authorized and regulated by the FCA when they carry out regulated activities such as lending.

In light of its competition objective, the FCA conducts market studies, sometimes jointly with the CMA. In 2013, the Bank of England and FSA announced that they would reduce entry barriers for new banks through a combination of reduced capital requirements and streamlined authorization.

The FCA has no statutory remit with respect to financial inclusion, but, in carrying out its competition objective, has a duty to “have regard” to the ease with which consumers can access financial services, including in areas affected by social or economic deprivation. In general, the implementation of financial inclusion policies has been the subject of voluntary agreements between the government and the industry rather than a matter of law or specific rules set and enforced by the regulator.

The Financial Services (Banking Reform) Act 2013 created a new competition-focused, economic regulator for payment systems in the UK: the payment systems regulator, which is a subsidiary of the FCA.

In addition, the Money Advice Service (MAS) has a statutory objective to enhance people’s ability to manage their own financial affairs. The regulatory system also has a binding alternative dispute resolution procedure (the Financial Ombudsman Service) and redress mechanism (the Financial Services Compensation Scheme). All of these institutions are funded by a levy on regulated firms.

3.4.2 Increasing Access to Banking Services

Problems of financial exclusion persist. A report published by HMT in 1999 estimated that 2.5 million–3.5 million adults lacked access to a transactional bank account. Most of the unbanked were unemployed, dependent on state benefits, and living in social housing.

In 2004, the government allocated £120 million for projects promoting financial inclusion (HMT 2004a; 2004b), in line with its priorities of (i) increasing the numbers of households with access to a bank account, (ii) developing models for affordable credit, and (iii) increasing the availability of free face-to-face money advice.¹¹ It set up a financial inclusion taskforce to monitor progress.

¹¹ Advice about personal debt was called “money advice” until around 2008. It is now more generally called “debt advice,” and that is the term used throughout this chapter.

The government negotiated a “shared goal” with the banks to halve the number of unbanked persons, and persuaded the major banks to introduce a “basic” bank account, which would allow people to make and receive payments and withdraw cash, but without an overdraft facility. At the same time, the government introduced a Post Office card account (POCA) for recipients of welfare benefits. The POCA could only be accessed at local post offices, and benefits were the only deposits accepted. Despite its limited functionality, the account proved popular, and over 5 million consumers requested a POCA.

Although the number of unbanked households halved in line with the shared goal, progress has stalled, and the proportion has stayed at around 4% for over 5 years. There are over 9 million live basic bank accounts, but they do not always meet consumers’ needs. A number only allow free access to ATMs from their own cash machines, or do not allow money to be withdrawn at a branch. Only one provider offers accounts to undischarged bankrupts. None pay interest on credit balances.

While basic bank accounts do not provide an overdraft facility, customers are still charged if they lack sufficient funds to cover a direct debit that falls due. A 2010 study of the “newly banked” (Ellison, Whyley, and Forster 2010) found that half had previous experience of banking, but had fallen out of the system due to problems with their accounts, particularly unpaid direct debits. Many still showed a preference for using cash. The profiles of the newly banked differed from those of the remaining unbanked: they were better off and generally more financially secure, and were motivated to open an account because third parties required it (e.g., an employer), rather than because they wanted one. This suggests that basic accounts are not meeting the needs of those with the lowest incomes.

New EU legislation, the Payments Account Directive, will give every EU citizen the right to a basic bank account for free or “at reasonable cost.”¹² In December 2014, the government announced that it had reached a voluntary agreement with the banks in advance of the implementation of the directive, which stipulated the provision of free basic accounts to eligible consumers.¹³ This agreement includes the removal of charges for unpaid items, which should give basic account holders more confidence that they will not encounter unexpected charges.

The government is phasing in universal credit, which will bring some existing welfare benefits together into a single monthly payment. While people on low incomes are generally capable of managing day-to-day spending (FSA 2006a), the change to monthly payments, and the

¹² Directive 2014/92/EU. eur-lex.europa.eu (accessed 13 March 2015).

¹³ Revised basic bank account agreement. www.gov.uk (accessed 18 December 2014).

need to pay housing costs directly rather than having them deducted at the source, will likely create budgeting challenges for many. Mainstream banks have failed to innovate to meet these challenges, for example by providing so-called “jam-jar” accounts, which enable essential spending to be ring-fenced within the account; or by providing budgeting tools that anticipate upcoming spending and help consumers budget by providing them with a “safe to spend” limit (Lindley 2014). The presumption that universal credit will be managed online will be problematic for the digitally excluded. According to a BBC media literacy study, 21% of adults in the UK cannot use the internet, and 14% do not have access to it at all.¹⁴ This proportion is higher for people on low incomes, those with disabilities, and older people.

3.4.3 Savings and Pensions

In the early 2000s, asset-building initiatives were widely seen as a policy tool for increasing financial and social inclusion. In 2005, the government introduced a Child Trust Fund (CTF) intended to (i) create an asset for every eligible child to access when they turned 18, (ii) build a savings habit, and (iii) promote financial education. Every parent or guardian received a £250 voucher that could be used to open an account for the child. Low-income families received an additional £250. The government added the same amounts on the child’s seventh birthday. Parents, friends, or family could add up to £1,200 a year to the account. All interest or capital gains on the accounts were tax-free. The child could manage their account from the age of 16, but only withdraw the money at 18.

Evaluation of the CTF found generally little impact on savings for children. However, total amounts saved increased by an estimated £618 for children living in homes that were not owner-occupied (Kempson, Finney, and Davies 2011), suggesting the scheme was effective in reaching children in poorer households.

At around the same time, the government piloted a matched funding “Saving Gateway” scheme for people with a low income. In the pilot, the average amount of monthly saving by participants almost doubled from £8.85 to £16.14, and the average balance by the end of the scheme was £282—just over three-quarters of the possible maximum of £375. Eight out of 10 participants described themselves as saving regularly at the end of the scheme, compared with only 17% at the start (Kempson, McKay, and Collard 2005).

¹⁴ BBC. http://www.bbc.co.uk/learning/overview/assets/bbcmedialiteracy_20130930.pdf (accessed 13 March 2015).

The government established a second pilot in 2005, and the Department for Education and Skills set up a parallel community and finance-learning initiative intended to increase access to free education and training, increase take-up of financial incentives for learning, build financial literacy skills, and support access to financial services, including finance for the development of microenterprises (Ecotec Research and Consulting 2005).

The second Saving Gateway pilot also saw a positive impact on saving (Ipsos MORI, and Institute for Fiscal Studies 2007). Participants became more familiar with financial products and information, and some came into contact with a bank for the first time in their lives. Although the Saving Gateway was demonstrably successful, the incoming government in 2010 decided to discontinue it. The government also reduced CTF payments, and stopped them altogether for children born after 3 January 2011.

The proportion of household spending on essentials such as energy increased from 19.9% in 2003 to 27.3% in 2013 (ONS 2013b), which has disproportionately impacted low-income households. However, savings incentives favor those on higher incomes. Individual savings accounts (ISAs) allow tax-advantaged savings or investments of up to £15,000 a year.¹⁵ Although households at all income levels hold ISAs, the proportion and value of the holdings increase with income. To compound the problem of regressive incentives, the government replaced the CTF with a junior ISA, which offers tax-free savings, but no government contribution.

To increase the number of individuals saving into a pension, the government introduced automatic enrollment. This places a legal duty on employers to designate a pension scheme for their staff and automatically enroll those aged between 22 and the state pension age who earn above a trigger threshold. Schemes must meet set quality standards, and there is a charge cap of 0.75% a year for those in a default fund.

Larger employers are already auto-enrolling their workforces; the smallest will do so by 2016. The minimum default level of contributions will also be increased until it reaches 8% of earnings (4% from the individual, 3% from the employer, and 1% from the government in the form of tax relief). Opt-out rates are low so far, and the proportion of employees contributing to a pension has increased for the first time for 10 years (Department for Work and Pensions 2014). The current default level of contributions will give those on median incomes a maximum retirement income of 45% of their working income, a replacement rate likely to be inadequate for many.

¹⁵ In 2014–2015.

The exclusion of the self-employed from automatic enrollment could widen the existing gap in pension provision between employees and the self-employed (D'Arcy and Gardiner 2014).

3.4.4 Insurance

Insurance has not had the same focus as other aspects of inclusion. In the early 2000s, the government and the insurance industry worked together to promote the take-up of “insurance with rent” schemes. These gave tenants in social housing the opportunity to access low-cost home contents insurance and pay for it alongside their rent. By 2006, insurance with rent schemes were available in 75% of local authorities. However, the government did not set targets to promote the take-up of the schemes (Treasury Select Committee 2006a). In 2009, the ABI noted that one-third of the 4.8 million people in social housing did not have contents insurance, despite the fact that (i) people in social housing were twice as likely to be burgled as those who owned their home, (ii) arson attacks were 30 times higher in lower-income communities, and (iii) low-income families were eight times more likely to be living in areas prone to flooding. The ABI issued guidance to local authorities and housing associations on contents insurance schemes for low-cost tenants; however, as Rowlingson and McKay (2014) noted, there has been almost no increase in the take-up of contents insurance.

3.4.5 Unsecured Credit

In a 2004 report, HMT found that people excluded from mainstream credit experienced excessive interest rates, poor price transparency, and pressure to take on more debt. Some resorted to illegal lenders. In response, the government encouraged banks to work with credit unions to expand their coverage and improve sustainability. It introduced a bespoke “light-touch” regulatory regime for credit unions, and increased the maximum interest rate that they could charge from 1% to 2% per month, to reflect the riskiness of borrowers excluded from the mainstream (HMT 2007a).

The government also expanded the scope of the Social Fund, which provided interest-free loans with repayments deducted from state benefits, and established a Growth Fund to support third-sector lenders. This provided £42 million in funding to CDFIs and credit unions during 2006–2011 for lending to individuals and microbusinesses. The government also instigated local projects to bring enforcement action against illegal lenders and help victims find local sources of affordable credit (HMT 2007a).

In April 2014, the FCA took over responsibility for consumer credit regulation from the OFT and introduced (i) a requirement for strict affordability checks to ensure that consumers can afford repayments, (ii) consumer protection from misleading advertisements, and (iii) a robust authorization regime. The FCA also introduced strict rules for HCSTC, limiting the number of times a loan can be rolled over, controlling collection practices, and including risk warnings and information on debt advice in financial promotions (FCA 2014b). The narrow definition of HCSTC excludes unauthorized overdrafts, and CDFIs are exempt from its provisions.

The Financial Services (Banking Reform) Act 2013 requires the FCA to implement a price cap for payday loans. The FCA set the price cap at 0.8% per day of the amount borrowed, a £15 cap on default charges, and a total cap on the cost of a loan of 100% of the amount borrowed (FCA 2014c). The FCA expects that 7% of borrowers—70,000 consumers—will no longer have access to payday loans following the introduction of the cap, and acknowledges that a small percentage of these may seek loans from illegal lenders.

3.4.6 Crowdfunding

The FCA regulates P2P platforms that lend to consumers, sole traders, and small partnerships with respect to disclosure and promotions, capital requirements, safeguarding client money, dispute resolution, and business continuity in cases of platform failure.

Firms offering certain unlisted investments can only promote them to professional clients, retail clients who are advised or certified as sophisticated or having high net worth, or retail clients who confirm that they will not invest more than 10% of their net investible assets in these products. For “non-advised” offers, firms must apply an “appropriateness” test, that is, to check that clients have the knowledge or experience to understand the risks involved (FCA 2014a).

3.4.7 Micro, Small, and Medium-Sized Enterprises and Consumer Protection

In general, MSMEs do not have the same level of consumer protection as do retail consumers (Fletcher, Karatzas, and Kreutzmann-Gallasch 2014). FCA rules broadly apply to firms selling to MSME customers only for

- (i) unsecured loans of less than £25,000 (some rules do not apply, for example, the requirement to assess creditworthiness);

- (ii) loans secured on residential property; and
- (iii) banking services to microbusinesses (EU definition), except that the rules on distance marketing apply only to retail consumers.

Microbusinesses also have the same access to the Financial Ombudsman Service as do retail consumers. Eligibility for redress depends on the product. In the case of IRHPs, in addition to MSMEs the FCA also included larger businesses based on tests of financial sophistication and experience. This meant that businesses not usually eligible for redress were awarded compensation.

3.4.8 Access to Finance

Intervention in financial services markets for MSME consumers has for many years focused on access to finance, with the aim of encouraging growth and sustainability. One in seven persons in the UK workforce is now self-employed, an increase of 650,000 persons since the 2008 financial crisis (D'Arcy and Gardiner 2014). At the start of 2012, SMEs employed over 14 million people. Three-quarters of all new jobs in the UK are created by MSMEs (National Audit Office 2013). High-growth microbusinesses contribute disproportionately to the economy in terms of growth and productivity (BIS 2010).

Policy has generally focused on small-scale community finance and a range of government programs aimed at MSMEs in general, or sectors such as technology. The Legislative Reform (Industrial and Provident Societies and Credit Unions) Order 2011 enabled credit unions to provide services to businesses, social enterprises, and community groups. In practice, few credit unions have chosen to exercise these new freedoms. Some provide small-value loans to self-employed individuals for business purposes, but very few credit unions have the necessary reserves to make bigger loans to businesses; those that do are concerned about the risks of making larger loans (Civitas 2013).

The government has encouraged the development of CDFIs through tax relief and direct funding. Community investment tax relief was introduced in 2002 for investments in accredited CDFIs held for at least 5 years. The relief is worth 25% of the investment. Since CDFIs became the delivery channel for the Start-Up Loans and New Enterprise Allowance schemes, the volume of loans to businesses increased from £30 million in 2012 to £52 million in 2013. There is evidence that CDFIs are lending to businesses that cannot obtain mainstream funding. In 2013, 93% of CDFI business loan recipients had previously been turned down for finance by a bank; and 57% had previously been unemployed

(CDFA 2013). However, CDFIs are a long way from being sustainable. In 2013, the UK central and local government and the EU accounted for 60% of the capital raised by CDFIs. A further 29% was raised through the Regional Growth Fund, which matched bank loans with central government grant funding.

In response to the declining availability of bank finance for MSMEs, the government has introduced some additional schemes since 2010. In 2013, there were 14 separate schemes with a variety of targets and delivery mechanisms in addition to the broader Funding for Lending scheme. These are summarized in Table 3.3.

Table 3.3: Government Schemes to Promote Access to Finance

Name of Scheme	Details	Target Groups	Delivery Mechanism	Total Funding for Main BIS Schemes
Start-Up Loans	Advice, small start-up loans (averaging £6,000), and mentoring.	Self-employed people and microbusinesses	CDFIs	£120 million
Regional Growth Fund	Grants and loans to businesses and SME finance providers alongside private investment	All businesses	CDFIs for SMEs	
New Enterprise Allowance	Weekly allowances, start-up loans, and mentoring for those on certain welfare benefits	Unemployed people establishing new businesses	Jobcentre Plus	
Technology-based SMEs	Grants, finance, networking, and monitoring for science, engineering, and technology R&D projects	Technology-based SMEs	Technology Strategy Boards	
Business finance partnerships	Investments in lenders who provide financing to businesses, that is, leveraging public money with private money	SMEs	Fund managers, non-traditional lenders, venture capitalists	£100 million
Seed Enterprise Investment Scheme	Tax incentives for investing in a small business, to a maximum of £150,000	Small businesses with fewer than 25 employees	HMRC	

continued on next page

Table 3.3 *continued*

Name of Scheme	Details	Target Groups	Delivery Mechanism	Total Funding for Main BIS Schemes
Enterprise Investment Scheme	Tax incentives for investing in qualifying companies or Enterprise Investment Funds, to a maximum of £1 million	SMEs with less than £15 million in assets	HMRC/fund managers	
Venture Capital Trusts	Tax incentives for investing in funds that invest in unquoted companies, to a maximum of £200,000 a year	Unquoted companies with less than £15 million in assets	HMRC/venture capital fund managers	
Business Angel Co-Investment Funds	Investments in business angel funds, which are making investments in SMEs in certain areas of the country	SMEs in qualifying areas	Individual angel funds	£80 million
Enterprise Capital Funds	Investments in funds that invest in SMEs.	SMEs	Fund managers	£200 million
UK Innovation Investment Fund	Investments in UK high-growth, technology-based businesses	Technology-based SMEs	Fund of funds managers	£150 million (government) + £180 million (private investors)
UK Export Finance Products	Export credit and finance to exporting businesses	Exporters, especially SMEs	UK Export Finance	
Enterprise Finance Guarantee	Guarantees for lenders making loans to eligible SMEs lacking security or track records	Businesses with a turnover of less than £41 million a year	Banks	Up to £2 billion
Growth Accelerator	Access to finance, mentoring, business development, and leadership training	SMEs	Growth Accelerator website	

BIS = Department for Business, Innovation and Skills; CDFI = community development finance institution; HMRC = Her Majesty's Revenue and Customs; R&D = research and development; SMEs = small and medium-sized enterprises; UK = United Kingdom.

Source: BIS 2013d.

In examining the value for money of the main access-to-finance schemes, the National Audit Office (2013) concluded that many delivered their individual targets, but that the initiatives were not managed as a unified program. It recommended some measures for defining success more precisely and for using evaluation to increase the schemes' effectiveness. It also noted the need to make MSMEs more aware of what was on offer—only 52% of MSMEs were aware of the main government and bank initiatives designed to improve access to finance. The government subsequently set up the Business Bank to coordinate access to finance for MSMEs.¹⁶

3.5 Financial Education

The Organisation for Economic Co-operation and Development (OECD) defines financial literacy as “a combination of awareness, knowledge, skills, attitudes and behaviors necessary to make sound financial decisions and ultimately achieve individual financial wellbeing” (Atkinson and Messy 2012).

In 2006, the FSA published a 5-year national strategy for improving the financial capability of UK citizens (FSA 2006a), based on the findings from a baseline survey that measured the financial capability of adults across the country (FSA 2006b). The survey defined five elements of financial capability: making ends meet, keeping track of personal money, planning ahead, choosing financial products, and staying informed about financial matters. It revealed low levels of financial capability, for example,

- (i) 81% thought that the state pension would not give them the standard of living they hoped for, but 37% of these had made no plans for an additional pension;
- (ii) 70% of people had made no provision to cover a sudden drop in income;
- (iii) 33% bought everyday products, like insurance, without shopping around;
- (iv) 40% of people with an equity ISA did not realize that they were exposed to investment risk, while 15% with a cash ISA thought they were; and
- (v) 9% of people who rented had bought (unnecessary) buildings insurance.

¹⁶ British Business Bank. <http://www.british-business-bank.co.uk> (accessed 23 January 2017).

Younger people (aged 20–30) were generally less capable than older age groups. Those on low incomes were good at making ends meet, but poor at planning ahead.

In 2012, the UK took part in an OECD pilot study (Atkinson and Messy 2012) aimed at comparing financial literacy across developed and developing countries. The OECD developed scores on three factors: knowledge, attitudes, and behaviors. Of the eight most developed countries, the UK scored sixth on knowledge and attitudes, and fourth on behavior. The MAS undertook another financial capability survey in 2013 to enable a comparison with the original baseline survey. This survey found knowledge gaps; for example, 16% of people were unable to identify the balance on a bank statement and 12% thought the Bank of England base rate was over 10% (it was 0.5%). Compared with 2006, 9 million more people were struggling to keep up with commitments and 5 million fewer were saving for a rainy day, but more were keeping track of their bank statements. As in 2006, young people showed low levels of financial capability—for example, 43% of those under 35 did not understand the impact of inflation on savings, and 14% thought it was best to start paying into a pension when they were in their 50s.

As well as putting consumers at a disadvantage in dealing with financial services firms, poor money management can also adversely affect health. A 2009 study (Taylor, Jenkins, and Sacker 2009) found that greater financial capability had a greater effect on mental wellbeing than increases in household income. The researchers also found that having low financial capability exacerbated the psychological costs associated with unemployment and divorce.

3.5.1 Creation of the Money Advice Service

Following two reports on its approach to financial capability (HMT 2007a; HMT and FSA 2008), the government commissioned an independent review of the feasibility of providing generic (unregulated) financial advice (Thoresen 2008). Thoresen concluded that general guidance would benefit up to 19 million people, including those with no access to advice, poor planning skills, low or no savings or protection products, difficulty making ends meet, and over-indebtedness.

The effectiveness of the approach was tested in a pathfinder (Kempson and Collard 2010), and the government brought forward legislation (included in the 2010 Financial Services Act) to set up an independent body to take over the FSA's financial capability role (originally the Consumer Financial Education Body, now the MAS). The MAS's statutory objectives are to enhance the financial understanding and knowledge of members of the public (including knowledge of the

UK financial system), and to enhance their ability to manage their own financial affairs.

The 2012 Financial Services Act gave the MAS additional responsibility for funding and improving the quality, consistency, and availability of debt advice.

Since its inception, the MAS has focused on providing a comprehensive website, including financial health check, budgeting, and product comparison tools, and information about the financial implications of different life stages and events. It also provides a web chat line, telephone helpline, and, through partners, face-to-face guidance. The MAS has concentrated mostly on serving the adult population, and financial education in schools has been supported by the UK charity the Personal Finance Education Group (pfeg),¹⁷ as well as other third-sector organizations.

The MAS has been reviewed many times in its short existence, most recently by independent reviewer Christine Farnish (HMT 2015). Farnish recommended a tighter role for the MAS, filling provision gaps and facilitating better consumer information.

3.5.2 Financial Education in Schools

There are compelling reasons for teaching personal finance education to all schoolchildren (All-Party Parliamentary Group on Financial Education for Young People 2011). Children are exposed to money issues at a very young age. A pfeg study found that 98% of children aged 11–17 had money of their own. There are also some prepaid debit cards on the market, some for children as young as eight (pfeg 2010).¹⁸

In money matters, parents are not always the best educators. Children learn both good and bad money habits from their parents (Centiq 2008). Parents who are financially illiterate often have low incomes. If their children do not learn to manage money well, this can reinforce cycles of deprivation.

Responsibility for education in the UK is devolved to the four home countries: England, Scotland, Wales, and Northern Ireland. Personal finance education in schools was first introduced in Scotland, and is also embedded in the curriculum in Wales and Northern Ireland. The National Curriculum in England was revised in 2014, making financial education a statutory subject for the first time. The subject is covered in both citizenship and mathematics. For children aged 11–14, the

¹⁷ Merged with Young Enterprise in September 2014.

¹⁸ For example, the family card goHenry.

citizenship curriculum covers the functions and uses of money, and the importance and practice of budgeting and managing risk. For older children (aged 14–16), topics include income and expenditure, credit and debt, insurance, savings and pensions, financial products and services, and how public money is raised and spent. In addition, the new mathematics curriculum is intended to ensure that “all young people leave school with an understanding of the mathematics skills needed for personal finance” (Hansard, House of Commons Debate 12 May 2014, c368W).

Schools across the UK use local credit unions or banks to support personal finance teaching. This support may take the form of assisting the classroom teacher, or developing teaching resources.¹⁹ An Office for Standards in Education study (2008: para.13) found that, in schools where personal finance education was being delivered effectively, “students had a good grasp of key concepts and could demonstrate the ability to make sound financial decisions.” They could, for example, identify what factors were relevant to investing a sum of money, balancing risk and return. Some older pupils used their skills to help their parents, e.g., by setting up direct debits for them to pay bills, helping with family budgeting, or recouping bank charges.

An independent study of the pfeg Learning Money Matters program (Spielhofer, Kerr, and Gardiner 2009) found that personal finance education lessons noticeably impacted students’ attitudes to saving and borrowing and their confidence in dealing with money. A similar study (RBS 2010) found that young people who had been exposed to a Money Sense program in school were more knowledgeable about financial products and services, more likely to keep track of their spending through formal methods, more likely to believe in the importance of saving, and more likely to have more realistic expectations.

Despite encouraging evidence, some have argued that financial education will never work, claiming that people behave irrationally, do not remember what they have learned, and in any case will always be outsmarted by the financial services industry. Policymakers are therefore increasingly designing normative interventions that “nudge” people into making the “right” decisions (Thaler and Sunstein 2008).

The distinction between “financial capability” and “financial wellbeing” is important in policy terms. Increasing financial capability will increase financial wellbeing (although some people will always make decisions that are not in their own best interests, as they are free to do in many aspects of life). Nudge initiatives, such as pension auto-

¹⁹ Examples can be found at <http://www.pfeg.org> (accessed 24 January 2017); pfeg also developed a quality mark for classroom resources.

enrollment, may increase wellbeing, but will not increase financial capability, and may even have the reverse effect by taking away decision-making responsibility. Lessons from behavioral economics can be used to good effect by reducing choices to a manageable number, or designing communications in such a way that they are most likely to be acted upon. However, such interventions should not be used as a substitute for financial education, which has benefits beyond simply optimizing personal finance decision-making.

3.5.3 Financial Education and Micro, Small, and Medium-Sized Enterprises

Most policy interventions have focused on increasing access to finance for MSMEs, but have not considered whether they have the awareness and skills to take advantage of these opportunities. Financial literacy is as important for MSMEs as for individuals and households, both in accessing appropriate start-up finance and empowering them to use financial products and services to manage risk and other business needs. The Association for Chartered Certified Accountants (2014) discussed the need for MSMEs to demonstrate creditworthiness and “investability” through high-quality financial information. The Association for Chartered Certified Accountants also notes that the UK SME Finance Monitor has demonstrated that credit providers are more likely to lend to SMEs that produce regular management reports; this advantage appears greater for SMEs that have not previously borrowed, and would otherwise be at a disadvantage. There are some online advisory services for MSMEs in the UK, but no specific programs to build financial capability.

3.6 Conclusions and Recommendations

Despite a high degree of access to financial products and services in the UK, mainstream providers do not meet the needs of a small, but significant proportion of people. The most vulnerable groups are still excluded, and many rely on expensive credit to manage their day-to-day living expenses. Attempts to generate sources of affordable credit have foundered because policymakers have failed to take into account the different profiles and needs of high-cost borrowers. These problems persist despite nearly 2 decades of financial inclusion policy interventions, and may be explained by the dominance of the Big 5 banks, which have been reluctant to serve low-income consumers and

have only done so in a series of deals with the government. These deals do not work because they are not transparent, and the banks are not accountable for delivering their side of the bargain.

At the same time, more risk has been transferred to consumers, particularly through changes to the pensions landscape, and financial products have become more numerous and complex. Technological advances have not been matched by product innovation. There is a risk that technological advances will ultimately exclude or underserve even more people, such as those who are unable or unwilling to do business online. Similarly, more sophisticated risk assessment and the use of “big data” will narrow risk pools for insurance and credit, causing many to be excluded from products to which they currently have access.

Decades of interventions intended to help MSMEs access finance have also yielded little in the way of concrete results, a situation that has worsened since the 2008 financial crisis. The large number of government-supported schemes can create complexity and bureaucracy for business. CDFIs are not yet sustainable, with public funding (from central and local governments, and the EU) accounting for 60% of their new capital in 2013. Credit unions have shown little appetite to diversify into business lending, and tax relief has so far been unsuccessful in attracting significant amounts of private capital from banks or external sources into microfinance institutions.

Strong consumer protection regulation has curbed some of the worst practices in financial services markets, but widespread problems remain. Financial education has a part to play, particularly in teaching children and young people how to manage money; however, even the most financially literate consumer cannot keep up with a rapidly changing environment, product innovation, poor disclosure, and impenetrable jargon. Equally, better transparency by firms requires a degree of consumer understanding, interest, and motivation to engage.

To improve financial inclusion and education, the following measures are recommended:

- (i) The financial inclusion agenda should be coordinated across the relevant government departments. Data on financial inclusion, in particular, access to products and services by individuals and MSMEs, and how these are used in practice, should be analyzed centrally. Particular attention should be paid to emerging causes of exclusion, such as technology and narrower risk pools.
- (ii) The FCA should monitor progress toward promoting financial inclusion as part of its competition objective, and should encourage the development of products and services meeting the needs of vulnerable and underserved consumers.

- (iii) The FCA should set and enforce rigorous standards for basic bank accounts to ensure that they meet the needs of low-income and vulnerable consumers. An appeals process for people turned down for an account should be established, and the cross-subsidy for basic bank accounts should be transparent, to make it clear who is paying, and how.
- (iv) Banks should make budgeting tools available as part of their basic bank account offer.
- (v) The FCA should examine the impact of more personalized insurance underwriting on the availability of general and protection insurance to different groups of consumers, and the government should consider the policy implications of risk demutualization.
- (vi) The government and FCA should carefully monitor the market for HCSTC in the wake of tightened regulation, and should take tough action against illegal lenders. They should also be prepared to support the development of alternative, low-cost credit products, if necessary. In considering these, it must be recognized explicitly that some consumers are high-risk borrowers who cannot be served commercially at an affordable interest rate. It should also be acknowledged that some people borrow to cover living expenses, and that these borrowers require tailored, sustainable solutions.
- (vii) The government should consider a more progressive approach to savings incentives, using proven approaches like matched funding to encourage saving among those on low incomes.
- (viii) The government should consider how to meet the retirement income needs of the self-employed, who are excluded from auto-enrollment.
- (ix) The MAS should focus on the needs of the most vulnerable, rather than predominantly providing a universal online service. It should examine “what works” nationally and internationally, and design programs to increase financial capability across the UK.
- (x) The MAS should consider with the BIS how to meet the financial education needs of the self-employed and smaller businesses. It should also ensure that specialized debt advice is available for the self-employed and actively promoted to them.
- (xi) The MAS should fund support for financial education in schools to help embed the new compulsory financial education curriculum in England; and ensure that all young

people come out of school able to manage their finances effectively.

- (xii) The FCA should examine online firms lending to MSMEs to ensure that their business models are not based on making profits through default. Online lenders should be subject to caps on default charges and restrictions on the use of continuous payment authorities, in line with the rules for retail HCSTC.
- (xiii) Investments by banks in microfinance institutions should count toward their total SME lending, which is used to determine the amount of funding they are able to access under the Funding for Lending Scheme.
- (xiv) The government should evaluate current access to finance schemes and redirect money to the most successful. It should also promote schemes more effectively to MSMEs. There should also be greater coordination among government departments responsible for business, financial policy, and the labor market.
- (xv) The FCA should promote competition and market entry from alternative sources of finance, while maintaining standards of consumer protection and stable access to finance. In particular, it should supervise the adequacy of P2P lenders' provision funds.

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4

Bangladesh

M. A. Baqui Khalily

4.1 Introduction

Following the 2008 global financial crisis, policymakers have focused on reducing financial risk and stabilizing the financial system. Of the various strategies proposed, particular emphasis has been placed on inclusive finance,¹ financial education,² and financial regulation. Inclusive finance for inclusive growth diversifies portfolios and minimizes risks for lenders on the one hand, and creates economic opportunities for deprived households, and micro and small enterprises in particular, on the other. Therefore, inclusive finance promotes growth through increased investment and the redistribution of financial resources, and promotes equitable and balanced regional growth within a country (King and Levine 1993; Beck et al. 2004; Levine 2005; Beck and Demirgüç-Kunt 2008; Khalily and Khaleque 2013a). It also contributes to financial stability (e.g., Morgan and Pontines 2014). The end result is higher financial development and economic growth (De Gregorio and Guidotti 1995; Demirgüç-Kunt, Beck and Monohan 1998; Rajan and Zingales 1998; Beck et al. 2001; Claessens and Laeven 2005; Claessens 2006).

¹ Inclusive finance refers to the availability and accessibility of provisions of formal financial services including savings, credit, and insurance at affordable prices to all members of an economy (Beck et al. 2004; Leeladhar 2005; Claessens and Laeven 2005; Ardic, Chen, and Latortue 2012).

² Financial literacy, as defined by the Organisation for Economic Co-operation and Development (OECD), is the combination of consumers and investors understanding financial products and concepts, and their ability to be aware of the financial risks and opportunities, enabling them to make informed choices, know where to go for help, and take effective steps to improve their financial welfare (Miller et al. 2009).

In Bangladesh, great emphasis has been placed on financial inclusion, but the responsibility for increasing financial inclusion lies with Bangladesh Bank, the central bank of Bangladesh. Bangladesh Bank has adopted various policy measures, including targeted credit programs, requiring banks to open branches in rural areas, promoting savings habits through school banking, requiring the opening of a bank account for conditional cash transfers, and encouraging financial innovations like mobile and online banking. Furthermore, changes have been made to Bangladesh's regulatory framework and institutional landscape. Such policy changes may have contributed to greater financial inclusion as the intensity of access to financial services through the banking sector has increased. Even without any policy intervention by the regulatory agency, that is, the Microcredit Regulatory Authority (MRA), microfinance institutions (MFIs) have also continued to expand financial services due to their flexibility and their objective of working to alleviate poverty.

This chapter's basic objective is to examine the issues of financial literacy and regulation in the context of inclusive finance for inclusive growth and financial stability in Bangladesh.

4.2 Structure of Financial Markets in Bangladesh

Financial markets in Bangladesh encompass a formal financial market (banks, insurance companies, and nonbank financial institutions [NBFIs]), a microfinance market (MFIs and cooperatives), and informal markets (friends, relatives, moneylenders, and traders). These three markets have different characteristics. Financial institutions in the formal market generally operate in urban areas, provide relatively large collateral-based loans at low transaction costs, and mobilize deposits from high- and middle-income households. MFIs in Bangladesh offer financial services to poor and low-income households, at relatively high transaction costs due to the small size of these “doorstep” services. The informal credit market continues to exist because of its flexibility, reciprocity, and product diversification (Adams and Fitchett 1992; Khalily and Khaleque 2013b). Both formal and microcredit markets can learn lessons from the experiences of the informal credit market.

4.2.1 The Banking Sector

Following financial liberalization in the mid-1980s and the privatization of the banking sector, four major types of banks operate in the formal

financial market—public commercial banks, development financial institutions (DFIs), private commercial banks, and foreign commercial banks. Some 55 scheduled banks—including four public commercial banks, four DFIs, 39 private commercial banks, and nine foreign commercial banks—operated within a network of 8,794 branches at the end of June 2014 (Table 4.1). Although the DFIs have been operating largely in rural areas, the commercial banks are largely concentrated in urban areas.

Table 4.1: Structure of the Banking System in Bangladesh at the End of June 2014

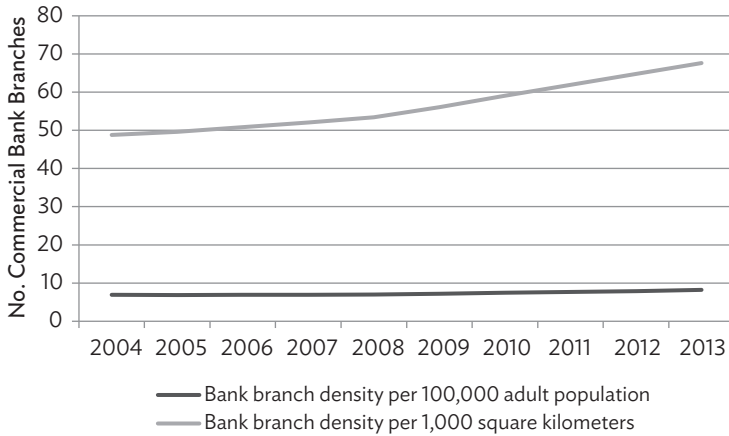
Bank Type	Number of Banks	Number of Branches		Deposits			Advances		
		Rural	Urban	Tk (billion)	(%)	Accounts (million)	Tk (billion)	(%)	Accounts (million)
PSCBs	4	2,271	1,282	1,816.8	26.2	28.11	912.2	18.0	2.88
DFIs	4	1,322	178	375.8	5.4	10.72	348.5	6.9	4.29
PCBs	39	1,557	2,360	4,403.0	63.5	30.17	3,594.8	70.8	2.39
FCBs	9	N/A	70	335.6	4.8	0.37	220.7	4.3	0.20
Total	55	5,150	3,890	6,931.1	100.0	69.37	5,076.3	100.0	9.76

DFI = development financial institution, FCB = foreign commercial bank, N/A = not applicable, PCB = private commercial bank, PSCB = public sector commercial bank.

Source: Bangladesh Bank, Schedule Bank Statistics, September–December 2014.

During 2004–2013, bank branch density per 1,000 square kilometers (km²) (geographical penetration) increased from 48.8 branches in 2004 to 67.6 in 2013, while branch density per 100,000 households (demographic penetration) increased from 6.9 in 2004 to 8.2 in 2013 (Figure 4.1). The lower growth of demographic penetration may indicate that banks have either not been very responsive to the growing demand for financial services of large segments of the population, or have focused mainly on urban clients with access to more resources.

Despite increasing geographical penetration, public commercial banks and private banks are mostly concentrated in urban areas. The banking sector's urban bias is evident in the advance–deposit ratios in rural and urban areas. This ratio decreased more than 20% from 0.54 in 2004 to 0.43 in 2014 in rural areas, whereas in urban areas it remained more or less the same at around 0.84 (Khalily and Islam 2014). The declining share of rural advances to rural deposits, despite an increasing trend in rural deposits, undermines rural investments

Figure 4.1: Bank Branch Density, 2004–2013

Sources: Bangladesh Bank; World Bank, Global Financial Development Database, 2005–2013. <http://www.worldbank.org/en/publication/gfdr/data/global-financial-development-database> (accessed 1 December 2014).

through banks. This decline cannot be attributed to a low demand for rural credit for investment, as MFIs have deepened both the size and scope of their operations. Another major cause for concern is that the total amount of rural loans disbursed by banks in 2013 was almost 30% less than the volume of microfinance loans disbursed by MFIs. Essentially, banks' approach of minimizing collateral-based risk and transaction costs, in conjunction with profit-maximizing behavior, restricts rural investments by banks. Banks are thus not expected to play a dominant role in terms of increasing inclusive growth in Bangladesh. The failure of formal financial institutions to do so has contributed to the emergence of MFIs.

4.2.2 The Microfinance Sector

In Bangladesh, MFIs are the dominant players in rural financial markets. Group-based targeted programs for poor households have expedited resource mobilization for onlending to borrowers. However, the clients and production technology of the formal banking and microfinance sectors differ. The traditional banking sector in Bangladesh has been

largely unable to reach a large segment of rural poor and low-income households, essentially due to asymmetric information and high transaction costs. The MFIs' group-based approach has solved these problems. Before the emergence of MFIs, these segmented population groups depended on informal credit markets for their investment or consumption needs as they are screened out of formal markets due to high transaction costs and their inability to offer collateral for loans.

Bangladesh's microfinance sector comprises two types of institutions. One type is Grameen Bank, which was established in 1983 under the Grameen Bank Ordinance enacted by the Government of Bangladesh. It operates like a specialized bank for poverty alleviation. The other type is the nongovernment organization (NGO) MFI, which includes institutions like the Bangladesh Rural Advancement Committee and the Association for Social Advancement. Before the establishment of a separate regulatory authority in 2006, these institutions were independent and self-regulated. Over the past 3 decades, many NGO MFIs have sprung up, including international NGOs. The development of the microfinance sector in Bangladesh has had two major drivers: cheap funds³ and the establishment of a wholesale lending agency, the Palli Karma Sahayak Foundation (PKSF).⁴ Dependency on donor funds was quite high from 1980–1995 (Khandker, Khalily, and Khan 1996; Khalily and Imam 2001). The latest statistics show that donor fund contributions to NGO MFIs' financing activities are negligible (Credit and Development Forum 2015). With PKSF funds becoming available, the microfinance sector has expanded enormously. The PKSF now finances about 220 NGO MFIs. Member savings finance almost 60% of loans, and commercial banks are also involved in financing these institutions.

Over the years, the microfinance sector has expanded rapidly in Bangladesh in terms of the number of NGO MFIs, branches, and active members. Since NGO MFIs started with a mission to alleviate

³ Cheap funds are funds bearing interest rates lower than banks' normal lending interest rates.

⁴ The PKSF was established in 1990 to facilitate rural economic activities with the aim of alleviating poverty by financing NGO MFI programs and implementing other models or programs for poverty reduction through partner NGO MFIs. A public organization that operates independently with almost no government intervention, the PKSF has broadened its activities from finance to non-finance interventions. It also contributes to the institutional development of financed NGO MFIs through both off- and on-site monitoring, and facilitating the development of appropriate governance structures. The government initially funded it through grants and loans from international agencies like the World Bank. In 2014, its total assets amounted to Tk52.71 billion (\$659 million), of which 66% is financed by capital funds (grants and retained earnings), and the remaining 44% by current liabilities.

poverty and empower the poor, these institutions emerged easily as social organizations. At present, Grameen Bank and some 692 licensed NGO MFIs operate with a network of 17,241 branches and 33.17 million members (Table 4.2).

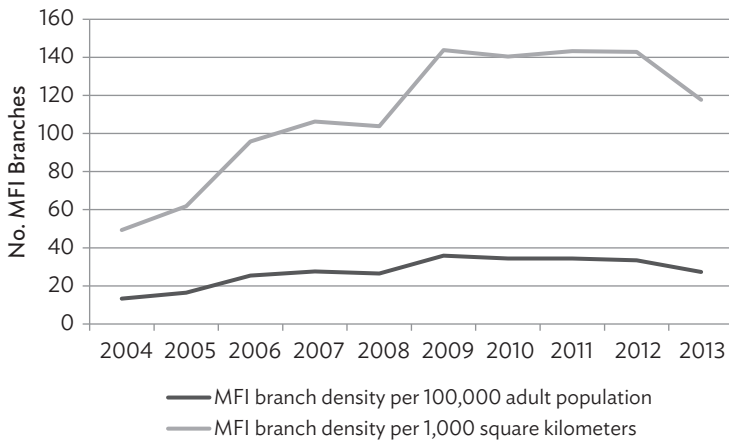
Table 4.2: Outreach of Microfinance Institutions in Bangladesh, 2011–2013

Year	Grameen Bank			Licensed NGO MFIs			Aggregate		
	2011	2012	2013	2011	2012	2013	2011	2012	2013
Number of Branches	2,565	2,567	2,567	18,066	17,977	14,674	20,631	20,544	17,241
Number of Members (million)	8.36	8.36	8.54	26.08	24.64	24.60	34.44	33.00	33.14
Number of Borrowers (million)	6.58	6.71	6.74	20.65	19.31	19.27	27.23	26.02	26.01
Loan Disbursement (Tk billion)	108.54	118.61	126.02	303.18	456.02	432.28	411.72	574.63	558.30
Loans Outstanding (Tk billion)	75.29	80.32	84.38	173.79	211.32	257.01	249.08	291.64	341.40
Borrowers per Branch	2,565	2,613	2,625	1,143	1,074	1,313	1,319	1,267	1,509
Clients per Branch	3,259	3,257	3,327	1,444	1,371	1,676	1,670	1,606	1,922

NGO MFI = nongovernment organization microfinance institution.

Sources: Grameen Bank; Microcredit Regulatory Authority Statistics, 2011–2013.

NGO MFIs differ in size; the top 20 NGO MFIs and Grameen Bank account for almost 75% of the microcredit market, while the other 672 licensed NGO MFIs account for the remaining 25% and operate like small localized or regional institutions, with fewer branches. This makes the market rather oligopolistic. Nevertheless, the branch density of MFIs in this market (both geographical and demographic penetration) is increasing (Figure 4.2), despite a decline from 2012 to 2013 due to a decrease in the number of MFI branches. Following the regulation of MFIs, many branches were merged to make them more cost-effective. This also led to an increase in average loan size and a marginal fall in the number of borrowers (Khalily, Khaleque, and Badruddoza 2014).

Figure 4.2: Microfinance Institution Branch Density, 2004–2013

MFI = microfinance institution.

Sources: Bangladesh Bank; World Bank, Global Financial Development Database, 2005–2013. <http://www.worldbank.org/en/publication/gfdr/data/global-financial-development-database> (accessed 1 December 2014).

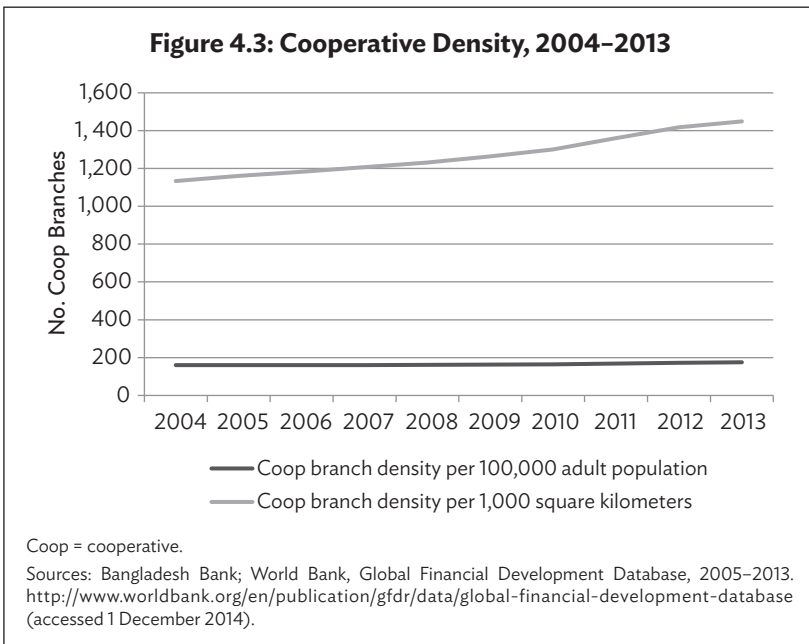
Nevertheless, with the expansion of their branch networks over the past decade, MFIs have facilitated greater geographical and demographic penetration, which has contributed to higher levels of inclusive finance and growth.

4.2.3 Cooperative Sector and Postal Savings Banks

Although Bangladesh's history of cooperative and postal banking is more than a century long, the cooperative movement and postal savings banks have not been successful, in part because households have access to more cost-effective and flexible alternative institutional services. Heterogeneous membership, the dominance of wealthy members in management committees, and limited financial resource capability are other key reasons for the failure of cooperatives in Bangladesh. Cooperatives are established legally under the Bangladesh Cooperatives Act.

The statistics of the Directorate of Cooperatives in Bangladesh show that, by the end of 2013, there were 193,512 primary cooperative societies with a total of 10.3 million members. However, the aggregate

unadjusted numbers show that the demographic density of these societies has remained more or less constant, with the number of members per cooperative society increasing from 160 in 2004 to 175 in 2013. On the other hand, geographical density appears to have increased a bit more over the same period (Figure 4.3). Nonetheless, cooperatives' contribution to inclusive finance appears to have been somewhat limited. A recent study found that almost 50% of cooperative societies are inactive (Ali and Ahmed 2014), indicating their limited effectiveness. This is validated by Khalily et al. (2013b), who showed that fewer than 1% of households have access to cooperative membership.



Postal savings banks date back to 1880, when there was only a limited banking network. Although post offices continue to provide financial services, their importance as financial services providers has declined with the increasing demographic and geographical penetration of banks and MFIs. The Directorate of Savings and the General Postal Department monitor the postal savings banks. By the end of 2014, there were 9,000 postal savings banks (no statistics are available on the number of accounts). The postal savings banks do not lend directly, but simply maintain the deposits of account holders.

4.3 Sources and Uses of Funds

Institutions operating in financial markets mobilize either deposits or savings, and have different characteristics. Banks mobilize large deposits and offer large loans by reducing transaction costs; they mostly operate in urban areas. MFIs offer financial services to unbanked poor households, most of which are in rural areas; they also mobilize small savings and offer small loans to members. Postal savings are limited. Table 4.3 shows the deposit market share of each type of institution.

Table 4.3: Deposits Mobilized by Institutional Source, June 2014

Types of Financial Institutions	Total Deposits (Including Current Deposits)		Total Deposits (Excluding Current Deposits)	
	(Tk million)	(%)	(Tk million)	(%)
State-Owned Banks	1,694,878.10	24.42	1,521,587.00	23.65
Private Banks	4,118,804.90	59.33	3,852,093.00	59.86
Specialized Banks	348,736.30	5.02	335,301.50	5.21
Foreign Banks	331,980.90	4.78	281,240.60	4.37
Microfinance Institutions and Cooperatives ^a	192,810.20	2.78	192,810.20	3.00
Nonbank Financial Institutions	210,467.00	3.03	207,703.20	3.23
Postal Banks ^b	44,045.00	0.63	44,045.00	0.68
Aggregate	6,941,722.40	100.00	6,434,780.50	100.00

^a Figures are for 2013.

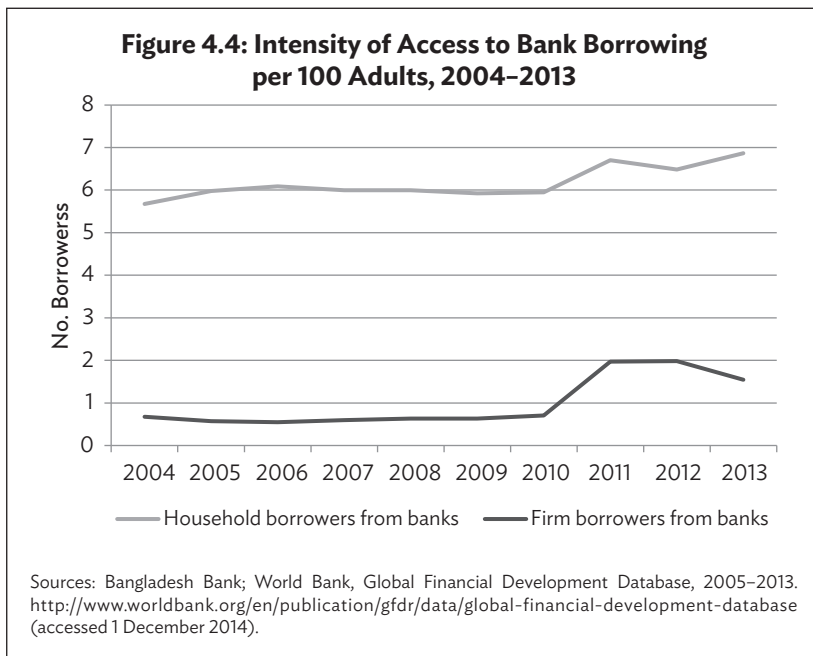
^b Figures are for 2012.

Sources: Bangladesh Bank; Ministry of Finance; Credit and Development Forum (2015).

Banks also accept current or checking deposits, but neither MFIs nor postal savings banks accept current deposits. Despite lower geographical and demographic banking density, banks have a large share of deposits. Private banks have the largest share, around 60%, while public banks have a share of about 25%. MFIs and cooperatives have a small share (2.78%), and postal savings banks have the smallest share. This suggests that banks play a significant role in financial deepening, despite a low intensity of household access to bank credit and deposits.

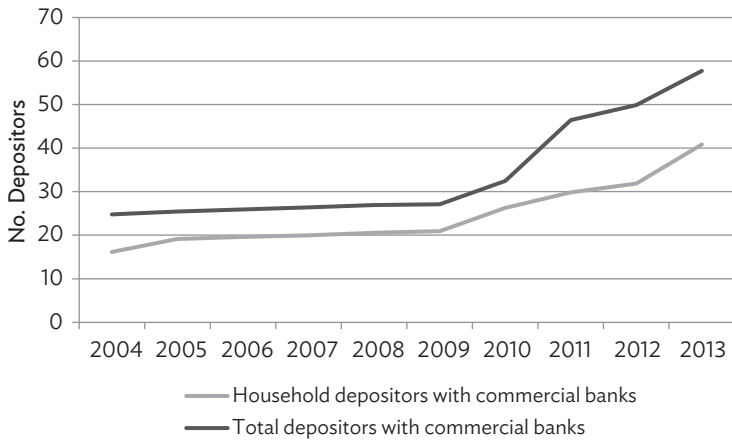
The estimates based on Global Financial Development data for Bangladesh show that around 7% of Bangladesh's adult population

(aged 18 or over) have access to bank credit, and around 58% have access to deposits. From 2004–2013, the intensity of access to credit steadily increased (Figure 4.4); a marginally steeper trend can be observed from 2010 after the introduction of pro-inclusive finance policies by Bangladesh Bank. The share of the adult population with access to bank deposit services (less than 30% during 2004–2009) increased substantially from 2010, reaching 58% in 2013 (Figure 4.5). Some aggressive policies of the central bank, like providing government subsidies to farmers, freedom fighters, and the elderly through the “Taka 10 Account” program, as well as introducing school banking, have contributed to this increase.



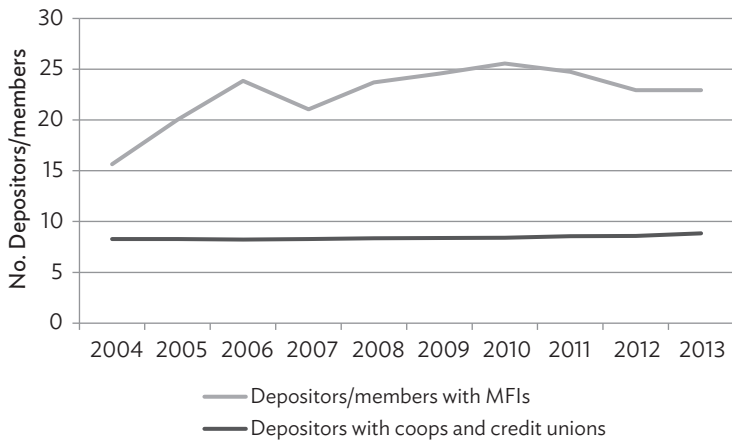
MFIs mobilize poor members’ savings and finance their income-generating economic activities and microenterprises. From 2004–2013, the intensity of deposits and borrowing increased (Figures 4.6 and 4.7); however, depositors’ and borrowers’ access to cooperatives has either remained constant or increased only marginally. Greater access to financial services is a prerequisite for inclusive growth, and MFIs

Figure 4.5: Intensity of Access to Bank Deposits per 100 Adults, 2004–2013



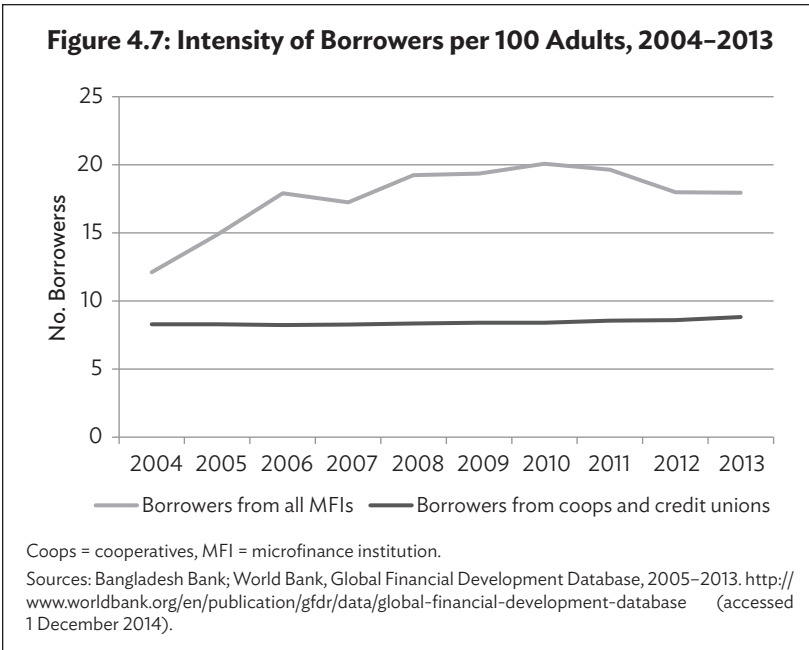
Sources: Bangladesh Bank; World Bank, Global Financial Development Database, 2005–2013. <http://www.worldbank.org/en/publication/gfdr/data/global-financial-development-database> (accessed 1 December 2014).

Figure 4.6: Intensity of Depositors per 100 Adults, 2004–2013



Coops = cooperatives, MFI = microfinance institution.

Sources: Bangladesh Bank; World Bank, Global Financial Development Database, 2005–2013. <http://www.worldbank.org/en/publication/gfdr/data/global-financial-development-database> (accessed 1 December 2014).



have played a pivotal role in boosting inclusive finance and growth in Bangladesh.

In Bangladesh, banks are the major providers of loan funds, in terms of both size and scope. Private and public commercial banks provide mostly industrial working capital loans and finance trade and commerce; these account for 70% of their loans (Table 4.4). Foreign banks provide loans for working capital and consumer finance. Specialized banks, such as the Bangladesh Krishi (Agricultural) Bank (BKB) finance working capital, trade, and commerce, but mostly agriculture. In recent years, MFIs have been increasing their presence in agricultural finance.

Banks contribute to growth by financing growth-oriented sectors like agriculture and industries. Interestingly, private banks have been key players in the credit supply, despite their limited number of branches (around one-third of the total number of branches), which are mostly located in urban areas. At the end of 2014, their market share was about 62%, compared with around 22% for public commercial and specialized banks. However, around 36% of both private and public banks' total loan portfolios are in industrial finance. In recent years, small and medium-sized enterprise (SME) financing has been regarded as a strategy for inclusive growth and employment creation. MFIs

Table 4.4: Use of Funds by Institution Type, June 2014
(%)

Use of Funds	State-Owned Banks	Private Banks	Specialized Banks	Foreign Banks	Microfinance Institutions	Nonbank Financial Institutions	Aggregate
Agriculture ^a	5.63	1.67	43.45	5.51	47.94	1.53	8.02
Industry ^b	36.39	35.91	21.05	41.85	47.43	42.49	36.42
SMEs	21.17	7.86	12.11	13.87	–	4.76	–
Construction	10.60	9.10	4.68	0.86	1.12	12.68	8.42
Transport	0.58	1.18	2.17	0.92	2.89	5.33	1.49
Trade and commerce	36.83	42.59	23.78	24.41	0.00	13.90	35.38
Other institutional loan	0.17	2.02	0.45	0.93	–	–	1.34
Consumer finance	7.70	5.02	2.27	22.68	0.62	–	5.41
Others	2.11	2.51	2.16	2.84	–	24.07	3.52
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Aggregate (Tk billion)	838.52	3,305.33	334.11	217.88	343.88	307.33	5,347.05
Share of each bank type in total loans	15.67	61.81	6.25	4.07	6.43	5.75	100.00

SMEs = small and medium-sized enterprises.

^a The BKB is a specialized bank that provides agricultural credit for farming, livestock, fisheries, and forestry. It also finances agriculture-related industries through term loans (more than 1 year) and working capital loans (1 year or less). Commercial banks also finance the agricultural sector, but their role is very limited. MFIs are bigger providers of agricultural credit than are specialized banks.

^b Commercial banks mostly provide working capital loans for industries, and often provide long-term loans. A specialized bank for industrial finance operates in Bangladesh, but its contribution has been negligible due to poor performance. The BKB provides term and working capital loans for agriculture-related industrial activities. MFIs finance microenterprises and micro and small manufacturing undertakings to a maximum amount of \$15,000. Industrial loans provided by banks are large and those provided by MFIs are very small.

Note: No disaggregated data on the use of loans from cooperatives are available. Bank statistics are for 2014, and MFI statistics for 2013. Specialized banks like the Bangladesh Krishi (Agricultural) Bank provide agricultural credit and finance working capital of agriculture-based industrial undertakings. Microfinance institutions finance poor households, and provide loans for financing agriculture and microenterprises, as well as micro-cottage industries. The maximum loan amount provided by MFIs is \$15,000.

Sources: Bangladesh Bank, Scheduled Bank Statistics (2014); Bangladesh Microfinance, Credit and Development Forum (2015).

in Bangladesh do not finance SMEs, but have increasingly financed microenterprises in recent years. The financing of SMEs, therefore, has become the responsibility of the banks. While private banks have a small share, public commercial and specialized banks are the major players in SME financing, due to their wider networks and targeted credit programs.

4.4 Inclusive Finance in Bangladesh⁵

Although expanding financial inclusion has received much attention in Bangladesh, there is unfortunately no national inclusive finance policy, which appears to be the responsibility of Bangladesh Bank more than of the government. Bangladesh Bank has no policy document dealing specifically with financial exclusion, but has implemented various policies to further financial inclusion in Bangladesh, including the Taka 10 Account program, expansion of rural bank branches, refinancing, mobile banking, SME financing, school banking, and street-child banking. Taken together, these policies have positively affected the intensity of financial inclusion through the banking sector in Bangladesh, as reiterated by the governor of Bangladesh Bank in his lectures on financial inclusion in Bangladesh.⁶

Measures of intensity of access to financial services, used above to indicate the intensity of inclusive finance in Bangladesh in terms of geographical and demographic indicators using aggregate financial data, may overestimate access due to overlapping service users. Service overlapping can be avoided if costly household or individual-level data is available. The use of primary datasets enables policymakers to identify people, households, or firms that have been excluded from financial markets.

⁵ Various indicators can be used to measure the extent of access to financial services. Mehrotra et al. (2009), Sarma and Pais (2011), and Demirgüç-Kunt and Klapper (2012) measured the extent of access to financial services using geographical penetration (the number of depositors or borrowers per 1,000 km²) and demographic penetration (the number of depositors or borrowers per 100,000 people). Broadly speaking, these indicators refer to two dimensions of financial access: outreach and actual usage. In the case of outreach, there are two types of indicators: geographical penetration (number of bank branches or ATMs per 1,000 km²) and demographic penetration (number of bank branches or ATMs per 100,000 people). More bank branches and ATMs per 1,000 km² signify lower distances to the nearest physical bank outlets and easier geographical access. Demographic penetration measures the average number of people served by each bank branch or ATM. Higher numbers imply that there are fewer clients per branch or ATM, and indicate easier access to bank services. Sarma and Pais (2011) provided a multidimensional index for measuring financial inclusion that includes information on bank penetration, the availability of banking services, and usage of the banking system. Demirgüç-Kunt, Beck, and Honohan (2008) also compiled demographic and geographical penetration data on access to general banking branches or ATMs. In the case of actual usage, two widely used indicators are (i) the number of loan accounts per 1,000 people; and (ii) the number of deposit accounts per 1,000 people. These indicators measure the use of banking services and access to financial services. Other frequently used indicators of usage are the deposit–gross domestic product (GDP) ratio, the credit–GDP ratio, or the (deposit plus credit)–GDP ratio.

⁶ Bangladesh Bank website: www.bb.org.bd

The Institute of Microfinance conducted two rounds of surveys on access to financial services in Bangladesh in 2010 and 2014. The 2014 survey considered savings, credit, and insurance in formal, microcredit, and informal markets (Khalily et al. 2015). Access to credit was defined based on transaction information in the past 5 years (1 year for informal credit). Access to deposits or savings was defined based on usage. The study also considered mobile banking; as it is tied to banks, it was considered a formal financial service and included in the formal banking sector.

Bangladesh is one of the leading countries in South Asia trying to achieve greater household access to financial services. Not every individual will use financial services, but they can access them when necessary. Therefore, reliable statistics on inclusive finance must cover long periods. The 2014 Institute of Microfinance survey showed that financial inclusion in Bangladesh has increased over the years (Khalily et al. 2015). Based on household financial access during 2005–2014, the survey found that intensity of access to financial services was around 89% in any market, including the informal market, but only 75% when access to the informal credit market was excluded. From a policy perspective, the relevant information is access to formal and microfinance markets.

Access to financial services based on usage was defined at the household and individual levels. Table 4.5 presents household access to financial services through the formal and microfinance markets. Formal financial markets include banks and insurance, and financial services include deposits, credit, mobile banking, and insurance. About 53% of households have access to formal financial services based on two major drivers—access to deposits and access to mobile banking; around 32% have access to deposits and around 27% have access to mobile banking. The net effect of mobile banking was a 10.81% increase in inclusive finance; this was deduced from the intensity of access to financial services being about 53% with mobile banking (Table 4.5) and around 43% without (Khalily et al. 2015). Only around 9% of households had access to bank credit; this share was marginally higher in the rural credit market. Such low bank penetration is due to the concentration of bank activities in urban areas and among non-poor households. Access to all types of insurance is relatively low—only around 13% of households have access to the insurance market. The formal market is not easily accessible due to high fees, the need for collateral, and lack of financial literacy.

Access to microfinance services has always been higher than access to the formal sector due to the characteristics and wider network of MFIs. Around 47% of households (around 48% in rural areas and 46% in urban areas) accessed microfinance services in 2014. Access to credit is a prerequisite for inclusive growth. MFIs in Bangladesh, with their

Table 4.5: Intensity of Access of Households to Financial Services by Market Type, 2005–2014
(%)

	Access to the Formal Financial Market				Aggregate Formal Finance
	Bank Credit	Bank Savings	Insurance	Mobile Banking	
National	8.95	31.50	12.61	26.87	53.38
Rural	9.34	29.18	11.99	25.11	50.88
Urban	7.62	39.50	14.54	35.54	62.03
Non-Poor	10.72	38.52	13.64	30.88	60.36
Poor	4.26	13.52	10.05	18.92	35.71

	Access to the Microfinance Market			Aggregate Access to Banks and MFIs (net of overlap)
	Microcredit	Microsavings	Aggregate Access to Microfinance	
National	40.10	45.83	46.91	75.12
Rural	40.31	46.19	47.34	73.58
Urban	39.40	44.58	45.43	80.46
Non-Poor	39.39	44.56	45.72	78.87
Poor	42.63	49.65	50.57	65.92

MFI = microfinance institution.

Note: Formal finance includes credit, deposits, mobile banking, and insurance. Poor households were defined based on the upper poverty line, which was constructed using food and non-food expenditures.

Source: Khalily et al. (2015).

branch network and technology, provide financial services to both poor and non-poor households, especially those at the margin of poverty.

When considering the combined effects of banks and MFIs, the state of inclusive finance in Bangladesh appears very healthy, with three out of four households having access to financial services. Intensity of access is higher in urban areas, where four out of five households have access to financial services; this is marginally lower in rural areas. Nevertheless, the fact that a significant proportion of poor households remains outside both the formal and microfinance markets must be carefully examined.

While intensity of access to financial services in terms of share of households is relatively high, a significant share of the adult population

Table 4.6: Intensity of Access of Bangladesh's Adult Population to Financial Services

	Bank Credit	Bank Savings	Insurance	Mobile Banking	Aggregate Formal Finance
National	3.11	13.55	4.20	13.07	26.17
Rural	3.21	12.13	3.92	12.22	24.65
Urban	2.76	18.53	5.20	16.07	31.49
Non-Poor	3.65	16.47	4.54	14.53	29.67
Poor	1.54	5.34	3.36	9.28	16.53

	Microcredit	Microsavings	Aggregate Microfinance	Aggregate Inclusive Finance
National	14.40	16.37	17.17	39.23
Rural	14.35	16.39	17.19	37.88
Urban	14.58	16.30	17.11	43.98
Non-Poor	13.86	15.59	16.40	41.57
Poor	16.25	18.82	19.59	32.98

Source: Khalily et al. (2015).

is left out. About 39% have access to financial services, including mobile banking in both formal and microfinance markets.

This percentage would be higher if the intensity of access to financial services by adults were measured using a time-series panel dataset. Almost 44% of urban adult individuals have access to financial services; as expected, this percentage is lower in rural areas. Despite a significant expansion of financial services to poor individuals, almost two-thirds of them remain outside the reach of financial markets.

Over the past 5 years, mobile banking has gained momentum and is becoming an increasingly important part of inclusive finance. A little over 13% of the adult population has access to mobile banking, and the use of this service is predictably higher in urban areas and among non-poor households. Intensity of access to formal finance increases to 26% when mobile banking is included, compared to 17% without mobile banking. MFIs are used by 17% of the adult population, a remarkable achievement since they target poor households, and have an equal share in urban and rural areas. The aggregate share of adults with access to either the banking sector or the microfinance sector

(net of multiple access to both markets) is around 40% (Khalily et al. 2015).

These results reveal that about 60% of adults are excluded. This implies that banks and MFIs have yet to penetrate at the individual level. Khalily et al. (2015) identified a gender dimension in financial services exclusion, in that women are more often excluded from the formal financial market, while men are more often excluded from the microfinance market (where around 90% of clients are women). The relatively less educated are also typically excluded from the formal finance market, but have greater access to the microfinance market. Similarly, lower income individuals are less well-represented in the formal finance market. These observations are in line with expectations, as formal financial markets are more inclined to operate in urban areas and among higher income households. In contrast, MFIs appear to be more effective in terms of inclusive finance and inclusive growth, as they cater to the needs of the households and individuals left out of the formal financial market.

The household-survey data differ from the Global Financial Development (GFD) data for Bangladesh, for several reasons. To understand this, we must understand the type of information provided in both the Institute of Microfinance household-level inclusive finance survey and the GFD data. As the GFD data include bank-level information relating to deposit and credit accounts, these have some limitations, the most important being an inherent weakness in terms of providing information on intensity of access to financial services, and multiple individual deposit accounts. As a result, demographic penetration is overestimated. While not all persons will have an individual account at a given point in time, what is important is whether every household is covered by the financial network. Such information cannot be deduced from the GFD data. Finally, the data provide little information for policy guidance from the perspective of those who are excluded, and do not indicate where to expand financial services. The use of costly household-level data can remove such limitations. Despite these limitations, over time the GFD data can provide useful information on trends.

As shown in Table 4.7, using GFD data to measure the intensity of access to financial services produced an inconsistently high estimate. This method revealed that about 93% of Bangladesh's adult population had deposit accounts in the banking and microfinance sectors at the end of 2013, while the Institute of Microfinance survey reported this as 39%. This difference is because GFD data for Bangladesh do not account for multiple deposit accounts. Intensity of access to credit is comparable because most individual borrowers have a single loan; however, what is important is the share of households with access to financial services in Bangladesh (which is quite high).

Table 4.7: Intensity of Access to Financial Services, 2013
(%)

	Households to Financial Services	Adult Population to Deposit Services	Borrowers in the Bank Credit Market	Adult Population to Bank and MFI Credit
GFD Data	N/A	92.8	8.83	17.90
INM Inclusive Finance Survey	75	39.0	8.29	17.07

GFD = Global Financial Development, INM = Institute of Microfinance, MFI = microfinance institution, N/A = not available.

Source: Khalily et al. (2015).

4.5 Financial Literacy in Bangladesh

Due to asymmetric information between consumers and financial institutions, the financial market is weak. Consumers are not able to access appropriate services at the right price, nor to make prudent investment decisions. Moreover, they are not fully aware of their rights and responsibilities, the financial risks involved, and any other relevant information. The problems of asymmetric information and inaccessible financial services can be resolved by boosting financial literacy. This strategy has received increased attention from policymakers and academics following the 2008 global financial crisis.

The Organisation for Economic Co-operation and Development (OECD) defines financial literacy as the combination of an understanding of financial products and concepts on the part of consumers and investors, and their ability to understand financial risks and opportunities, so that they can make informed choices, know where to go for help, and take further effective steps to improve their financial welfare (Miller et al. 2009). Financially literate individuals are able to prepare household budgets and allocate resources efficiently, plan for savings, and formulate strategic investment decisions (Greenspan 2002). Therefore, financial literacy should improve the financial behavior of individuals, firms, and households (Hilgert, Hogarth, and Beverly 2003; Van Rooij, Lusardi, and Alessie 2007).

4.5.1 Financial Literacy Policy

Bangladesh has no national financial literacy policy, but Bangladesh Bank's policy statement on financial literacy says that it strives to ensure that people have access to all financial products and information on banks and

NBFIs.⁷ It stresses the need to disseminate financial information to help people make informed financial decisions. Furthermore, it encourages all banks to develop targeted financial products for schoolchildren, poor households, and the elderly. As a part of Bangladesh Bank's programs to increase financial inclusion and improve financial literacy, school banking has been introduced; targeted credit programs have been formulated for poor and farm households; the Taka 10 Account scheme has been implemented; and sensitive financial information has been disseminated via print and electronic media. While these programs may have increased access to financial services, they may not necessarily have made clients more financially literate or better able to make informed decisions. In addition to the targeted programs of banks, MFIs provide training to the group members on investment decisions and well-being. As evident in this review, both supply- and demand-side factors contribute to informed decisions and access to financial services.

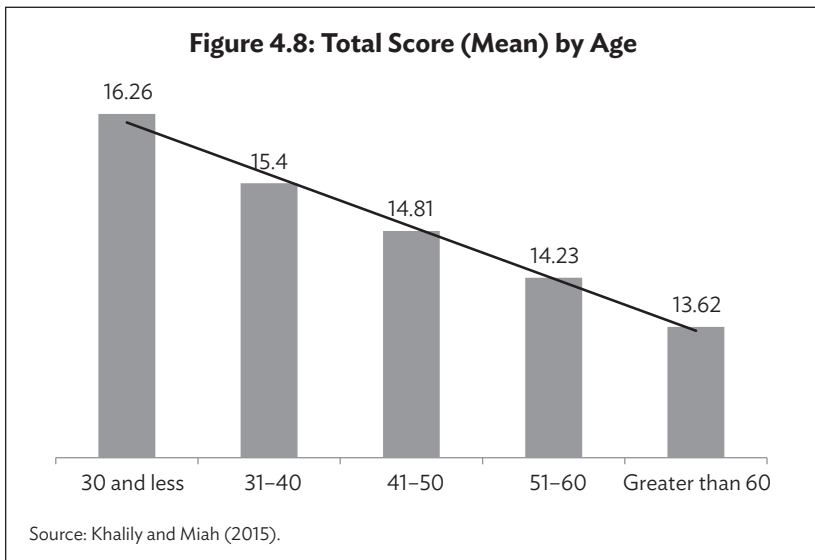
4.5.2 Empirical Evidence on Financial Literacy in Bangladesh

There is growing evidence that individuals or households are better off being financially literate, as this helps them minimize financial risks. However, many individuals around the world lack substantial financial knowledge (Banks and Oldfield 2007; Banks, O'Dea and Oldfield 2010; Lusardi and Mitchell 2009; Cole, Sampson, and Zia 2011; Courchane and Zorn 2005; Jappelli and Padula 2013). Despite the importance of financial literacy, no major attempts had been made in the past to assess the extent of financial literacy and its impacts on inclusive finance in Bangladesh. Khalily and Miah (2015) carried out a major study assessing financial literacy as part of the national survey on access to financial services in Bangladesh. The study contained 38 questions covering three dimensions of financial knowledge: bank-related knowledge, mathematical knowledge, and an understanding of inflation and discounting. Most of the questions were related to bank and inflation-related knowledge, and mathematics and discount-related knowledge was covered by five questions. Each question was assigned one point and, in line with the passing marks in general examinations in Bangladesh, 40% was considered the minimum passing score. Khalily and Miah (2015) reported that the average score was 15.2 out of a total score of 38, and only 38.5% of the test participants obtained a passing mark.

Several studies (Worthington 2004; Lusardi and Tufano 2008; Monticone 2010) showed that employment type, income, and occupation

⁷ www.bb.org.bd

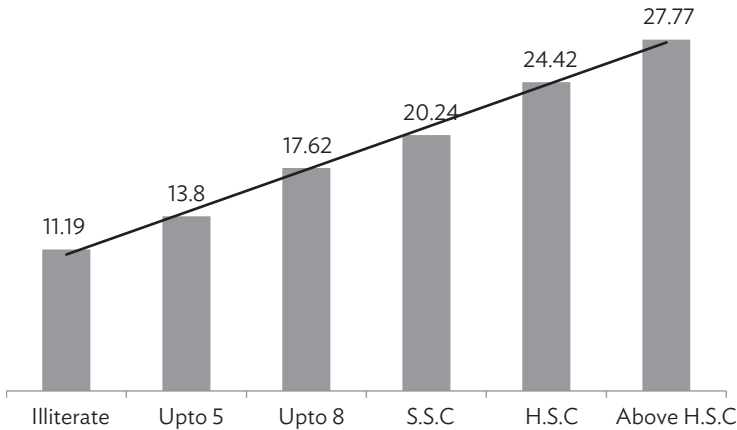
can be important factors in determining levels of financial literacy. White-collar workers, professionals, and business owners are more likely to have greater financial knowledge. The evidence in Bangladesh corroborates earlier findings that financial literacy is inversely related to age and positively related to education. According to Khalily and Miah (2015), professionals and people in business and services have greater financial knowledge, and total literacy scores gradually decline as age increases (Figure 4.8).



This is consistent with other empirical findings, which showed that people aged 60 or over are less likely to be financially knowledgeable. On the other hand, a gender-based analysis revealed a gender gap in financial literacy. For cultural reasons and due to their more limited involvement in professional activities in Bangladesh, females are less likely to be involved in investment and personal finance, unless they are household heads. There was also a linear relationship between respondents' education and financial knowledge (Figure 4.9). Respondents with more than a college degree scored above 70%, compared with 30% for respondents with no formal education.

Not all respondents obtained the minimum passing mark. The results are inversely related to age and positively related to education and certain occupations. Mathematics-related knowledge was more pronounced among the younger group; more than 68% of individuals aged 30 or younger obtained passing marks, compared with 42% of those aged 60 and over (Figure 4.10).

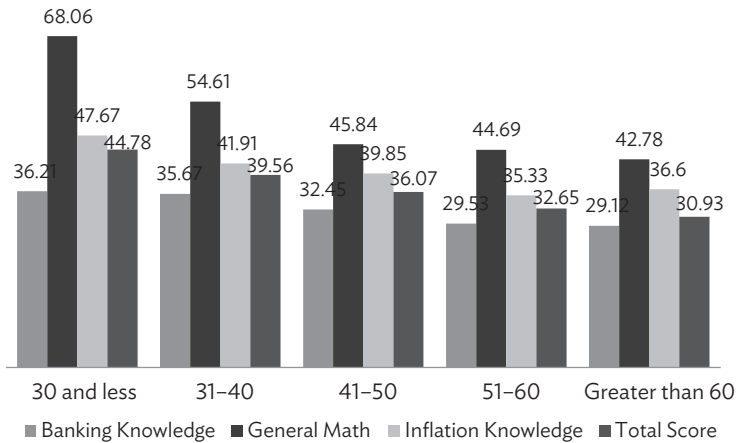
Figure 4.9: Total Score (Mean) by Education



Above HSC = more than 12 years of schooling completed, HSC = Higher School Certificate (equivalent to completing 12 years of schooling), SSC = Secondary School Certificate (equivalent to completing 10 years of schooling), Up to 5 = up to grade 5, Up to 8 = up to grade 8.

Source: Khalily and Miah (2015).

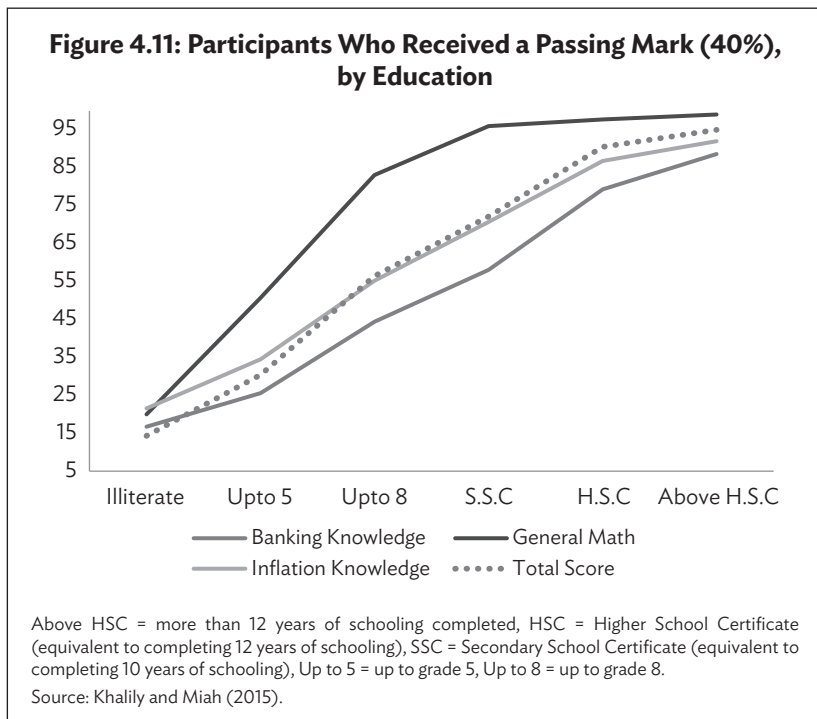
Figure 4.10: Participants Who Received a Passing Mark (40%), by Age



Source: Khalily and Miah (2015).

Similarly, more than 90% of respondents with a college education or higher have sufficient mathematical knowledge (Figure 4.11). However, knowledge of the critical elements (i.e., banking- or inflation-related knowledge) was quite low among respondents, regardless of age; only a little over one-third of respondents obtained the minimum passing marks. These results increase parallel to years of schooling. This could be because as people become more educated they are more likely to be exposed to financial services as they take on white-collar jobs and earn higher incomes. A similar trend is observed in the case of inflation- and discount-related questions. This evidence supports the hypothesis of Campbell (2006) that households with higher education levels face less information asymmetry and are more active in financial markets. A higher share of respondents in business, professional, and service occupations passed the financial literacy test.

The econometric results derived by Khalily and Miah (2015) support the causalities described above. Age appears to have no effect on banking-related knowledge, but is inversely and significantly correlated with scores in general mathematics-, inflation-, and discount-related



knowledge, as well as the total score. Education strongly affects bank-, inflation-, and general mathematics-related knowledge. Gender is also a highly significant determinant of financial literacy. Men are more likely to achieve a high score, as they are perhaps more exposed to financial matters on a daily basis. Rural households are more likely than urban households to have lower levels of financial literacy.

4.5.3 Impact of Financial Literacy on Financial Inclusion in Bangladesh

Evaluating the impact of financial literacy on inclusive finance is generally difficult, as this is determined by individual characteristics. Access to finance is also determined by supply-side factors. Findings in the literature have been mixed. There had been no empirical study on the impact of financial knowledge on inclusive finance in Bangladesh before the study by Khalily and Miah (2015). They derived their estimates using two different models, the functional specification of which is as follows:

$$ATFIN = f(Finknow, Regionchar) \quad (1)$$

$$ATFIN = f(Finknow, Indivchar, HHchar, Regionchar) \quad (2)$$

where *ATFIN* is access to finance; *Finknow* is financial knowledge; *Regionchar* is regional characteristics and controls for regional heterogeneity; *Indivchar* refers to individual characteristics, including education and age variables; and *HHchar* includes household characteristics, like family literacy rates and the education and age of the household head. These two models were specified and tested for possible correlations among financial knowledge and individual and household characteristics. Therefore, the validity of the possible impact of financial literacy as specified in equation 1 is derived if there is no change in sign of the coefficients of the financial literacy-related variables in equation 2, which controls for individual, household, and regional heterogeneity.

To analyze the impact of financial literacy on financial inclusion, the study used the logit regression technique, with access to savings, credit, and any financial service in any market as dependent variables defined as dummy variables (one for access and zero otherwise), and different score categories as explanatory variables are estimated (Table 4.8).

The results clearly demonstrate that financial literacy positively impacts access to finance. The impact of bank-related knowledge was consistent and positive, and no significant change was observed. This

Table 4.8: Logit Regression on Financial Inclusion with Different Financial Scores

Variable	Model 1			Model 2		
	Access to Savings	Access to Credit	Access to any Market	Access to Savings	Access to Credit	Access to any Market
Bank-Related Knowledge	0.1570 ^a (0.00714)	0.0592 ^a (0.00609)	0.1760 ^a (0.00860)	0.1510 ^a (0.00906)	0.0532 ^a (0.00856)	0.1530 ^a (0.00955)
Mathematics-Related Knowledge	0.0448 ^b (0.0175)	-0.0821 ^a (0.0164)	0.0232 (0.0209)	0.0951 ^a (0.0279)	0.0246 (0.0268)	0.0334 (0.0284)
Inflation-Related Knowledge	-0.020100 (0.0212)	-0.042300 ^b (0.0196)	0.076800 ^a (0.0252)	0.017200 (0.0281)	-0.000615 (0.0275)	0.129000 ^a (0.0289)
Constant	-1.132 ^a (0.251)	-1.209 ^a (0.230)	-0.940 ^a (0.278)	-3.675 ^a (0.419)	-2.522 ^a (0.412)	-2.342 ^a (0.421)

^a Significant at $\alpha=0.01$ level.

^b Significant at $\alpha=0.05$ level.

Note: The coefficients of other parameters in Model 2 are not reported here.

Source: Khalily and Miah (2015).

indicates that a one-point increase in bank-related knowledge increases the probability of access to savings by 0.15 and that of access to credit by 0.05. Mathematics-related knowledge positively affects access to savings, and inflation-related knowledge positively impacts access to finance in any financial market, but not specifically access to savings or credit. However, in another estimate, Khalily and Miah (2015) showed that overall financial literacy improves access to financial services.

In sum, the results suggest that, while general levels of financial literacy are mediocre, financial knowledge positively influences inclusive finance, which warrants a specific approach to financial literacy.

These findings are useful for policymaking, as they reveal that enhancing financial literacy may directly impact aggregate access to financial services, savings, and credit (i.e., financial inclusion). The findings reveal not only the need to focus more on banking-related literacy, but also the necessary target groups: women, the elderly, the less-educated, rural inhabitants, and those employed in labor and non-income-generating activities. These groups are most vulnerable to financial illiteracy and therefore to financial exclusion. Thus, financial inclusion policies should first be drafted or modified to increase financial knowledge, such as through training programs. These policies should target rural areas, women, laborers, the less-educated, and other vulnerable groups. It is imperative to increase the financial literacy of these groups to improve access to financial services in Bangladesh.

4.6 Financial Regulation

In Bangladesh, two groups of institutions operate in financial markets—banks of all types and natures, and MFIs. They are regulated by two agencies: Bangladesh Bank, the central bank that regulates the behavior of banks and NBFIs; and the MRA, which regulates MFIs. Bangladesh Bank was established under the Bangladesh Bank Order 1972 after Bangladesh became an independent state in 1971, and the MRA was established under the Microcredit Regulatory Authority Act 2006. These two agencies both ensure the financial health and stability of the institutions under their mandate, and promote inclusive finance for inclusive growth through their regulatory policies.

4.6.1 Regulations for Inclusive Finance and Growth

Banks in Bangladesh have generally been risk-averse in expanding their branch networks and financing preferential sectors like SMEs and agriculture in rural financial markets. Bangladesh Bank has intervened with regulatory policy measures—including progressive branches, refinancing, Taka 10 accounts, and mobile banking—to expand financial services, promote preferential sectors, and promote inclusive growth through inclusive finance in Bangladesh.

Branch policy. During the past 40 years, Bangladesh Bank had to force banks several times to expand their branch networks in rural areas and provide finances to preferential or “unbankable” populations in rural areas. In 1977–1978, Bangladesh Bank enforced a “two-for-one” branch policy under which banks were required to operate two rural branches for each urban branch. This resulted in the comparatively fast expansion of rural branches; their numbers nearly doubled from 857 in 1978 to 1,527 in 1981 (Khalily, Meyer, and Hushak 1987). In 2010, to expand banking services further, Bangladesh Bank enforced a “one-for-two” branch policy requiring banks to open one branch outside the capital city, Dhaka, for every two branches in Dhaka. In 2011, Bangladesh Bank implemented a “one-for-one” branch policy requiring private banks to open one rural bank branch for every urban branch. The circular was amended in December 2011 in favor of a “four-for-one” policy—four rural branches for each urban branch, with branches outside municipality or City Corporation areas recognized as rural branches. These policies have led to the expansion of banking services, particularly in rural areas, and have boosted inclusive finance and rural deposits.

Refinancing policy. Financing agricultural and preferential sectors requires special treatment, as banks consider such financing risky. Refinancing policy, under which loans are refinanced at subsidized

rates, promotes agricultural and preferential sector financing. Several refinancing schemes are available for banks, particularly the BKB, including agro-based refinancing, SME refinancing, home loan refinancing, women's entrepreneurship under SME financing, and green refinancing. Bangladesh Bank refines credit under these schemes at subsidized rates.⁸

Taka 10 account.⁹ One of the many initiatives undertaken by Bangladesh Bank to deepen financial inclusion was the introduction of the Taka 10 account. The basic objective of this initiative is to provide subsidies and grants to farmers and beneficiaries of social safety net programs. In 2010, Bangladesh Bank introduced this special account to be opened with any government-owned, commercial or specialized bank. The scheme has resulted in more inclusive finance. Khalily et al. (2015) showed that around 6% of households and around 7% of rural households have Taka 10 accounts. The concentration of account holders varies by region. As expected, a large share of account holders were farmers (just over 16%). Around 2% of adults (aged 15 and over) hold these accounts. A recent estimate reported by Bangladesh Bank revealed that the number of individuals who had opened a Taka 10 account increased from 13.2 million at the end of June 2013 to 14.0 million by the end of June 2014. However, many of these accounts may remain inactive until the account holders begin to receive subsidies and grants regularly.

Mobile banking. In the past few years, financial innovations, particularly mobile banking, have gained ground in developing countries. This reduces transaction costs for both service-providing and service-receiving agents, and enables households, individuals, and firms to access formal financial services in inaccessible areas. Mobile banking now appears to be the most popular payment mechanism and means of transferring funds, particularly among internal migrants. Most banks in Bangladesh provide mobile banking services, and around 35% of urban households and 25% of rural households use mobile banking.

School banking. In the 1960s, a "school banking" program introduced by Bangladesh Bank was a popular way for students to develop saving habits and build awareness of financial services offered by

⁸ This scheme offers agro-based refinancing for farming and the development of agriculture-related enterprises. By the end of June 2014, Tk5 billion had been disbursed to 1,897 enterprises on a revolving basis. The central bank allocated Tk6 billion to support small enterprises in Bangladesh; this was eventually extended to banks and financial institutions at the bank rate against their financing of small entrepreneurs. By the end of June 2014, Tk20 billion (including a women's fund) had been refinanced to 22 banks and 22 financial institutions to support 22,321 enterprises. At least 15% of the SME credit is reserved for women entrepreneurs and is provided to them at a preferential interest rate.

⁹ Tk10 is equivalent to \$0.14.

banks. However, it ceased to exist in practice after 1971. The program was reintroduced in 2010 as part of the strategy to expand inclusive finance in Bangladesh following the 2008 global financial crisis. Guidelines for banks were formulated in 2013, and about 0.85 million school banking accounts, with net deposits of Tk7.17 million, had been opened by the end of 2014. The program has thus contributed to increasing inclusive finance.

4.6.2 Regulation of Microfinance Institutions

Except for Grameen Bank, all MFIs were self-regulated until 2006. Most of these organizations started as voluntary organizations and were largely managed with quasi-formal structures. Any regulatory and governance-related changes to MFIs prior to 2006 had occurred at the behest of the PKSF, a wholesale lending agency that both provides financial support to partner MFIs, and strengthens their operation and governance through policy measures. However, the MFIs' general self-regulation posed a potential threat to financial stability.

In 2006, the government established the MRA to regulate NGO MFIs. By being licensed, these institutions have become part of the formal financial system and are required to comply with regulatory rules and regulations. The MRA regulates the behavior of MFIs through off- and on-site monitoring and a set of rules and regulations. As per the licensing rules,¹⁰ MFIs with at least Tk4 million (\$50,000) in outstanding loans or 1,000 borrowers can get a license (Khalily, Khaleque, and Badruddoza 2014). MFIs are now monitored and regulated by MRA regulations introduced in 2010. The MRA made several policy decisions: (i) it imposed a 27% lending interest rate ceiling and 6% deposit interest floor; (ii) restricted the term of the chair of the governing body to two consecutive terms; (iii) reduced fee deductions from loans; and, most importantly, (iv) required all licensed MFIs to maintain cash liquidity of 15% of their total net deposits and 10% of their surplus as reserve. It should be noted that NGO MFIs in Bangladesh are not equity-based institutions. Grameen Bank, which was established by the Grameen Bank Ordinance 1983, is regarded as a microfinance bank; operationally, the bank is independent and its governing board makes policy decisions, but Bangladesh Bank monitors its behavior. International NGO MFIs are required to be registered with the NGO Affairs Bureau and licensed by the MRA.

¹⁰ Some operating MFIs have been unable to comply with licensing requirements. The MRA recently granted MFIs with Tk1 million (\$12,500) in start-up cash capital permission to operate in the microcredit market, with the aim of complying with the licensing requirements in 3 years.

One of the necessary conditions for ensuring financial stability and effecting monetary policy is the formal linkage between the MRA and Bangladesh Bank; this is achieved through the governor of Bangladesh Bank, who is the chair of the MRA's board of directors. The MRA's executive vice chair operates with policy guidelines from the governor; however, the senior Bangladesh Bank officials working on deputation at MRA have established more effective operational rules.

Khalily, Khaleque, and Badruddoza (2014) showed that regulation positively impacts the cost efficiency of licensed MFIs, and Latif, Hasan, and Khaleque (2013) showed that regulation has increased the confidence of clients and licensed MFIs. Most importantly, regulation has formalized the microfinance sector.

4.6.3 Regulation of Insurance Companies and Cooperatives

The weakest part of Bangladesh's regulatory regime is the body tasked with overseeing the insurance companies. Of the 77 insurance companies in the country, 46 are general insurance companies, which are regulated under the Insurance Companies Act 2010 and the Insurance Development and Regulatory Authority (IDRA) Bangladesh Ordinance 2010. Before 2010, insurance companies were unregulated. Thus far, the IDRA has not been very effective due to its limited organizational infrastructure and enforcement mechanism, resistance from the insurance companies, and political interventions. With the government's support, the IDRA has gradually become more effective at implementing its rules and regulations, and the weak regulatory regime has not affected claims settlement and the reinsurance of assured risks. Cooperative societies are regulated under the Cooperatives Act issued by the government's Department of Cooperatives; however, there is no separate entity regulating their behavior. Since cooperatives provide financial services, they should be regulated by an entity like the MRA.

4.7 Conclusion

Financial deepening and inclusive finance in Bangladesh have expanded since 2006. While financial institutions and MFIs have both contributed to more inclusive finance, their roles differ. Banks are more present in urban areas and among the relatively more literate as well as high-income households. One of the most crucial policies in promoting inclusive finance through the banking sector is branch policy. By facilitating the transfer of funds and payment services, innovation, like mobile banking,

has also boosted inclusive finance. MFIs have a dominant position in inclusive finance, particularly in rural areas. Regarding access to financial services for adults, this analysis showed that the intensity of inclusive finance remains low. However, with around 75% of households in Bangladesh having access to finance, appropriate financial policies and innovations will continue to promote inclusive finance.

Greater access to finance may not necessarily lead to inclusive growth unless opportunities are created. Inclusive finance should create inclusive growth by financing firms and enterprises. This analysis showed that access to bank credit is relatively low. While banks that lend large loans can influence growth, they cannot create opportunities for all those who need services. MFIs play a greater role here due to their wider networks and financial services offered at their clients' doorsteps, and create more opportunities for investment, at least for poor and low-income households. Such opportunities have also been extended to micro and small enterprises through lateral entry to the microfinance market. As a result, MFIs are likely to play a greater role in inclusive growth.

Expanding the financial services of banks and MFIs will also significantly influence growth. Bangladesh Bank has responded proactively by regulating banks' behavior to promote inclusive finance, and has brought more individuals into the banking network through its aggressive branch and Taka 10 Account policies. MFIs are now regulated by the MRA, which formulated effective sets of rules and regulations in 2010 to regulate the MFIs' behavior, and will formulate more as the MFIs begin to provide large loans to micro and small enterprises. The weakest regulatory regime is that of the insurance sector. The IDRA has yet to become fully effective as a regulatory agency due to its limited infrastructure, low enforcement, the influence of insurance companies, and political interventions; however, it is moving gradually in the right direction.

These findings highlight a very important point regarding inclusion and outreach. Education and financial literacy levels are the major determinants of financial inclusion in any country. The low level of financial literacy in Bangladesh negatively impacts inclusive finance. The experience of banks and MFIs shows that supply-side interventions can make people significantly more financially literate in general. MFIs appear to be more effective at inculcating financial knowledge among their uneducated or less-educated, low-income clients. Efforts have focused on introducing financial products for financial inclusion; however, financial knowledge for investment decisions and about risk-minimizing instruments is missing. This should be seriously considered in a country like Bangladesh. Prudent and sound investment decisions

often do not ensure that investors are better able to cope with covariate shocks, and the absence of an insurance market or lack of insurance knowledge may be costly. In Bangladesh, most households and individuals lack access to insurance.

Information technology is becoming very popular in banking in Bangladesh. Mobile banking is now popular due to its comparative advantages, including low-cost services. Nonetheless, an appropriate policy is necessary to maximize the benefits of such technology and ensure fund security in remote areas.

Finally, to increase financial inclusion and inclusive growth, a complementary relationship should exist between financial institutions (both public and private banks) and MFIs, as it contradicts banks' profit maximization objective to provide services in every corner of Bangladesh. While banks operate from their branches, MFIs operate at the doorsteps of their (potential) clients. Consequently, the transaction cost of accessing financial services is lower through MFIs than through banks. In this situation, a principal-agent approach can create a mutually beneficial partnership between banks and MFIs that will provide financial services in every corner of the country. The other policy that may positively affect inclusive finance and growth is the "upstreaming" (from microcredit to micro and small enterprise credit) of MFIs in Bangladesh; however, this must be approached carefully to avoid losing focus of low-income households.

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5

India

Abheek Barua, Rajat Kathuria, and Neha Malik

5.1 Introduction: The Paradigm Shift in the Concept of Financial Inclusion

The general consensus among economists is that financial development acts as a catalyst for the overall growth and development of an economy. Moreover, empirical research demonstrates that developing a strong, sound financial system contributes to economic growth (Rajan and Zingales 2003). As a result, the governments of most developing countries are promoting financial inclusion¹ as a policy goal, especially for those persons frequently ignored by formal institutions.

In India, financial inclusion has always been a priority, given the country's socialist beginnings. Since 1969, when banks were nationalized, the strategy for addressing the banking needs of the poor has focused on providing credit while neglecting other aspects, such as building a deposit base, promoting a savings culture, or extending the payment network. This credit drive was implemented by (i) directing a significant fraction of credit directly to credit-starved poor households and micro, small, and medium-sized enterprises (MSMEs) through priority sector targets for banks; and (ii) creating specialized entities, such as regional rural banks and cooperative banks. This policy has met with limited success, as banks find it difficult to reach the intended beneficiaries and instead meet their priority sector targets by lending

¹ In 2008, the Committee on Financial Inclusion defined financial inclusion as “the process of ensuring access to financial services and timely and adequate credit where needed by vulnerable groups such as weaker sections and low income groups at an affordable cost” (Rangarajan 2008). This definition was later enhanced by the Reserve Bank of India (RBI) as follows: “financial inclusion is the process of ensuring access to appropriate financial products and services needed by vulnerable groups such as weaker sections and low income groups at an affordable cost in a fair and transparent manner by mainstream institutional players” (RBI 2014a).

to other intermediaries, such as microfinance institutions (MFIs) that have emerged largely due to the failure of banks to promote financial inclusion.

However, since the early 2000s, India's financial inclusion agenda has shifted from an emphasis on credit to a more comprehensive financial services approach, particularly opening bank accounts and offering basic financial products, such as insurance. This shift has been partly driven by the need to achieve other public policy goals, such as replacing product subsidies with cash transfers, which require beneficiaries to have bank accounts to expedite the transfers. Concerns regarding growing macroeconomic imbalances, as seen in declining rates of financial savings that partly reflect inadequate bank branch penetration, have also been a driver.

This new approach requires a change in the financial architecture of India's economy. Since bank account creation is an integral part of this agenda, banks must be more directly involved, as regulations mandate deposit-taking as their exclusive domain. Intermediaries, such as business correspondents, must supplement the banks' efforts, and new specialist payment banks must facilitate access to a robust payment network. As the new agenda involves multiple entities and involves MFIs further, balance is also necessary. Risks, such as those related to stability, solvency, anti-money laundering, and combating the financing of terrorism, must be addressed through regulation, while also ensuring that such regulation does not stifle inclusion.

Financially excluded households and microenterprises are forced to deal mostly in cash due to a lack of access to formal institutions. This, in turn, limits their options for building assets or saving for old age. The lack of savings and savings avenues forces them to approach informal sources of finance, which often charge 60%–100% in annual interest payments. Exposure to high rates of interest and the inability to service such loans ensure that these borrowers remain trapped in debt, exacerbating the cycle of poverty. The new financial inclusion agenda seeks to address both of these long-standing concerns for India.

5.2 Structure of the Banking and Microfinance Institution Sector in India

Soon after independence in 1947, a highly regulated banking system was put in place in India. The nationalization of the Imperial Bank as the State Bank of India in 1955 was followed in 1969 by the nationalization of 14 private commercial banks. In 1991, the banking industry was

deregulated to allow the entry of new private banks, and their foreign equity limit was increased to 74%. Simultaneously, the licensing of branches of domestic-scheduled commercial banks was phased out, and interest rates were deregulated.

India's banking sector is now diversified (Table 5.1), reflecting the banking needs of various sectors. Besides typical commercial banks, which operate on an "all-India" basis, small banks with limited operational areas were set up to promote financial inclusion and reduce poverty. Credit cooperatives serve the needs of small, marginal farmers and the poor in urban and semi-urban areas. Regional rural banks were created to combine the positive features of credit cooperatives, and commercial banks to address the credit needs of poor rural areas (Gandhi 2015). Local area banks were expected to fortify the institutional credit framework in rural and semi-urban areas.

India's banking system has grown rapidly since 2000 (Table 5.2). A credit boom ensued, with the share of credit-gross domestic product (GDP) increasing from 23.6% in 2000 to 52.8% in 2014. The bulk of this consisted of bank lending (Government of India, Ministry of Finance [MOF] 2015b).²

Public sector banks dominate the market, with around 74.0% of total deposits and 73.2% of total advances as of March 2015 (Table 5.3). Nevertheless, their performance has been weak compared to that of their private counterparts. Their gross nonperforming loans (NPLs) were 4.36% versus 3.83% for all banks, and their total stressed assets were 10.67% versus 9.03% for all banks. New private banks recorded much lower NPLs of 1.73% and total stressed assets of 3.28%. Of course, the performance of public banks varies significantly (RBI 2013b).

A specific challenge confronting banking in India is the resourcing of public sector banks to overcome the problem of stressed and restructured assets to meet the imminent Basel III requirements of capital adequacy.³ Recapitalization requirements for public sector banks have been estimated to range from Rs48 trillion (\$0.8 trillion) to Rs100 trillion (\$1.6 trillion), depending on forbearance assumptions and the ratio of restructured assets turning into NPLs (RBI 2014c).

² It has been shown empirically that, as countries become richer, they tend to see a rise in credit, but the banking sector's share of total credit shrinks relative to other sources of funding, such as capital markets (Government of India, MOF 2015b).

³ See Basel III: international regulatory framework for banks, <http://www.bis.org/bcbs/basel3.htm> (accessed 13 February 2017). As a matter of prudence, the RBI decided that scheduled commercial banks (excluding local area banks and regional rural banks) operating in India shall maintain a minimum total capital of 9% of total risk weighted assets (i.e., capital to risk weighted assets).

Table 5.1: Structure of Banking in India

Type of Bank	Composition	Bank Name	Number of Branches
Commercial Banks	Public banks (26) (72,661 branches)	State Bank of India	14,699
		Associate banks	5,482
		Nationalized banks	52,480
		Other public banks	1
	Private banks (20)	Old private banks	6,047
		New private banks	9,522
	Foreign banks (43)	Branch mode of presence	332
	Regional rural banks (64)	Limited area of operation	
	Local area banks (4)	Limited area of operation	
Cooperative Banks	Urban cooperative banks (1,606)	Multistate urban cooperative banks	43
		Single state urban cooperative banks	1,563
	Rural cooperatives (93,551)	Short-term	92,834
		State cooperative banks	31
		District central cooperative banks	371
		Primary agriculture cooperative societies	92,432
		Long-term	717
		State cooperative agriculture and rural development banks	20
		Primary cooperative agriculture and rural development banks	697
Microfinance Institutions	As of June 2015, 52 microfinance institutions have either received or applied for registration from the Reserve Bank of India. They constitute over 90% of all microfinance industry business in the country.	Arohan, Bandhan, BSS, Cashpor, Disha, Equitas, ESAF, Grama Vidiyal	10,553

BSS = Barclay's Shared Services, ESAF = Evangelical Social Action Forum.

Sources: Reserve Bank of India (2014a); Government of India, Ministry of Finance (2015a).

Table 5.2: Growth in Deposits and Credit in India's Banking System
(Rs billion)

	1951	1961	1971	1981	1991	2001	2011	2014
Aggregate deposits	8	17	59	380	1,925	9,629	52,080	85,331
(% of GDP)	-7.9	-10.0	-12.8	-26.1	-33.8	-44.4	-66.9	-67.9
Aggregate credit	5	13	47	254	1,164	5,114	39,420	67,352
(% of GDP)	-5.0	-7.7	-10.1	-17.5	-20.4	-23.6	-50.6	-52.8
Branches				35,707	60,220	65,919	90,918	116,450
ATMs							74,505	160,055

GDP = gross domestic product.

Note: As of 31 March.

Source: Government of India, Ministry of Finance (2015b).

Table 5.3: Market Share of Different Types of Banks in India
(%)

Bank Group	Deposits	Credit
State Bank of India and its associates	21.5	22.1
Nationalized banks	52.4	51.1
Foreign banks	4.3	4.8
Regional rural banks	2.9	2.5
Private banks	18.8	19.4
All scheduled commercial banks	100.0	100.0

Source: Reserve Bank of India (2015).

Traditionally, banks have not considered the poor a viable market. Most formal financial institutions are reluctant to serve them and MSMEs due to perceived high risks, the high cost of small transactions, low relative profitability, and the borrowers' inability to provide the physical collateral usually required by such institutions (International Monetary Fund 2004). In technical terms, problems of adverse selection and information asymmetries make it difficult for financial institutions to screen and monitor credit decisions.

MFIs emerged to address this market failure and provide financial services to low-income clients, but their character has changed since commencing operations. The pioneer MFIs operated as nonprofit, nongovernment organizations with a strong social focus. They developed

new credit techniques; instead of requiring collateral, they reduced risk through group guarantees, appraisals of household cash flow, and small initial loans to test clients.⁴ Today, however, MFIs have changed from nongovernment organizations to nonbank finance companies (NBFCs), and have modified how they raise finance. Once primarily donor-led, MFIs are now increasingly funded by banks and private and shareholder equity.

India's regulated microfinance market currently has over 30 million clients served by nearly 50 regulated institutions with a gross loan portfolio of about \$7 billion, reflecting 61% growth during 2013–2014 (MicroMeter 2015). The 10 largest MFIs account for 75% of the total industry loans. MFIs have a network of 10,553 branches, with 80,097 employees across 32 states and union territories. MFI activity is only set to grow, especially because only 8% of adults have loans from formal financial institutions. Moreover, only 35% have bank accounts, and more than half of these are inactive or semi-active (World Bank 2015).

5.3 State of Financial Inclusion

India's record of financial inclusion is poor despite the existence of a large and well-regulated financial system dominated by commercial banks. Aggregate macro data indicate that India's household debt–GDP ratio of 8.9% is among the lowest in the region, in contrast to that of the People's Republic of China (36.8%) and Thailand (around 83.0%) (Citi Research cited in Chakravarty 2014). The absence of inclusion is especially conspicuous in rural India, where around 60% of the population live. In rural areas during 2013–2014, deposits per capita were only Rs9,244 (about \$154), and credit per capita about Rs6,000 (about \$100) (Table 5.4). Similarly, some sections of the urban population (e.g., migrant laborers) also lack access to the formal financial sector.

Another manifestation of the lack of inclusion is the inadequate number of bank branches. The number of branches per 100,000 people in rural areas is roughly one-third of that in urban areas (Table 5.5).

A similar urban bias is seen in access to banking transaction points, such as ATMs (Table 5.6).

The International Monetary Fund Financial Access Survey, which compared access to financial services across countries, reinforced this exclusionary narrative for India. The survey showed that, while India

⁴ Experience has shown that the poor repay uncollateralized loans reliably and are willing to pay the full cost of providing them, as they prioritize access over cost.

Table 5.4: Per Capita Deposits and Credit in Rural and Urban India
(Rs)

Fiscal Year	Rural		Urban	
	Deposits	Credit	Deposits	Credit
2007–2008	3,735	3,977	85,003	60,405
2008–2009	4,441	3,779	100,146	71,437
2009–2010	5,088	4,662	113,747	81,313
2010–2011	5,924	4,713	131,303	98,772
2011–2012	6,830	5,269	144,138	114,185
2012–2013	7,923	6,197	162,145	127,854
2013–2014	9,244	6,161	178,942	143,718

Source: Author estimates based on data from the Reserve Bank of India. Data Releases. <https://www.rbi.org.in/Scripts/Statistics.aspx> (accessed 13 February 2017); and the World Bank. World Development Indicators. <http://data.worldbank.org/data-catalog/world-development-indicators> (accessed 13 February 2017).

Table 5.5: Number of Bank Branches in Rural and Urban Centers
(per 100,000 people)

Fiscal Year	Rural	Urban
2007–2008	3.79	13.05
2008–2009	3.84	13.65
2009–2010	3.93	14.49
2010–2011	4.08	15.28
2011–2012	4.35	16.22
2012–2013	4.70	16.99
2013–2014	5.25	17.91

Source: Author estimates based on data from the Reserve Bank of India. Data Releases. <https://www.rbi.org.in/Scripts/Statistics.aspx> (accessed 13 February 2017); and the World Bank. World Development Indicators. <http://data.worldbank.org/data-catalog/world-development-indicators> (accessed 13 February 2017).

has made remarkable progress in terms of financial deepening and widening, a large percentage of the population lacks access to basic financial services. Table 5.7 shows there are only 13.3 ATMs per 100,000 adults in India, the lowest in the sample. Similarly, with 12.2 commercial branches per 100,000 adults, India ranks lowest in the group, with the exception of Indonesia. However, India outperforms the others with regard to deposit accounts; the number of these per 1,000 adults increased from 611.0 in 2005 to 1,197.6 in 2013.

Table 5.6: ATM Penetration in Various Rural and Urban Centers
(per 100,000 people)

Time	Rural	Urban
December 2013	2.1	30.9
December 2014	3.3	36.1
March 2015	3.7	36.5

Source: Author estimates based on data from the Reserve Bank of India. Data Releases <https://www.rbi.org.in/Scripts/Statistics.aspx> (accessed 13 February 2017).

Table 5.7: Financial Access in Selected Countries

Country	Year	ATMs (per 100,000 adults)	ATMs (per 1,000 kilometers)	Commercial Bank Branches (per 100,000 adults)	Commercial Bank Branches (per 1,000 kilometers)	Deposit Accounts with Commercial Banks (per 1,000 adults)	Loan Accounts with Commercial Banks (per 1,000 adults)
India	2005	2.3	5.9	9.0	23.2	611.00	101.0
	2013	13.3	39.0	12.2	35.7	1,197.60	147.0
Brazil	2005	108.9	17.4			705.70	
	2013	130.7	23.2	47.7	8.4	1,153.50	
People's Republic of China	2005						
	2013	46.9	55.7	7.8	9.3	40.40	
Indonesia	2005	9.4	7.7	5.3	4.4	508.60	139.7
	2013	42.4	39.8	10.4	9.8	863.00	217.0
Sri Lanka	2005			8.9	20.9		
	2013	16.7	40.5	18.6	45.1		
France	2005	92.9	87.3	22.0	20.7		
	2013	109.2	107.0	38.7	38.0		
United Kingdom	2005	117.9	240.9	28.4	58.0		145.0
	2012	126.8	273.4	22.2	47.9		113.7

Source: International Monetary Fund. Financial Access Survey. <http://data.imf.org/?sk=E5DCAB7E-A5CA-4892-A6EA-598B5463A34C> (accessed on 18 February 2017).

India's impressive performance in deposit account uptake is primarily due to the Government of India's initiative to transfer national employment guarantee wages directly to the worker. In 2009, the government mandated that the transfer of wages under the Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA) be

made directly to workers' bank accounts. The objective was twofold: (i) to reduce leakages, and (ii) to widen access to basic banking services.⁵ However, the number of loans from commercial banks remains low, indicating that most of these accounts are used merely for receiving wages.

Another survey conducted by the World Bank captured how adults save, borrow, make payments, and manage risk (Table 5.8). The data showed that, despite the vigorous promotion of electronic modes of payment over paper-based payments, the use of electronic payments is still being adopted in India. Only 2.0% of people surveyed said that they use electronic payment methods. Further, while 22.4% of people saved money, only 11.6% did so at a formal financial institution.

Against this background, it is useful to identify the needs of financially excluded households: (i) a basic savings account with overdraft facilities; (ii) an instrument for remittances that plugs into the nationwide electronic funds transfer network; (iii) a pure savings instrument with relatively high returns and a lock-in period; and (iv) credit. A recent initiative toward these goals has been the Pradhan Mantri Jan Dhan Yojana (PMJDY), an ambitious plan that seeks to provide each household in India with a bank account.⁶ Over 190 million Jan Dhan accounts were operational in October 2015,⁷ and 15 million bank accounts were opened on the first day of the program. Account holders are given debit and credit cards, while microinsurance is likely to be added later. It is envisaged that, after 6 months, account holders will be entitled to overdraft facilities as well.

Since 2005, the Reserve Bank of India (RBI) has also made an effort to create basic financial services facilities for the excluded. In April 2005, the RBI recognized that vast sections of the population lacked access to banking services due to minimum balance requirements. To achieve greater access, the RBI counseled banks to open basic banking or “no-frills” accounts with no or very low minimum balances and

⁵ The MGNREGA mandates that any adult who applies for employment in rural areas must be given work on local public works within 15 days. If employment is not given, an unemployment allowance must be paid. MGNREGA. <http://www.mgnrega.co.in/> (accessed 26 January 2017).

⁶ The PMJDY has six pillars: (i) universal access to banking facilities; (ii) the provision of a basic bank account with an overdraft facility and a RuPay debit card to all households; (iii) the encouragement of financial literacy to enable use of financial products; (iv) a credit guarantee fund to mitigate risks stemming from overdraft facilities extended to these accounts; (v) the provision of microinsurance for all account holders; and (vi) unorganized sector pension schemes, such as Swavalamban Yojana.

⁷ PMJDY. <http://www.pmjdy.gov.in/account-statistics-country.aspx> (accessed 26 January 2017).

Table 5.8: World Bank's Global Index

	India	Brazil	People's Republic of China	Indonesia	Sri Lanka	France	United Kingdom
Payments							
Check used to make payments	6.7	6.7	1.8	1.5	2.8	79.5	50.1
Electronic payment used to make payments	2.0	16.6	6.9	3.1	0.5	65.1	65.3
Mobile telephone used to pay bills	2.2	1.3	1.3	0.2	2.4		
Loan in the past year							
Loan from a financial institution	7.7	6.3	7.3	8.5	17.7	18.6	11.8
Loan from a financial institution (income: bottom 40%)	7.9	3.5	7.7	6.4	19.1	16.1	11.1
Loan from a financial institution (income: top 60%)	7.5	8.2	7.0	10.1	16.5	20.3	13.2
Insurance							
Personally paid for health insurance	6.8	7.6	47.2	0.9	7.5		
Purchased agriculture insurance (% working in agriculture)	6.6	11.2	7.2	0.0	8.1		
Savings in the past year							
Saved at a financial institution	11.6	10.3	32.1	15.3	28.1	49.5	43.8
Saved at a financial institution (income: bottom 40%)	10.4	5.8	18.3	7.8	19.0	37.7	43.5
Saved at a financial institution (income: top 60%)	12.9	13.3	41.7	20.8	36.4	57.0	44.3
Saved any money in the past year	22.4	21.1	38.4	40.5	36.3	61.8	56.7
Saved any money (income: bottom 40%)	19.4	12.1	23.3	31.9	24.1	51.0	56.2
Saved any money (income: top 60%)	25.8	27.1	48.9	46.8	47.4	68.6	57.7

Source: World Bank (2014).

no or minimal charges. Recognizing the stigma associated with the nomenclature “no-frills,” banks were advised to offer a “basic savings bank deposit account” (BSBDA) with simplified know-your-customer norms.⁸

As of March 2014, 243 million BSBDA had been opened; however, the increase in the number of accounts was not reflected in a corresponding increase in the number of transactions (RBI 2014a). Table 5.9 shows that outstanding deposits in BSBDA were only Rs312.3 billion, while overdrafts used in these accounts amounted to only Rs16.0 billion. Moreover, most MGNREGA accounts are only used to receive wages, and beneficiaries withdraw their money immediately after it is deposited, leaving very low balances in these accounts (RBI 2014a). Similarly, many of the new PMJDY Jan Dhan accounts remain dormant, resulting in costs for banks and limited gains for the beneficiaries. According to one estimate, 80% of opened accounts lack transactions, revealing that the account holders remain essentially financially excluded (Patel 2014).

Table 5.9: Banking Penetration Progress, 2010–2014

	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
Banking outlets in villages					
Branches	33,378	34,811	37,471	40,837	46,126
Business correspondents	34,174	80,802	141,136	221,341	337,678
Other modes					
Total	142	595	3,146	6,276	
	67,674	116,208	181,753	268,454	383,804
Urban locations through business correspondents	447	3,771	5,891	27,143	60,730
Basic savings bank deposit account branches					
(million)	60.19	73.13	81.20	100.80	126.00
(Rs billion)	44.33	57.89	109.87	164.69	273.30
Basic savings bank deposit account business correspondents					

continued on next page

⁸ There are three basic requirements for BSBDA: (i) all credits in a financial year cannot exceed Rs100,000; (ii) withdrawals and transfers cannot exceed Rs10,000 per month; and (iii) balances at any point cannot exceed Rs50,000.

Table 5.9 *continued*

	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
(million)	13.27	31.63	57.30	81.27	116.90
(Rs billion)	10.69	18.23	10.54	18.22	39.00
Overdraft availed in basic savings bank deposit accounts					
(million)	0.18	0.61	2.71	3.92	5.90
(Rs billion)	0.10	0.26	1.08	1.55	16.00
Kisan ^a credit cards (million)	24.31	27.11	30.24	33.79	39.90

FY = fiscal year.

^a Kisan = small farmer.

Note: The fiscal year of the Government of India ends on 31 March.

Source: Reserve Bank of India (2014).

The inference is that bundling government welfare payments into BSBDA through direct cash transfers is only necessary to ensure that the accounts are used. It is necessary to create customized products and services that are relevant to account holders; until then, the poor will open accounts only because it is mandatory to do so.

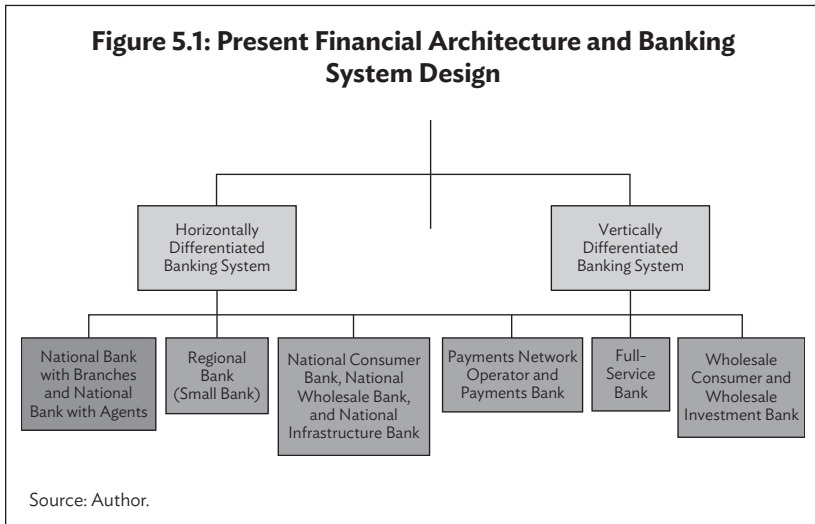
5.4 Delivery Models, Regulations, and Other Issues

5.4.1 The Mor Committee

The Mor Committee on Comprehensive Financial Services for Small Businesses and Low-Income Households created a comprehensive blueprint for the architecture of inclusion in 2014. The committee proposed the following to be achieved by 1 January 2016: (i) providing each resident aged 18 and above with an individual, full-service electronic bank account; (ii) establishing widely distributed electronic payment access points offering reasonably priced deposit and withdrawal facilities; (iii) providing each low-income household with convenient access to formally regulated providers that can provide suitable and reasonably priced credit, investment, deposit, insurance, and risk management products; and (iv) providing every customer with the legally protected right to be offered suitable financial services.

One criticism of these recommendations was that the targets and timelines set by the committee were aggressive. The RBI identified 490,000 villages, and allotted them to various banks for coverage by 2016. This required these banks to open 80,000 additional rural branches during 2013–2016; however, only 7,459 rural branches were ultimately opened. The committee’s recommendations were also skewed toward payments and deposit creation, and inadequate to ensure the improved delivery of credit or risk products to the poor.

The Mor Committee did recognize that an optimally designed banking system for India must involve a mix of horizontally and vertically differentiated banking systems (Figure 5.1). Banking systems across the world are based on these two designs. With horizontal differentiation, the basic design element remains a full-service bank that combines the three building blocks of payments, deposits, and credit, but is differentiated primarily on size, geography, or sector; with vertical differentiation, the full-service bank is replaced by banks that specialize in one or more of the building blocks of payments, deposits, and credit (i.e., a functional design configuration).



5.4.2 Small Banks

Globally, small banks have been seen as a crucial link in the financial inclusion process. This has led to the creation of a range of structures in India’s financial system, such as regional rural banks, united community

banks, and local area banks. These are locally governed and funded out of the local deposit base. RBI data show that the total number of regional rural bank offices was above 17,000 as of 2012–2013, with about 75% located in rural areas. These were created in the mid-1970s and 1980s, largely due to the regulatory advantages of lower capital adequacy norms offered to them as subsidiaries of sponsor commercial banks. Yet, most proved unviable by the end of the 1990s. The number of regional rural banks dwindled from 196 in 2005 to 62 as of 31 March 2013 (Subbarao 2013). Further, only four of any six local area banks in India licensed by the RBI are functioning; the rest have shut down, primarily due to mismanagement.

Global evidence regarding the performance of small banks is mixed. Small banks in developing countries (e.g., Ghana and Nigeria) have solvency problems. The United States model is also beginning to develop cracks, mainly due to the failure of such banks to keep pace with advances in banking technology (RBI 2014b). Regional banks in Germany and Switzerland, on the other hand, are backed by an effective risk management structure and have thus been able to survive.

Although small banks do possess certain benefits in the form of low-cost services customized to local needs and a near absence of contagion effects, they are vulnerable to capture and concentration due to their localized operations and to political influence (RBI 2014b). Other risks, such as commodity price volatility and weather vagaries, create the need for a high capital adequacy ratio. Moreover, small banks cannot experience economies of scale, as they are expected to operate within specified limits, and they lack the capacity to finance big projects.

Smallness or localization does not present a strong case for the creation of new banks based on regulatory forbearance. Instead, the licensing of new banks should be driven by the “level playing field” principle; if a local NBFC or other candidate for a license has the necessary financial strength or is otherwise eligible, it should be given a license. Of the 10 entities recently granted a license for small finance banks by the RBI, eight are MFIs.⁹ The key motivation for companies to convert to a small finance bank is access to deposits; they will also be able to offer customers a wider range of loan products. The converted companies must follow banks’ pricing structure, which is linked to their base rate.

⁹ Disha Microfin, Equitas Holdings, Evangelical Social Action Forum Microfinance and Investments, Janalakshmi Financial Services, Rashtriya Grameen Vikas Nidhi (Northeast) Microfinance, Suryoday Micro Finance, Ujjivan Financial Services, and Utkarsh Micro Finance (RBI 2015).

5.4.3 Microfinance Institutions

MFIs who did not receive or apply for a small bank license remain integral to the objective of inclusion. After a turbulent year in 2010, India's microfinance industry underwent some significant changes in regulations and operations.¹⁰ The 2010 crisis stemmed from extremely high and often usurious interest rates, coercive debt collection practices, and multiple lending. All three problems related to the interface between the borrower and the MFI. In 2011, the RBI mandated clear communication of lending rates and loan tenures, repayment flexibility, and the need to create a customer redress mechanism. MFIs have retained their priority sector lending status, while the RBI recently introduced self-regulatory initiatives such as the Industry Code of Conduct, and is developing a credit bureau to support responsible microfinance.

The RBI now recognizes the MFI industry bodies—the Microfinance Institutions Network (MFIN) and Sa-Dhan—as self-regulated organizations.¹¹ It is not yet clear if they will report to the RBI or to the newly created Micro Units Development and Refinance Agency (MUDRA) Bank.¹² Self-regulation is difficult and does not imply discretionary regulation; it is simply a model of regulatory outsourcing that obliges the organization to monitor members and ensure compliance with the RBI's extant regulations, including responsible lending. Self-regulated organizations are required to formulate a code of conduct and have an effective grievance redress system for borrowers, as well as a dispute resolution structure for members. In the current framework, MFIs can report to either Sa-Dhan or the MFIN, which is not necessarily good for regulatory efficiency. Moreover, such competition could result in regulatory arbitrage, since, in practice, some MFIs could be members of both Sa-Dhan and the MFIN.¹³

¹⁰ See Shylendra (2006) for an account of the crisis.

¹¹ In March 2015, Sa-Dhan, an association of MFIs, was accorded the status of a self-regulatory organization, which gave it powers to monitor MFIs and ensure that lenders comply with the rules. Sa-Dhan is the second association to be given this status by the central bank; the MFIN was given that status in 2014.

¹² The MUDRA Bank was launched on 8 April 2015 to provide formal or institutional financial support to non-corporate small businesses. The bank, which had an initial corpus of \$3.5 billion, is charged to provide “bottom-of-the-pyramid” entrepreneurs, popularly known as the “missing middle,” with access to formal systems of credit.

¹³ Since the model for the sector is new, it is too early to comment on its utility. It takes time for institutions to establish the desirable characteristics of independence and credibility; the test lies in the institutions' actual behavior when faced with difficult decisions involving substantial interest group conflict (Melody 1997).

Self-regulated organizations could become immediately effective by aligning members' interest charges with their costs. This would lead to price differentials across NBFCs that would both exert downward pressure on interest charges and lead to greater operating efficiency in the system. While more efficient NBFCs may see a temporary drop in margins, they would benefit in the long term. Less-efficient companies would see a loss in business volume, while fitter companies should see their losses in margins offset by a rise in volume.

5.4.4 Business Correspondents

Another significant regulatory change toward financial inclusion has been the relaxing of norms for business correspondents or bank *mitras* (agents) to complement the classic approach of physical branch-led distribution. Business correspondents provide last-mile connectivity for financial services in remote and underbanked locations. While initially restricting the kind of players who can qualify as business correspondents, the regulatory norms have been eased significantly, and now permit profit-making entities.

Business correspondents are microbankers outside the regulators' purview. Although they are "protected" by the capital of a sponsor bank, the moral hazard of risky lending becomes a distinct possibility since they do not provide any capital themselves. Banks in Brazil and India have not been comfortable with allowing business correspondents to lend. Some efforts have been made to overcome this moral hazard problem, such as allowing business correspondents to hold capital against the loans that they sanction.¹⁴ Since financial viability remains an issue, it is still uncertain whether the business correspondent model can be scaled.

5.4.5 Payment System

A policy encouraging large financial institutions to customize products for low-income customers enjoyed only moderate success in India, triggering a review by the RBI that led to the creation of new regulatory financial architecture.¹⁵ In 2015, the RBI approved the establishment of

¹⁴ In 2005–2006, the Industrial Credit and Investment Corporation of India Bank successfully experimented with the concept of a credit franchisee, who is similar to a business correspondent or facilitator but is required to place a fixed deposit with the bank of 10% of the amount of loans that he or she would sanction. Upon default, the deposit would function as a first loss deficiency guarantee.

¹⁵ For a brief analytic discussion, see National Council of Applied Economic Research (2011).

11 payment banks and 10 small finance banks (RBI 2015). Payment banks are permitted to accept demand deposits (i.e., current deposits) and savings deposits from individuals, small businesses, and other entities. They are restricted to a maximum balance of Rs100,000 per individual customer, and cannot issue credit cards or undertake lending activities. Payment banks are permitted to set up outlets such as branches and ATMs, and appoint business correspondents. Small finance banks will undertake basic banking activities, such as the acceptance of deposits and lending to unserved and underserved sections, including small business units, small and marginal farmers, MSMEs, and unorganized sector entities.

A large informal sector and vast pool of migrant workers means that about 65% of transactions in India occur in cash (RBI 2009). Informal channels for cash transfers exist, but are expensive and inefficient compared to electronic methods. Thus, a crucial aim of the inclusion agenda is to provide a robust payment system that minimizes the use of cash. This involves the convergence of banking, digitization, and mobile telephones as invoked in the JAM Number Trinity solution (i.e., Jan Dhan Yojana, Aadhaar cards, and mobile numbers) proposed in the *Economic Survey 2014–15* that allows the state to transfer subsidies to poor households in a targeted manner (Government of India, MOF 2015b).

While enhanced payment efficiency is the principal objective, products such as digital wallets can also function as savings instruments earning interest.¹⁶ Although most scheduled commercial banks have the credentials and balance sheet strength to offer mobile-based financial products, the main issue is the desirability of entry of nonbank participants into this space. Currently, 27 private participants (i.e., prepaid instrument providers) are allowed to offer digital wallets containing up to Rs50,000, which must be backed by escrow deposits placed with a commercial bank. While expanding this private network will promote inclusion, there are potential risks. Customer authentication is critical for any money transfer scheme.¹⁷ There is also merit in converting prepaid instrument providers to payment banks, as the RBI has recently done, as mobile wallets gain the status of deposits and earn returns (RBI 2009).

¹⁶ The success of mobile wallets and fully digital banking in African economies, such as the M-Pesa model in Kenya, is well documented. This mobile telephone-based banking model has also been successfully transplanted to other markets, such as Afghanistan.

¹⁷ News reports suggest that this risk has increased in countries such as Kenya and Tanzania that have extensive mobile banking channels, forcing a review of their regulation and monitoring.

Further, India Post, which has 155,000 outlets, has recently been awarded a payment-banking license. Apart from their core activities, they also (i) provide financial services, such as savings schemes; (ii) issue cash certificates, money orders, and insurance; and (iii) sell mutual funds, pension products, and remittance services. With its core activities facing competition from private players, the post office needs to reinvent itself. Given its longstanding reputation and deep network that has served many isolated areas, the post office is likely to succeed in its new role.

5.4.6 Policies

An important instrument of financial inclusion in India has been the priority sector lending targets, which mandate that all domestic commercial banks, public or private, lend 40% of their adjusted net bank credit or credit equivalent to the amount of their off-balance sheet exposure (whichever is higher) to priority sectors. This figure is 32% for foreign banks with more than 20 branches. Further, public banks have clearly defined rules in the subcategories of agriculture, MSMEs, education, housing, and export credit. For example, 45% of all priority sector lending must be made to agriculture (Government of India, MOF 2015b).¹⁸ However, the economic objectives that underlie priority sector lending, although laudable, must be reinforced by robust implementation, including the careful monitoring of distribution (Ramakumar and Chavan 2014). The quality of execution is widely seen as weak; in many cases, institutions have had to be recapitalized or amalgamated (Government of India, MOF 2015b).

Another critical issue relates to interest rate regulation. The charge on all loans is currently linked to banks' base rate (except the charge on farm loans, which is capped at 7%). Banks receive a 2% interest subvention from the government; however, as a uniform cap often means that many loans are priced out of sync with their risk profiles, this should be removed. Accordingly, in April 2014, the RBI removed the 26% price cap on loans advanced by MFIs, the only lenders eligible to lend through the microfinance channel. The rate at which MFIs now advance loans is either the margin spread over the cost of funds, or the average base rate of the five largest commercial banks by assets multiplied by 2.75, whichever is lower (Vishwanathan 2014).

This inclusion agenda can succeed in the long term only if banks view it as a viable business model. They must also be allowed to price risk freely. Interest rates, on the other hand, can be brought down in a sustainable and commercially viable way by increasing competition

¹⁸ According to the latest figures from the Central Statistical Office, agriculture constitutes 14% of GDP and supports over 48% of livelihoods in India.

in the system, as shown by international experience. The Consultative Group to Assist the Poor examined the experience of 30 countries and found that interest rate ceilings impeded the penetration of microcredit (Helms and Reille 2004).

The stability of the new financial system depends on their ability to gauge and monitor the risk associated with borrowers. It is imperative to link all transactions, but especially small loans like self-help group loans or *kisan* (small farmer) credit cards, to credit bureaus. On a broader level, a data-sharing arrangement among telecommunications operators, electric utilities, and credit bureaus can provide a detailed risk matrix for the economy.

Proportionality in regulation, that is, a policy and regulatory framework that is proportionate to the risks and benefits involved, is also vital. A proportionate approach requires the regulator to understand the risks presented by a specific type of institution, activity, product, or service; and to design regulation and supervision so that the costs to the regulator, institutions, and consumers are proportionate to the risks being addressed, taking into consideration the anticipated benefits as well. A proportionate approach is crucial to avoid overly burdensome regulation and supervision that may inhibit new entrants and innovations, including those that could beneficially serve people who currently lack access to financial services (Lauer and Tarazi 2012).

5.4.7 Suitability and Financial Literacy

Another goal emphasized by the Mor Committee is the right to suitability, meaning the right of every customer (e.g., a household or small firm) to be sold a suitable product in keeping with their risk and income profile. This right, not to be “mis-sold” a financial service by a financial institution, is the most difficult to implement. The new customer protection rules of the Financial Sector Legislation Regulation Reforms Commission clearly define processes for monitoring suitability and penal actions for violations. Both the commission and the Mor Committee recommended the creation of a unified financial redress agency for customer grievances across all financial products and services, which will, in turn, coordinate with the respective regulator.

More stringent customer protection laws alone are unlikely to achieve financial inclusion. This must be complemented by a significant increase in financial literacy.¹⁹ In 2013, India ranked the lowest in

¹⁹ The concept of financial literacy must encompass the understanding of both financial products and services, as well as the basic and advanced operations of the banking system. For example, customers in rural areas are not well equipped to deal with advanced biometric systems, and most lack even basic knowledge about opening a deposit account.

financial literacy among 16 countries in the Asia-Pacific region, based on a survey of 7,756 respondents aged 16–64 (MasterCard 2015). To help improve financial literacy, some banks have set up literacy centers that work with microfinance organizations. The Citi Center for Financial Literacy, in Ahmedabad, has an outreach of 500,000 stakeholders, a significant number for an individual bank, but tiny in relation to the entire underbanked population. The RBI also launched a financial literacy project among target groups of schoolchildren, senior citizens, and military personnel. In its school-level initiative, RBI personnel use an interactive module to teach the fundamental concepts of financial literacy. It has also been suggested that financial literacy be included in school curricula, as stand-alone financial literacy drives, similar to many other awareness campaigns, are likely to have only limited success.

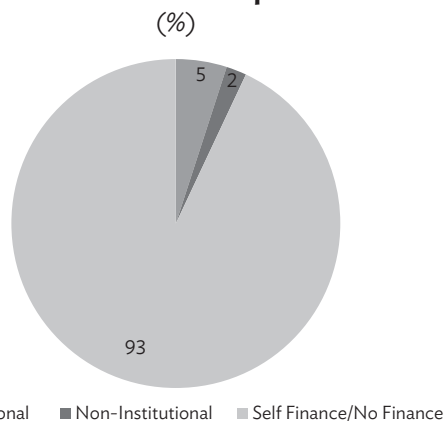
The extensive penetration of mobile telephones makes them a potent platform for promoting financial literacy. Media experts have suggested that games and competitions built around a financial literacy theme can be disseminated through the telecommunications network. Financial literacy modules can also be shown along with television programs and films; rural India has many traveling cinemas that can support this objective.

5.5 Micro, Small, and Medium-sized Enterprises

It is well recognized that MSMEs are sizable contributors to the national GDP and provide meaningful employment to over 100 million workers (Government of India, Ministry of Micro, Small and Medium Enterprises 2014). It is also well established that the formal financial system has largely ignored the credit needs of these enterprises. The sector employs an estimated 59.7 million persons in 26.1 million enterprises. In terms of value, it accounts for about 45% of the manufacturing output and around 40% of the country's total exports (second only to agriculture). The survey showed that only 5.18% of these units (both registered and unregistered) received finance from institutional sources, 2.05% received finance from non-institutional sources, and the majority (92.77%) had no finance or depended on self-finance. This is partly due to the inadequate penetration of banking facilities in remote areas; the RBI is encouraging banks to bridge this through structured financial inclusion plans. Since alternative sources of finance, such as risk or venture capital, are scarce, these enterprises have to fall back on debt from informal institutional sources, often at extremely high interest rates.

The survey also revealed that the few who borrow from banks do so at prohibitively high interest rates (13%–15%). The lack of formal finance

Figure 5.2: Financial Exclusion in the Micro, Small, and Medium-Sized Enterprise Sector



Source: Chakrabarty (2013).

for these units is often driven by the perception that they constitute poor-quality credit and that their loan impairment ratio is high (Chakrabarty 2013). However, adjusting for write-offs and restructuring, micro and small enterprises actually fare better than do their larger counterparts (Table 5.10).

Table 5.10: Impaired Assets Ratio
(%)

Segment	March 2009	March 2010	March 2011	March 2012	March 2013
Micro and Small Enterprises	10.7	10.6	9.4	9.7	10.6
Medium-Sized and Large Enterprises	7.8	9.4	8.0	11.2	14.8

Note: Impaired assets ratio = (gross nonperforming assets + restructured standard advances + cumulative write-off) to (total advances + cumulative write-off).

Source: Chakrabarty (2013).

Some of the constraints faced by MSMEs will be met by greater banking penetration, either through physical branches, information and communications technology-based branches, or business

correspondents. However, these must be combined with aggregate credit targets specified by the Prime Minister's Task Force on MSMEs, which stipulated 20% credit growth to micro and small enterprises on a year-on-year basis. Banks have also been directed to follow a cluster-based approach to MSMEs to ensure that they develop specialized industry expertise in their lending while reducing their transaction costs (Government of India, Ministry of Micro, Small and Medium Enterprises 2010). The RBI has also directed banks to open more specialized branches for MSMEs and to simplify credit approval processes.

A serious dearth of equity capital is another major impediment for first-generation entrepreneurs who require equity financing for start-up ventures. This has been partly addressed by dedicated platforms set up for MSMEs by the National Stock Exchange of India and Bombay Stock Exchange. Listings on these two exchanges began to increase in mid-2013. The Bombay Stock Exchange platform has 90 firms listed on it; the National Stock Exchange of India has far fewer. In fact, the numbers of firms operating on both exchanges are small given the sector's size.²⁰

MSMEs are particularly vulnerable to considerable delays in the settlement of dues and payment of bills by large-scale buyers. This must be tackled institutionally by factoring, and banks should provide such services, particularly to MSMEs. To facilitate factoring services, the government passed the Factoring Regulation Act in 2011, which addresses payment delays and MSMEs' liquidity problems. Factoring provides MSMEs with liquidity against their receivables from customers, and is regarded as a cash management tool. Factors are entitled to take legal recourse to recover assigned debt and receivables from buyers of goods and services. However, despite the institution of a legal framework, factoring has not yet taken off significantly, due to a lack of credit insurance, clarity on stamp duty waivers by states, and access to debt-recovery platforms. These issues must be resolved as part of the financial inclusion initiative.

Banks also have a vital role to play in nurturing the sector, and this cannot cease with the provision of credit. Banks and other financial institutions must view themselves not just as providers of credit but as partners in the growth of these enterprises, by aiding first-generation entrepreneurs. MSMEs typically operate with low productivity of capital and have either too little or too much cash. The tools for this work are fully developed (e.g., cash-flow forecasts and management). The financial management needs of MSMEs are predictable, and banks, by providing these services, can reap enormous rewards in terms of fee-

²⁰ Issue sizes on the exchanges have ranged from Rs50 million to Rs250 million.

income, enhancing business volumes, and boosting the credit quality of these firms.

The speedy disbursement of loans to MSMEs is contingent on the efficiency of the appraisal process. An important dimension of efficiency in the context of lending decisions is the speed with which any individual decision is taken. Efficiency is improved by the better evaluation of future payment performance, which enables the lender to choose whom to accept. The RBI recommended that a credit-scoring approach typical for large-volume consumer loans be used, instead of a more elaborate credit-rating approach.

The newly formed MUDRA Bank plays a key role in catalyzing fund flows to MSMEs. The MUDRA Bank aims to meet the credit needs of the unfunded categories, broadly defined as self-employed or own-account enterprises. Borrowers in these MSMEs generally lack standardized documents and the collateral that formal financial institutions seek. This market segment is large, almost entirely unorganized, and vulnerable to a range of economic shocks. The bank's primary purpose is refinancing for lending to MSMEs. It is also expected to perform regulatory functions for all types of entities in the microfinance space.

Experience in India has shown that incorporating regulation and financing functions within a single institution can be challenging. As the RBI currently oversees the MFIs' activities, dual oversight and the attendant risk of regulatory arbitrage are a possibility. In the aftermath of the 2010 crisis, the RBI facilitated the development of a well-articulated framework for governance, including a revival of investor confidence. At present, the RBI supervises MFIs representing over 90% of the microfinance industry.

5.6 Conclusion

India has an enormous opportunity to address the market's failure to provide financial services to low-income clients. For the first time since 2001, financial inclusion is at the heart of the policy agenda, and this has been widened to include savings, credit, insurance, and pensions. Technology increasingly offers opportunities to improve delivery, especially technologies that enable better targeting and transfer of financial resources to households.

Today, India has several strategic assets providing favorable conditions for change-leveraging technology. A strong banking network of 115,000 branches linked to e-Kuber (the RBI's core banking solution) is spreading into rural areas that lack banks. India Post, with 155,000 outlets, has a payment-banking license, and point-of-sale networks and

ATMs facilitate cash transactions across the country. India's vibrant network of almost 1 billion mobile connections, covering 75% of the population, can facilitate the spread of banking services through the business correspondent model and also enable funds transfer over mobile telephones. Moreover, Aadhaar, the national identification system that seeks to cover the entire population by 2016, can provide back-end verification and a security architecture.

MFIs have also emerged as important features in the financial inclusion agenda, which was successfully revitalized after the 2010 crisis due to regulatory intervention and candid introspection following severe public censure (Sane and Thomas 2013). Clients are now offered services with clear communication of lending rates, loan tenures, and repayment flexibility. Complementing these regulatory directions, many self-regulatory initiatives aim to promote responsible business practices in the microfinance market. The RBI has also raised its lending limits for MFIs, allowing them to serve a wider section of borrowers.

The new architecture of inclusion reflects the failure of the traditional formal sector and the need to adopt modern methods to serve the poor. In this context, regulation has a fundamental role to play in ensuring that market-oriented solutions to poverty alleviation coexist with other social initiatives. India's financial inclusion agenda has seen a welcome shift away from an emphasis on credit to a more comprehensive approach.

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6

Indonesia

Tulus Tambunan

6.1 Introduction

During the so-called “New Order” era (1966–1998), Indonesia experienced rapid economic development and annual growth rates of 6%–8%. The regime lowered poverty rates through rural economic development based on agricultural modernization and industrialization. Due to these achievements, Indonesia was called one of the “Asian Tigers,” along with Malaysia and Thailand. However, this economic performance at the macro level hid some problems, since the development strategy adopted by the country created inefficiencies and market distortions. Indonesia suffered from high economic costs and a growing gap in income levels. During the New Order era, the development process was exclusive, and affected only certain regions, such as Java, and only certain groups in society, that is, those whom policymakers considered important.

The Asian financial crisis of 1997–1998 hit Indonesia particularly hard. The most severe economic crisis to occur in Indonesia since the country’s independence in 1945, it led to an economic recession in 1998, with growth levels of –13%. Since recovering from the recession, Indonesia has undergone a profound transformation. It has embarked upon far-reaching institutional changes and has become one of the region’s most vibrant democracies. Indonesia has also seen much social and economic progress. Wide reforms have been carried out in all areas of economic, social, and political policy, and a new development strategy, inclusive economic development and growth, has been adopted. To this end, the Government of Indonesia has adopted a triple-tracked strategy: “pro-growth,” “pro-job,” and “pro-poor.” This strategy is considered important for Indonesia, since Indonesia still faces serious poverty issues despite robust economic growth after the 1998 crisis (Tambunan 2012).

One important element of inclusive development is financial inclusion, meaning broad access to financial services. This implies an absence of price and non-price barriers that might deter people from obtaining financial services. More institutions are now paying attention to the issue of financial inclusion. At the Group of 20 Toronto Summit in June 2010, global leaders pledged to support financial inclusion to empower about one-third of the world's population who are still living in poverty. Financial inclusion has also been integrated into the 2015 Association of Southeast Asian Nations (ASEAN) Economic Community Blueprint.

In Indonesia, financial inclusion is linked to poverty alleviation and financial stability. The government strongly believes that improving access to finance and the use of financial services will enhance public welfare. Bank Indonesia, the Indonesian central bank, took concrete action to this end by launching the National Strategy of Financial Inclusion in December 2010. Since then, the government and monetary authorities, such as Bank Indonesia and the Indonesia Financial Services Authority (*Otoritas Jasa Keuangan* [OJK]) have had many high-level discussions on financial inclusion, focusing on how to provide better access to banking services. They recognize that a major issue is asymmetric information between the supply of (from banks), and the demand for (especially from the poor) information on financial inclusion (Hadad 2010).

This chapter is based on an ongoing study on inclusive economic development in Indonesia, with a focus on financial inclusion during 2013–2015. The author and a team from the Center for Industry, SME and Business Competition Studies, Trisakti University are conducting the project. Its main objectives are to (i) study the significance of the shift in the national economic development strategy from an “exclusive” orientation during the New Order era (before the 1997–1998 Asian financial crisis) toward an “inclusive” orientation; (ii) explore the impact of this shift on the poor, including micro, small, and medium-sized enterprises (MSMEs); and (iii) understand the main constraints currently facing Indonesia in implementing inclusive development, particularly financial inclusion.

6.2 Inclusive Economic Development

According to Ali and Son (2007), Ali and Zhuang (2007), and Rauniyar and Kanbur (2009), the term “inclusive economic development” has no widely accepted definition. The concept clearly encompasses inclusion and economic development, and views inclusion as a process as well as

a goal. Inclusion can be seen as social transformation to accommodate difference by removing all barriers that discriminate against, or exclude, certain individuals or groups within that society. It sees society as the problem, not the individual. Rauniyar and Kanbur (2009) stated that inclusive economic development is economic growth coupled with equal economic opportunities. It focuses on creating economic opportunities and making them accessible to everyone at all levels of society, not just the poor. An economic development process is said to be inclusive when all members of a society participate in, and contribute to, that process equally, regardless of their individual circumstances or backgrounds. In the same way, inclusive economic growth is one that emphasizes that economic opportunities created by economic growth are freely available to all, particularly the poor. Inclusive economic development is therefore the process of ensuring that all marginalized and/or excluded groups within a society are included in the development process. Because inclusion involves all members of a community, collaboration, partnership, and networking among individual members in the community are core strategies to achieve inclusion (Tambunan 2012).

According to Sachs (2004), however, an inclusive development strategy requires three components to give all members of a community the same opportunities. First, it is essential to ensure the exercise of civil, civic, and political rights. Sen (1999) emphasized that democracy is a truly foundational value, as it also guarantees the transparency and accountability necessary for development processes to work. For Sachs, civil, civic, and political rights are the precondition for inclusive development. Second, all citizens must have equal access to welfare programs for the disabled, mothers and children, and the elderly, as these programs are designed to compensate for natural or physical inequalities. Compensatory social policies financed out of income redistribution should also include benefits for the unemployed. Third, the entire population should have equal opportunities to access public services, such as education, health protection, and housing.

The idea of inclusive economic development arose after the introduction of the Millennium Development Goals (MDGs). These were developed because, although many countries have achieved remarkable results in their long-term economic development in terms of high economic growth, high income per capita, and rapid structural change from agriculture-based to industry-based economies, poverty remains high in many countries and the gap between the rich and poor has grown wider. It is widely acknowledged that sustained poverty reduction depends on rapid economic growth; however, the connection is not automatic. Some fast-growing economies have failed to tackle poverty, while other countries with slower economic growth have been

more successful (Tambunan 2012). The United Nations Conference on Trade and Development (2010) argued that a fundamental problem in achieving the MDGs has been the lack of a more inclusive economic development strategy that integrates and supports its “human development” ambitions.

As stated above (para. 6.2), the key issues in inclusive economic development are poverty alleviation, participation, collaboration, and networking. Poverty alleviation is, or should be, at the center of inclusive economic development policies. To eliminate or reduce poverty, there is a need not only for direct policies to alleviate poverty, but also wider economic development policies, programs, and projects to promote poverty reduction while preserving efficiency, productivity, and competitiveness.

6.3 Indonesia’s Inclusive Development Strategy

From 1997 to 1998, Indonesia was badly affected by the Asian financial crisis, and thereafter by social and political disturbances and conflicts. This multidimensional crisis led to the fall of Soeharto’s New Order regime in May 1998. Since this date, when the Indonesian people decided to pursue democracy, the political system has been fundamentally transformed by the implementation of democracy and decentralization, and by the amendment of the 1945 constitution. Society has changed drastically and some previous public institutions are no longer functional.

Although the government during the New Order era seriously tried to address poverty issues in the country and initiated many pro-poor programs that led to a marked decline in poverty rates, the gap between the rich and poor did not decline significantly. In fact, during this era, the adopted development strategy was more exclusive than inclusive, as many regulations, policies, and facilities favored a small group of big companies (or conglomerates) at the expense of MSMEs (Tambunan 2012).

In the period following the 1997–1998 Asian financial crisis, known as the era of reform (*Reformasi*), government attention has been shifting toward inclusive economic development. In his 2009 address on national development from a regional perspective,¹ Susilo Bambang Yudhoyono, then the President of Indonesia, stated that the paradigm of development

¹ The speech was presented before the special plenary session of the House of Regional Representatives of the Republic of Indonesia in Jakarta, August 2009.

for all in the context of Indonesia can only be carried out by adopting six fundamental development strategies (Sekretariat Negara Republik Indonesia 2009). The first of these strategies is inclusive development that ensures equity and justice and respects and maintains the diversity of the Indonesian people. To reach this goal, the central and regional governments formed a consensus on Indonesia's development. This consensus is guided by Indonesia's medium- and long-term visions and missions.²

To achieve inclusive development, the government has adopted a triple-tracked strategy: "pro-growth," "pro-job," and "pro-poor." With respect to pro-poor strategies, the government is implementing various programs to alleviate poverty both directly and indirectly. These programs complement economic growth as the main engine to eliminate poverty, rather than being substitutes for it. The most popular program, the National Self-Reliant Community Empowerment Program (*Program Nasional Pemberdayaan Masyarakat Mandiri*), empowers people directly at the subdistrict and village levels, by enabling them to decide on the development priorities of their respective regions (Tambunan 2012).

Other pro-poor programs include Unconditional Direct Cash Assistance (*Bantuan Langsung Tunai*), Public Health Insurance (*Jamkesmas*), School Operational Support, the provision of subsidies (e.g., rice, fertilizers, and program credits), and the Family Hope Program (*Program Keluarga Harapan*), which are earmarked for poor and near-poor families all over the archipelago. The Family Hope Program is implemented to meet the basic needs of households that are unable to meet them in any other way. Some of the programs, such as the National Self-Reliant Community Empowerment Program, take the form of the "fishing rod," to empower people and communities by providing up to Rp3 billion in funds per subdistrict per year, the use of which is determined by the people themselves at the village level.

The government also allocates a budget for MSMEs in the form of subsidized credit, and the banking sector has been asked to channel a certain portion of its funds as credit for MSMEs. This policy is a key element of Indonesia's financial inclusion policies.

² Indonesia's long-term direction for 2005–2025 is stated in Law No. 17/2007, National Long-Term Development Plan, 2005–2025; the country's medium-term direction is given in each 5-year stage of the Medium-Term Plans. Each stage has a scale of priorities and development strategies constituting a continuity of priorities and development strategies from preceding periods.

6.4 Financial Inclusion

After the 1997–1998 Asian financial crisis, Indonesia changed its national development strategy in all areas, including the financial sector, from an exclusive orientation to a more inclusive one. The country has strong reasons for adopting financial inclusion as its new national development policy objective, given that (i) the financial sector is highly concentrated, being dominated by banks (the most profitable institutions, with low levels of intermediation) with growing capital markets (although they are still concentrated in a few big companies) and a low penetration of pension funds, insurance, and other nonbank financial institutions (NBFIs); (ii) only a small part of Indonesia’s total population has access to banking services; and (iii) poverty remains a serious problem in Indonesia.

6.4.1 Current Developments

The indicator most frequently used to measure the level of financial inclusion is the percentage of the adult population with access to a bank account in the formal financial sector. According to the 2011 Global Financial Inclusion Index from the World Bank (World Bank, Financial Inclusion Database website) (Table 6.1), Indonesia has a low uptake

Table 6.1: Share of the Adult Population with a Bank Account in the Formal Financial Sector in Indonesia and Other Selected Countries and Regions, 2011

Country/Region	Share (%)
Brazil	55.9
PRC	63.8
India	35.2
Indonesia	19.6
Malaysia	66.7
Philippines	26.5
Russian Federation	48.2
Thailand	77.7
Viet Nam	21.4
Central Asia and Eastern Europe	50.0
East Asia and Pacific	42.0
High-income OECD and non-OECD	92.0
Latin America and Caribbean	40.0
Middle East and North Africa	42.0
Sub-Saharan Africa	12.0
South Asia	22.0

PRC = People’s Republic of China; OECD = Organisation for Economic Co-operation and Development.

Source: World Bank, Global Findex Database. <http://datatopics.worldbank.org/financialinclusion/> (accessed 13 March 2014).

rate of slightly under 20%. This contrasts with Thailand's uptake rate of almost 78%. Table 6.2 shows statistics relating to bank account usage by Indonesian adults (aged 15 and above).

Furthermore, the Bank Indonesia Household Balance Sheet Survey 2011 shows that only 48% of households in Indonesia have accounts with banks and other formal financial institutions (Bank Indonesia 2013). These two sources of information suggest that access to banking services or formal financial institutions in Indonesia remains low. Moreover, less than one-fifth of the population borrows from banks, and access to risk management (pension funds and/or insurance) is also quite low. By region, there tends to be low access to banking financial

Table 6.2: Share of the Adult Population with an Account in the Formal Financial Sector in Indonesia, East Asia, and the Pacific; and Lower Middle-Income Groups by Selected Components of the Financial Balance Sheet, 2011
(%)

Component	Indonesia	East Asia and the Pacific	Low-Income Group
ATMs are the main mode of deposit ^a	5.9	13.9	4.5
Bank tellers are the main mode of deposit ^a	84.9	76.4	80.2
Bank agents are the main mode of deposit ^a	5.9	2.5	4.0
ATMs are the main mode of withdrawal ^a	51.1	39.1	31.0
Bank tellers are the main mode of withdrawal ^a	43.9	55.9	56.8
Bank agents are the main mode of withdrawal ^a	3.0	1.3	3.0
Has a debit card	10.5	34.5	10.1
Uses an account for business purposes	3.2	3.2	4.1
Uses an account to receive wages	7.7	16.9	8.5
Uses an account to receive government payments	2.6	6.3	3.9
Uses an account to receive remittances	6.1	8.8	3.7
Uses an account to send remittances	5.5	7.1	3.0
Saved any money in the past year	40.5	39.8	27.6
Saved at a formal financial institution in the past year	15.3	28.4	11.1
Saved using a savings club in the past year	13.9	4.3	7.2
Loan from a formal financial institution in the past year	8.5	8.6	7.3
Loan from family or friends in the past year	42.3	27.2	26.6
Loan from an informal private lender in the past year	2.0	1.9	5.3
Personally paid for health insurance	0.9	36.8	5.1

^a Percentage of those with an account.

Source: World Bank (2012).

services in east Indonesia, and high access in Java and Bali, with Jakarta, the capital city, having the highest uptake (Bank Indonesia 2013).

In terms of savings, a report on improving access to financial services in Indonesia by the World Bank in 2010 (Wibowo 2013) suggested that 68% of Indonesia's population save, and the remaining 32% do not. The reasons given for failing to save include having no money (79%), having no job (9%), being unable to see the benefit (4%), and lacking understanding about banks (3%). Of the 68% with savings, half hold them with formal financial institutions and half with the informal sector. Of the 50% with savings in financial institutions, 47% hold them with banks and 3% use NBFIs. Of the 47% who save with a bank, 41% use their own bank account and the remaining 6% use the bank account of another person.

Regarding loans, 60% of the population borrows money; of the 40% that do not currently borrow, 60% are not creditworthy, 20% have no wish to borrow, 4% have no collateral, and 16% have other reasons. Of the 60% who borrow money, 43% do so from the informal sector and 17% do so from banks.

The Financial Services Survey by the International Monetary Fund (IMF) also provides two interesting facts about financial inclusion in Indonesia, from both the demand side (use of finance) and the supply side (access to finance). As seen in Table 6.3, from the supply side, the number of commercial bank branches per 1,000 square kilometers is 9.24, or 9.59 per 100,000 adults. From the demand side, there are 222.93 household loan accounts with commercial banks per 1,000 adults. Further, as the financial inclusion policy in Indonesia aims to

Table 6.3: Access to and Use of Formal Financial Services in Indonesia, 2012

Commercial bank branches per 1,000 km ²	9.24	Commercial bank branches per 100,000 adults	9.59
ATMs per 1,000 km ²	35.15	ATMs per 100,000 adults	36.47
Outstanding deposits with commercial banks (% of GDP)	39.13	Outstanding loans from commercial banks (% of GDP)	32.85
Deposit accounts with commercial banks per 1,000 adults	708.12	Loan accounts with commercial banks per 1,000 adults	225.89
Household deposit accounts with commercial banks per 1,000 adults	672.97	Household loan accounts with commercial banks per 1,000 adults	222.93

GDP = gross domestic product, km² = square kilometer.

Source: IMF (2012).

provide all households with access to bank services, annual changes in the number of household deposits and loan accounts with commercial banks (Table 6.4) may show the trend of financial inclusion over time for households in Indonesia.

Table 6.4: Number of Households in Indonesia with Deposit and Loan Bank Accounts, 2004–2012

Variable	2004	2005	2006	2007	2008	2009	2010	2011	2012
Household deposit accounts with commercial banks per 1,000 adults	485.00	497.29	451.94	458.04	467.23	486.27	566.43	615.20	672.97
Household loan accounts with commercial banks per 1,000 adults	117.51	135.94	139.89	148.72	175.29	193.48	200.31	218.00	222.93

Source: IMF (2012).

6.4.2 Credit

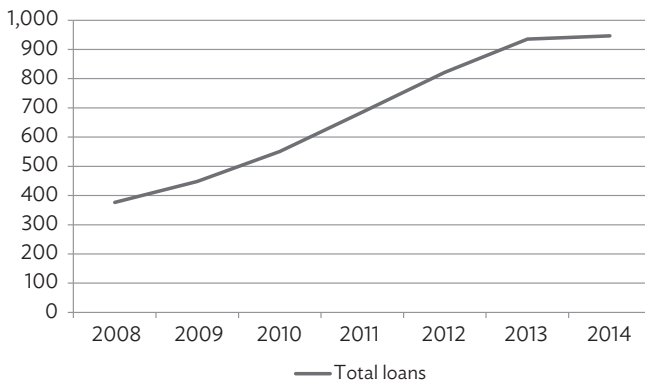
Indonesia Banking, a monthly publication that gives an overview of banking developments in Indonesia, receives its data from figures published by Indonesia Banking Statistics. These data derive from commercial, Sharia, and rural bank monthly reports. Data from the commercial and Sharia bank monthly reports, submitted by the reporting banks to Bank Indonesia, are processed using the Bank Indonesia Banking Information System and are presented in PDF as well as Excel format. Recorded data include information about distributed credit and outstanding loans in rupiah and foreign currencies from commercial and rural banks. The data are organized by banking group, economic sector, debtor group, type of loan (investment, working capital, or consumption), location (province), loan utilization purpose, and outstanding MSME credit for commercial banks (OJK 2014).

6.4.3 Credit for Households

Of all the banks that provide household credit in various schemes—commercial, state-owned, rural, and regional development banks—Bank Perkreditan Rakyat (BPR), regional or provincial development

banks (*bank pembangunan daerah* [BPDs]), and the Indonesian People's Bank (*Bank Rakyat Indonesia* [BRI]) are key institutions providing microfinance to households (e.g., housing loans [mortgages], vehicle loans, and other consumer credit). BPRs are also known as rural banks, people's credit banks, smallholder credit banks, or second-tier banks to serve MSMEs, lower-income groups, and/or poor households. A BPD is a regional or provincial development bank owned by provincial governments; its legal form is now the same as that of a commercial bank. The BRI has various credit schemes, including microcredit known as Kredit Umum Pedesaan (KUPEDES), allocated through all BRI *unit desa* (village branches). KUPEDES is a general-purpose rural loan scheme with competitive interest rates. It offers loans (working capital and investment) to those who fulfill the requirements in all economic sectors, from businesses in agriculture, trade, industry, and services; to individual borrowers who require loans for education, house renovation, and the purchase of vehicles, for example. Figure 6.1 shows the trend of outstanding consumption loans of commercial and rural banks by bank group over time (specific data on microcredit consumption are unfortunately unavailable). Bank Indonesia provides official data on all types of household credit from commercial and rural banks.

Figure 6.1: Outstanding Consumption Loans (in Rupiah and Foreign Currencies) of Commercial Banks and Rural Banks, 2008–2014
(Rp billion)



Note: 2013 = December; 2014 = March.

Source: OJK (2014).

6.4.4 Credit for Micro, Small, and Medium-Sized Enterprises

In Indonesia, the number of MSMEs has increased steadily every year (Table 6.5). In 2012, MSMEs accounted for around 99% of all enterprises (including large enterprises). The majority of these are micro and small enterprises (MSEs), which are scattered widely throughout rural areas and will therefore likely play an important role in developing villagers' (especially women's) technical and entrepreneurial skills. However, most MSEs are established and run by poor individuals or households, as either their primary or secondary (supplementary) source of income, because they cannot find better employment. Therefore, the presence of MSEs in Indonesia is often seen as a reflection of the problems of poverty and unemployment rather than entrepreneurial spirit.

Table 6.5: Total Number of Enterprises by Size in All Economic Sectors of Indonesia, 2000–2012
(‘000)

Size Category	2000	2003	2005	2007	2009	2010	2011	2012
MSE	39,705.0	43,372.9	47,006.9	47,720.3	52,723.5	53,781.1	55,162.2	56,485.6
ME	78.800	87.400	95.900	120.300	41.100	42.600	44.200	48.997
LE	5.70	6.50	6.80	4.50	4.70	4.80	4.95	4.97
Total	39,789.7	43,466.8	47,109.6	49,845.0	52,769.3	53,828.5	55,211.4	56,539.6

LE = large enterprise, ME = medium enterprise, MSE = micro or small enterprise.

Source: Processed data from the National Agency for Statistics (*Badan Pusat Statistik* [BPS] 2010) and the website of Kementerian Koperasi dan Usaha Kecil dan Menengah Republik Indonesia. www.depkop.go.id (accessed 16 February 2017).

- The majority of MSMEs in Indonesia are engaged in agriculture. In 2008, the agriculture sector comprised about 42.7 million laborers, of whom almost 99.5% were employed in MSMEs, and about 26.4 million firms, almost 100% of which were MSMEs. Within the MSMEs, more MSEs are agriculture-based. The second-most important sector for MSMEs is trade, hotels, and restaurants. Indonesian MSMEs are traditionally less strong in the manufacturing industry than are large Indonesian enterprises or MSMEs in developed Asian economies such as Japan, the Republic of Korea, and Taipei, China. In those economies, MSMEs are traditionally well represented, having

production linkages with large enterprises as suppliers or vendors, especially in the automotive, electronics, and machinery industries. However, the structure of Indonesian MSMEs by sector is not unique to Indonesia, but is a key feature of this category of enterprise in developing countries, especially when the country's level of industrialization and income per capita are relatively low.

MSMEs' access to formal financial institutions can be a good indicator of financial inclusion, since they are often excluded from this sector. Based on limited information from various sources (e.g., government reports, national surveys, and case studies), Tambunan (2008a; 2008b) made a list of key constraints common to MSMEs in some developing countries in Asia (Table 6.6). He found that, in all countries

Table 6.6: Main Constraints Facing Micro, Small, and Medium-Sized Enterprises in Developing Countries in Asia

Country	Main Constraints										
	Raw materials	Marketing	Capital	Energy	Information	Technology and skills	Infrastructure	Tax	Inflation	Market distortions	Labor issues
Bangladesh			√	√		√					√
Brunei Darussalam		√	√			√					
Cambodia			√	√		√					√
PRC		√	√			√	√				
India		√	√				√				√
Indonesia	√	√	√	√	√						
Lao PDR	√		√					√	√		
Malaysia	√		√		√	√					
Nepal		√	√			√					√
Pakistan		√	√								√
Philippines		√	√			√					
Thailand	√	√	√		√	√					
Viet Nam			√			√	√				√

PRC = People's Republic of China; Lao PDR = Lao People's Democratic Republic.
Sources: Tambunan (2008a, 2008b).

under review, a key constraint faced by MSMEs is a lack of capital, which is mainly due to a lack of access to banks and other formal NBFIs. In many developing Asian countries, this problem is experienced mainly by MSEs, especially those located in rural or less-developed areas.

Based on data from the National Agency for Statistics (*Badan Pusat Statistik* [BPS]) from 2005 and 2010, Table 6.7 highlights the main constraints faced by MSEs in Indonesia's manufacturing industry. A lack of capital is the most important constraint, followed by marketing difficulties and a lack of raw materials. Within the MSE group, a lack of capital—mostly working capital—is a more serious issue for microenterprises than for small enterprises. The majority of microenterprises facing capital constraints are located in rural or less-developed regions where access to financial credit from banks or other government-sponsored MSME credit schemes is either minimal or absent.

Table 6.7: Main Constraints Facing Manufacturing Micro and Small Enterprises in Indonesia, 2005 and 2010
(number of firms)

	2005	2010
Have no serious obstacles	674,135	599,591
Have serious obstacles:	2,054,565	2,133,133
(i) Lack of raw materials or high cost of raw materials	421,277	483,468
(ii) Marketing difficulties	629,406	495,123
(iii) Lack of capital	714,629	806,578
(iv) Transportation and distribution obstacles	54,945	39,571
(v) Lack of energy supply or high cost of energy supply	55,420	34,759
(vi) Lack of skilled labor or high labor costs	16,650	89,046
(vii) Other constraints	162,238	184,408
Total	2,728,700	2,732,724

Sources: Tambunan (2008a); BPS (2010).

The data in Table 6.7 are consistent with the fact that only a small percentage of MSMEs in Indonesia have ever obtained credit from banks or other formal NBFIs. For example, for MSEs in the manufacturing industry, 2005 BPS data show that the majority of sampled producers (82.41% of microenterprises and 68.85% of small enterprises) financed their businesses fully using their own money; very few (2.90% of

microenterprises and almost 1.80% of small enterprises) borrowed money to do so. Data from 2010 (Table 6.8) show that the majority of producers financed their operations completely by themselves (although the ratio varies by industry sector). Of those who financed their businesses partially or fully from outside sources, only a few borrowed money from banks.

Table 6.8: Micro and Small Enterprises in the Manufacturing Industry in Indonesia, by Industry Sector and Source of Capital, 2010

Industry Sector	Number of Firms	Source of Capital (% of total)		
		100% Owned	Partly Owned	100% Outside Source
Food	929,910	0.830	0.150	0.0200
Beverages	30,395	0.910	0.080	0.0100
Processed tobacco	53,169	0.570	0.410	0.0200
Textiles	234,657	0.760	0.160	0.0800
Garments	276,548	0.740	0.220	0.0400
Leather and its products, including footwear	32,910	0.570	0.380	0.0500
Wood and its products (not including furniture) and handicrafts	639,106	0.870	0.098	0.0300
Paper and its products	7,268	0.410	0.390	0.2000
Publishing and recording media reproduction	24,305	0.698	0.280	0.2200
Chemicals and their products	19,168	0.750	0.190	0.0600
Pharmaceutical, chemical, and medical products, and traditional medicine	5,043	0.930	0.050	0.0200
Rubber, plastic, and their products	13,786	0.580	0.220	0.2000
Excavated, non-metal products	215,558	0.720	0.250	0.0300
Base metals	1,553	0.570	0.420	0.0100
Metal products, non-machinery, and tools	61,731	0.750	0.230	0.0200
Computers, electronic goods, and optics	434	0.980	0.020	0.0000
Electrical tools	199	0.610	0.390	0.0000
Machinery and related tools	1,540	0.530	0.340	0.1300

continued on next page

Table 6.8 *continued*

Industry Sector	Number of Firms	Source of Capital (% of total)		
		100% Owned	Partly Owned	100% Outside Source
Vehicles, trailers, and semi-trailers	3,488	0.990	0.010	0.0014
Other transportation modes	4,708	0.750	0.210	0.0400
Furniture	107,166	0.730	0.240	0.0300
Other manufacturers	62,898	0.750	0.200	0.0500
Repair services, machines, and their tools	7,184	0.860	0.139	0.0100
Total	2,732,724	0.795	0.170	0.0350

Source: BPS (2010).

This is consistent with the IMF's Financial Service Survey, which found that, in 2011, total outstanding loans from commercial banks were equivalent to 29.64% of Indonesia's total gross domestic product, while that of MSMEs in the same period was only 6.17%. In 2012, these figures were 32.85% and 6.39% (IMF 2012). This is also consistent with findings from the 2009 Enterprise Survey by the World Bank and International Finance Corporation (2010) (Table 6.9).

Tables 6.10–6.12 show the sources of capital for MSEs in the manufacturing industry (Table 6.10), the origin of the loans received by those MSEs (Table 6.11), and the main reasons why MSEs do not borrow money from banks or other formal NBFIs (Table 6.12). Table 6.10 shows that more micro than small enterprises used their own money to run their businesses. Interestingly, of those who took loans from the formal financial sector, more micro than small enterprises used credit from banks (Table 6.11). Table 6.12 shows that the main reasons why businesses do not borrow money from banks or other formal NBFIs are that the businesses lack collateral and find the administrative procedures to apply for credit too complex.

Figure 6.2 shows the allocation of credit to MSMEs (mainly for working capital and investment) by commercial banks in Indonesia from 2011 to 2013, and Tables 6.13 and 6.14 provide data on MSME credit by sector. The supply of credit to MSMEs increases annually, although the level of credit received and the rate of credit growth vary by sector. The largest amount of MSME credit is found in the trade and manufacturing industries, as these are two key MSME sectors. However, MSME credit accounts for, on average, much less than 30% of total credit (consisting

Table 6.9: Enterprise Survey, 2009: Financial Indicators of Micro, Small, and Medium-Sized Enterprises in Indonesia
(%)

	Indonesia	Firm Size		
		MSEs	MEs	LEs
Internal finance for investment	88.3	88.9	87.4	82.0
Bank finance for investment	6.4	6.1	6.8	8.7
Trade credit finance for investment	0.8	0.9	0.1	1.5
Equity, sale of stock for investment	3.2	2.6	5.1	6.2
Other finance for investment	1.3	1.4	0.5	1.7
Working capital external finance	14.4	13.3	23.5	18.6
Value of collateral needed for the loan (% of the loan amount)	53.1	51.3	56.1	68.5
Firms with bank loans and lines of credit	18.2	16.5	27.6	47.1
Firms with a checking or savings account	51.5	46.3	89.1	92.5

LE = large enterprise (100+ employees); ME = medium-sized enterprise (20–99 employees); MSE = micro or small enterprise (1–19 employees).

Source: World Bank and International Finance Corporation (2010).

Table 6.10: Sources of Capital for Micro and Small Enterprises in the Manufacturing Industry in Indonesia, 2005
(% of total sampled enterprises)

Source of Capital	MEs	SEs
Own	82.41	68.85
Borrowed	2.86	1.75
Own and borrowed	14.73	29.40
Total	100.00	100.00

ME = microenterprise, SE = small enterprise.

Source: BPS (2010).

Table 6.11: The Origin of Loans for Micro and Small Enterprises in the Manufacturing Sector in Indonesia, 2005
(% of sampled enterprises)

Origin of Loan	MEs	SEs
Formal Sources		
Bank	54.54	15.62
Cooperative	5.57	3.83
Venture capital	1.63	1.34
Nonbank institutions	4.75	3.06
Informal Sources		
Family	12.61	11.21
Friends	23.64	44.35
Others	14.24	28.35

ME = microenterprise, SE = small enterprise.

Source: BPS (2010).

Table 6.12: Reasons Why Micro and Small Enterprises Do Not Borrow Money from Banks, 2006
(%)

Reason	MEs	SEs
No collateral	20.69	28.55
No knowledge of procedure	10.56	14.50
Overly complex procedure	24.31	10.00
High interest rate	14.12	8.67
Not interested	28.00	37.50
Application rejected	2.32	0.78
Total	100.00	100.00

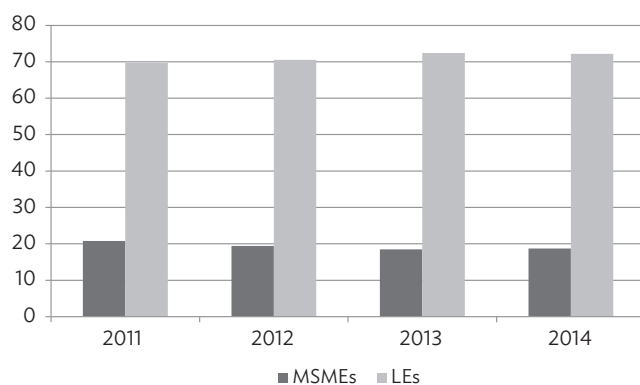
ME = microenterprise, SE = small enterprise.

Source: Tambunan (2011).

of credit for business [investment and working capital] and consumption credit) issued by commercial banks, and is much lower than the percentage of credit received by large enterprises.

With respect to financing MSMEs, Indonesia had some successes with institutional development in the decade preceding the 1997–1998 Asian financial crisis, including the development of a comprehensive set

Figure 6.2: Total Credit Received from Commercial Banks in Indonesia by Large Enterprises, and Micro, Small, and Medium-Sized Enterprises, 2011–2014
(% of total business and consumption credit)



LE = large enterprise; MSME = micro, small, or medium-sized enterprise.

Note: 2013 = December; 2014 = March.

Source: OJK (2014).

Table 6.13: Total Bank Credit of Micro, Small, and Medium-Sized Enterprises by Sector, 2002–2010
(Rp trillion)

Sector	2002	2003	2004	2005	2006	2007	2008 Dec	2010 Aug
Agriculture	8.60	8.6	12.1	12.60	13.3	16.1	19.4	18.00
Mining	0.50	0.6	0.9	0.97	1.3	1.5	1.8	6.10
Manufacturing	22.00	24.4	26.6	32.50	36.7	37.8	46.1	53.99
Electricity, gas, and clean water	0.10	0.1	0.1	0.30	1.5	0.3	0.6	0.95
Construction	3.60	4.6	5.9	7.70	10.1	13.2	17.1	21.40
Trade	38.60	52.8	67.2	87.50	107.3	134.6	157.1	194.20
Transport	3.70	5.1	6.0	6.50	6.6	7.2	8.6	11.96
Business services	7.96	13.3	15.6	20.70	23.5	30.5	40.9	46.99
Social services	2.20	3.0	4.3	5.30	6.0	6.7	7.6	35.30
Others	73.60	94.7	132.4	180.90	203.5	254.9	334.8	481.00
Total	160.86	207.2	271.1	354.97	409.8	502.8	634.0	869.89

Source: Bank Indonesia. www.bi.go.id (accessed 2 March 2014).

Table 6.14: Total Bank Credit of Micro, Small, and Medium-Sized Enterprises by Sector, 2011–2014
(Rp billion)

	2011 Dec	2012 Dec	2013 Dec	2014 Mar
All sectors	458,164	526,397	608,823	619,400
Agriculture, livestock, forestry, and fishery	29,794	43,609	51,900	53,094
Mining and quarrying	3,938	5,427	4,753	5,047
Manufacturing	52,231	59,500	60,087	64,187
Electricity, gas, and water supply	1,218	1,474	1,750	1,664
Construction	24,279	30,594	38,780	36,314
Trade, hotels, and restaurants	212,462	262,584	341,188	346,287
Transport and communication	18,068	20,219	23,882	23,969
Financial, ownership, and business services	30,594	40,465	46,009	46,897
Other services	85,579	62,524	40,473	41,940
Others	1	0	1	-

Source: Bank Indonesia. www.bi.go.id (accessed 15 May 2014).

of institutions serving all market levels. However, these institutions were neither particularly efficient nor comprehensive, and they faced some difficulties even before the crisis. That many of them were financially and structurally weak manifested in high transaction costs and limited market penetration. As a result, an overwhelming number of MSEs were not served (Martowijoyo 2007).

Information from Bank Indonesia also shows that the loan portfolios of most of Indonesia's big banks remain dominated by loans to large businesses and corporate clients. As of 2012, total financing of MSMEs in Indonesia, around Rp612 trillion, only accounted for around 20.1% of total bank credit. Of this amount, microenterprises received only 20.7%. According to Bank Indonesia, there are many reasons why banks only finance a small portion of MSMEs in Indonesia. First, banks or other formal NBFIs often consider these businesses "invisible," either because (from a market perspective) their products are not in high demand, or because (from a management perspective) they lack the ability to manage their businesses professionally (this is especially true for MSEs, which are often not well organized or lack a well-developed organizational and management system). Second, MSMEs often lack valuable assets that can be used as collateral (Kompas 2013).

Rosengard and Prasetyantoko (2012) also concluded that Indonesia is underbanked, especially with respect to microfinance and MSME finance. Of the six largest banks, only the BRI and Bank Danamon include a majority share of MSME loans in their portfolios. Despite potentially lucrative unserved or underserved markets—including low-income households and family businesses—Indonesia’s monetary policy and the regulatory regime set by Bank Indonesia has unintentionally created barriers to outreach and innovation for microfinance institutions (MFIs). This has also incentivized commercial banks to forsake MSME finance in favor of consumer finance and alternative non-loan investments.

During the Asian financial crisis, MSMEs proved more resilient than their larger counterparts (many of which were directly hit by the crisis and went bankrupt), and prevented a rapid increase in unemployment. Since then, Bank Indonesia has encouraged commercial banks to lend to MSMEs using self-determined targets in their business plans. Bank Indonesia has also defined microcredit as including loans of up to Rp50 million (approximately \$5,450). Under this broad definition, commercial banks in Indonesia dominate microcredit, which in 2007 served 48% of all borrowers, with loans totaling 82.8% of the aggregate outstanding microfinance loan portfolio. BRI units, which accounted for nearly half of all commercial bank outlets, accounted for 10.8% of borrowers and 12.6% of outstanding microloans in 2007. The average size of a microloan given by a commercial bank was \$983.50 (around 85% of annual per capita income), as compared to \$53 (approximately 5% of annual per capita income) for village credit institutions (*Badan Kredit Desa* [BKDs]) (Martowijoyo 2007).

6.4.5 Microfinance

6.4.5.1 Developments in Microfinance since the New Order Era

Indonesia is one of the few developing countries that have successfully run sustainable microfinance on a relatively large scale. It has had lengthy experience implementing microfinance, beginning in the early 1970s with the BRI as the key engine. The government continues to improve the systems of existing microcredit schemes and strengthen their implementation process. The BRI unit network is now the largest and one of the most profitable rural microbanking networks in the developing world. This makes microfinance in Indonesia an interesting research subject from which best practices can be learned. The government has taken measures to improve microfinance, and recently launched two new regulations, namely Undang-undang (UU) No. 17 Tahun 2012 on cooperatives (since the government encourages cooperatives in Indonesia to act as MFIs), and UU No. 1 Tahun 2013 on

MFI. Bank Indonesia defines microfinance or microcredit as a loan of less than Rp50 million (\$5,373), and/or a financial product provided by formal and semiformal financial providers in Indonesia (Bramono et al. 2013).

During Soeharto's New Order era (1966–1998) there were many popular microfinance programs, including (i) *Bimbingan Massal* (mass guidance), a rice intensification program with a subsidized credit component for rice farmers allocated through village unit credit (*Kredit Unit Desa* [KUD]); and (ii) the BRI *unit desa*, which was later succeeded by *Kredit Usaha Tani*, a subsidized farming credit for small farms. There were also two special credit schemes for MSEs in agriculture: *Kredit Investasi Kecil* (small investment credit), and *Kredit Modal Kerja Permanen* (permanent working capital credit); as well as various special credit schemes for MSEs in other sectors (e.g., Kredit Mini, Kredit Midi, KUPEDES, and Kredit Candak Kulak), allocated through KUD. Many other microfinance schemes were also implemented at the local level, such as *Kredit Usaha Rakyat Kecil* (KUR) (business credit for the poor), implemented in East Java in 1984, and *Kredit Usaha Kecil* (small business credit), which offered loans to small enterprises and cooperatives to fulfill the banks' credit quota of 20% of their loan portfolios (Martowijoyo 2007).

Besides these schemes, special village-based nonbank MFIs—*Lembaga Dana Kredit Perdesaan* (LDKPs) (rural credit fund institutions)—were established. Many others were also set up, such as (i) Badan Kredit Kecamatan in Central Java and South Kalimantan, a subdistrict-level MFI founded by the Provincial Government of Central Java in the 1970s; (ii) Lembaga Perkreditan Kecamatan in West Java; (iii) Lumbung Pitih Nagari in West Sumatra; and (iv) Lembaga Perkreditan Desa (LPD) in Bali (Baskara 2013).

Indonesia has also replicated the Grameen Bank program, starting with Karya Usaha Mandiri in Bogor, West Java in 1989, followed by Mitra Karya East Java in Malang, East Java in 1993. In Sumatra, the Grameen Bank model was replicated by Yayasan Pokmas Mandiri (Sarumpaet 2005, cited by Siti Khadijah et al. 2013).

Islamic finance was introduced to Indonesia—the largest Muslim country in the world—during the New Order era as an option to enable people on low incomes to access funds to improve their lives and lift them out of poverty. However, Indonesia only began to implement Islamic microfinance after the 1997–1998 Asian financial crisis. There are three types of Islamic MFIs in Indonesia: (i) the Islamic Rural Bank, well known in Indonesia as *Bank Pembiayaan Rakyat Syariah* (BPRS); (ii) *Koperasi Baytul Maal wat Tamwil* (BMTs), savings and credit cooperatives implementing a profit- and loss-sharing approach;

and (iii) Grameen-model Islamic microfinance. These three institutions are contracted to a micro *Takāful* provider (an entity that provides microinsurance in an Islamic context) via an agent known as *Takāful Mikro Indonesia*. (Timberg 1999; Haryadi 2010; Siti Khadijah et al. 2013).

The BPRS, which was established in the early 1990s, is governed by Bank Indonesia under Law No. 10, 1998. It operates under the same effective prudential regulation and supervision as do commercial and conventional rural banks such as BPRs, and focuses on microeconomic activities. While both BPRs and the BPRS were (mostly) established by wealthy local people, BPRs' owners are commercially oriented toward increasing their wealth, while the BPRS's owners have a social mission, combined with an intention to at least cover their costs. Through financing transactions (loans), the BPRS provides funds mainly to microenterprises, through either a purchase system (*murabahah*), profit-and loss-sharing (*musyarakah*), or lease (*ijarah*). The BPRS also runs an Islamic pawnshop (*ar-rahn*) (Haryadi 2010; Siti Khadijah et al. 2013).

There are several other equally important MFIs. The oldest is BKD, which was one of the first MFIs established before the country's independence. It comprises *lumbung desa* (paddy banks) and *bank desa* (village banks), which are MFIs that originated in the Dutch colonial period and still operate in Java and Madura. They have been awarded a BPR license. Another important group of MFIs is the LDKPs, rural credit institutions that the Soeharto government established in the 1980s to consolidate all nonbank MFIs that had been operating throughout the country, especially in Java, since the 1970s. Another MFI group comprises Badan Kredit Kecamatan, Lembaga Perkreditan Kecamatan, Lumbung Piti Nagari, and LPD, which were established in the 1970s and 1980s (Martowijoyo 2007; Baskara 2013).

There are five main types of old and new MFIs in Indonesia: (i) BRI units; (ii) BPRs, consisting of BKDs and non-BKDs ("new" BPRs and old MFIs that have converted to BPR status); (iii) nonbank, non-cooperative MFIs (the LDKPs and subdistrict- and village-level MFIs founded by provincial or district governments); (iv) cooperatives (credit cooperatives and savings and loan units, including credit unions and BMTs); and (v) Grameen Bank replicators (mostly unlicensed) and some nongovernment organizations (NGOs), most of which have a foundation license (Martowijoyo 2007). Currently, the key MFIs in Indonesia are (i) the BRI, which is still considered the leading MFI; (ii) Bank Syariah; (iii) BPRs; (iv) BPDs; and (v) a number of commercial banks. The BRI and BPRs have the lengthiest experience in microfinance, having been established in the early 1970s in all 27 provinces (the BRI itself was established in 1896 from *Algemene Volkerediet Bank*). In addition,

many nonbank organizations, such as cooperatives and local-community initiated NGOs, also provide microfinance.

However, some argue that there are currently too many microfinance banks, nonbank institutions, and microfinance services in Indonesia. It is argued that overlapping regulations, coverage, and responsibilities make it difficult for the government and monetary authority to evaluate and control the development of microfinance in the country. For instance, Baskara (2013) found that in the province of Bali alone many formal MFIs and banks target microenterprises, including LPD; KUD (or village-based cooperatives supported by the government); Koperasi Serba Usaha; Koperasi Simpan Pinjam (similar to credit unions) established by the local community; BPRs; the BRI; and Danamon *Simpan Pinjam* (savings and loan units of Bank Danamon, a private commercial bank). He also found that many MFIs unregistered by the monetary authority operate locally in other provinces besides Bali. These include Badan Usaha Kredit Pedesaa in Daerah Instimewa Yogyakarta, Lembaga Pembiayaan Usaha Kecil in South Kalimantan, Lembaga Kredit Pedesaan in West Nusa Tenggara, and Lembaga Kredit Kecamatan in Daerah Instimewa Aceh. Many of these informal, local MFIs have stopped operating because they were run in unhealthy, non-professional ways.

The Asian Resource Center for Microfinance (ARCM) indicates that there are almost 9,000 public, rural, unlicensed financial institutions that can be categorized as generic BPRs. These include village-owned BKDs in Java and Madura, and the LDKPs, which are owned mainly by provincial governments (or in some cases, by villages) (ARCM 2005).

Within the informal sector, the most popular MFI found throughout the country is the traditional *arisan*, or Indonesian rotating savings and credit associations. The number of *arisan* is estimated to be in the millions. Many people join more than one *arisan* for economic and social purposes, while others manage *arisan* as a side job. In rural areas, traders offer loans against standing crops through the *tebasan* and *ijon* systems, and retail traders of clothes or household utensils provide smaller loans called *mindring*. Farmers also commonly get in-kind loans of rice and farm inputs from traders or shopkeepers at prices higher than cash prices. Commercial moneylenders also still operate in rural areas where they cater to the short-term needs of the poorest, although they are not flourishing as they did in the past. Some moneylenders disguise their activities under the name of “cooperatives” (Martowijoyo 2007).

The current number of MFIs in Indonesia, especially nonbanks, is unfortunately unclear. According to a study by Martowijoyo (2007), as of mid-2005, there were over 54,000 microfinance outlets serving over 29 million borrowers (13% of the population) and more than 43 million depositors (19% of the population). Haryanti (2014) suggested that

there are about 600,000 microfinance bank and nonbank institutions (including local, informal institutions) in all provinces—the OJK is still ascertaining the exact number. Some of these MFIs already have a status as a formal legal entity, such as a limited liability company or cooperative, and a legal operating license as NBFIs. Nonetheless, they are still regarded as semiformal entities. Some of these MFIs have proved effective in providing financial services to unbanked groups, such as the poor, MSEs, women, and other economically active persons who mainly work in the informal sector and lack assets valuable enough to act as collateral, or whose valuable assets are unprotected by legal documents. These MFIs have offered innovative approaches, including using social capital and local wisdom to make social sanctions work effectively and replace the function of physical collateral.

Annual aggregate data on microcredit are also limited. Bank Indonesia does have data on total distributed credits and loans (monthly, quarterly, and annually) by bank group, sector, type of credit, and region; and data on total distributed credit including microcredit. However, it lacks specific data on microcredit. The ARCM, which has information about MFI development in Indonesia on its website, does not have data on total microcredit provided by all banks and formal NBFIs (ARCM 2005).

In his presentation about MFIs in Indonesia, Siregar (2014) only provided aggregate data for 2005 (Table 6.15). According to his data, MFIs in Indonesia are dominated by informal institutions, including 637,838 LDKPs, BKDs, and various microfinance units initiated by local communities such as credit unions, BMTs, and NGOs. Table 6.16

Table 6.15: Total Microfinance Institutions, 2005

Institution	Total Units	Total Depositors and Debtors
BRI unit desa	4,046	30,776,000
BPRs	2,161	5,480,000
Nonbank finance institutions	7,617	2,084,000
Cooperatives	6,495	6,100,000
Arisan	250,000	5,000,000
Others	105,147	22,855,000
Total	375,466	72,295,000

Arisan = Indonesian rotating savings and credit associations, BPR = Bank Perkreditan Rakyat, BRI *unit desa* = village unit of the Indonesian People's Bank (*Bank Rakyat Indonesia*).

Source: Siregar (2014).

Table 6.16: Microfinance by Key Institution in Indonesia

Institution	Number of Units or Offices	Borrowers ('000)	Outstanding Loans (\$ million/ Rp billion)	Depositors ('000)	Deposits (\$ million/ Rp billion)
Commercial banks' microloans (2006)	8,069	14,271.0	\$14,036.0	N/A	N/A
(March 2014)	18,704	N/A	N/A	N/A	Rp1,652,976.0
- BRI units (2002)	3,916	3,000.0	Rp12,000.0	28,200	R 23,460.0
(2005)	4,046	3,211.0	\$2,134.0	31,271	\$3,288.0
(2007)	5,400	N/A	N/A	N/A	N/A
(March 2014)	9,350	9,794.8	Rp27,721.1	N/A	N/A
Rural banks (BPRs):					
(2003)	2,133	1,900.0	Rp7,088.0	5,100	Rp6,629.0
(2005)	4,482	395.0	\$21.0	466	\$51.0
(March 2014)	4,717	N/A	Rp58,977.0	N/A	Rp34,963.0
- BKDs (2002)	5,345	450.0	Rp185.0	540	Rp25,000.0
(2005)	2,062	2,331.0	\$1,380.0	5,864	\$1,223.0
LDKPs (2005)	1,620	1,326.0	\$45.0	N/A	\$42.0
Credit cooperatives (2004)	1,596	885.0	\$116.0	481	\$33.0
- Credit unions (2004)	1,041	N/A	\$958.0	480	\$0.9
S&L units (2004)	36,466	10,524.0	\$1,349.0	5,016	\$145.0
- BMTs (2004)	3,038	1,200.0	\$20.0	N/A	\$26.0
Grameen Bank replicators (2007)	21	20.0	\$0.5	20	\$0.3

BKD = village credit institutions (*Badan Kredit Desa*), BMTs = Koperasi Baytul Maal wat Tamwil, BPR = Bank Perkreditan Rakyat, BRI = Indonesian People's Bank (*Bank Rakyat Indonesia*), LDKP = Lembaga Dana Kredit Perdesaan, N/A = not available, S&L = savings and loan.

Sources: Martowijoyo (2007); OJK (2014).

summarizes data on microfinance by key institutions collected from various sources by Martowijoyo (2007) and data from the OJK (2014).

Alternatively, information on microcredit should be collected from individual microfinance-providing banks (e.g., the BRI and BPRs) and other nonbank organizations. One organization doing so is the MixMarket Organisation, which has a unique database sourced from data submissions from more than 15,000 MFIs during 2004–2014, covering more than 2,100 MFIs in over 110 countries, including Indonesia. Data from selected MFIs in Indonesia are in Table 6.17.³

³ For more data, see <http://www.mixmarket.org/microfinance-data#ixzz34PL8lam6> (accessed 26 January 2017).

Table 6.17: Profiles of Selected Microfinance Institutions in Indonesia from 2011 Onward

Microfinance Institution	Report Year	Loans (\$)	Number of Borrowers	Deposits (\$)	Number of Depositors
Amartha					
Microfinance	2013	205,890	2,612	26,143	2,617
Bina Artha	2012	2,041,313	21,397	N/A	N/A
BMT Sanama	2012	452,733	188	55,748	342
BPR AK	2011	5,739,431	7,841	3,156,576	30,852
BPR DMG	2011	920,710	525	904,781	1,910
BPR Hitamajaya	2011	2,117,364	2,344	1,111,037	7,565
BPR NBP 2	2011	5,119,451	6,302	2,525,500	20,817
BPR NSI	2011	4,587,175	14,523	1,052,444	9,242
BPR Pinang Artha	2012	5,470,846	3,683	5,813,842	33,241
BPR Surya Yudha Kencana	2011	70,274,699	35,530	50,295,139	74,679
BRI	2012	10,897,400,395	N/A	12,918,433,257	N/A
CU Sawiran	2012	5,470,846	3,683	5,813,842	33,241
Dian Mandiri	2013	2,709,156	44,276	819,459	N/A
KOMIDA	2011	5,583,754	68,278	530,937	45,518
Koperasi SK	2012	5,470,846	3,683	5,813,842	33,241
MBK Ventura	2014	54,721,534	369,738	N/A	N/A
Mitra Usaha	2010	489,684	5,277	389,627	4,664
TLM	2013	12,597,849	32,407	13,836,030	N/A
WKP	2011	87,086	684	17,579	N/A
MBK Ventura	2014	54,721,534	369,738	N/A	N/A

Bina Artha = Bina Artha Ventura, BMT Sanama = Koperasi Baytul Maal wat Tamwil Sanama, BPR = Bank Perkreditan Rakyat, BPR AK = Koperasi Bank Perkreditan Rakyat Arta Kencana, BPR Hitamajaya = Bank Perkreditan Rakyat Hitamajaya Agamandiri, BRI = Indonesian People's Bank (*Bank Rakyat Indonesia*), CU Sawiran = Koperasi Kredit Sawiran, Dian Mandiri = Dian Mandiri Foundation, DMG = Dana Multi Guna, KOMIDA = Koperasi Mitra Dhuafa, Koperasi SK = Koperasi Simpan Pinjam Surya Kenchana, MBK Ventura = Mitra Bisnis Keluarga Ventura, Mitra Usaha = Yayasan Mitra Usaha, N/A = not available, NPB = Nusanantara Bona Pasogit, NSI = Nur Semesta Indah, TLM = Tanaoba Lais Manekat, WKP = Wahana Kria Putri.

Source: MixMarket. <http://www.mixmarket.org> (accessed 15 May 2014).

The most important and famous microfinance scheme in Indonesia in the post-Soeharto era is likely KUR, which was launched by President Susilo Bambang Yudhoyono in November 2007. KUR's main aim is to help finance feasible, but non-bankable MSMEs. This is known as credit without collateral, and is a loan for working and investment capital for

individual producers or owners of productive MSMEs and cooperatives with an upper credit limit of Rp500 million. The scheme is 100% financed by national commercial banks (the BRI, Bank Negara Indonesia, Bank Mandiri, Bank Tabungan Negara, Bank Syariah Mandiri, Bank Bukopin, and Bank Negara Indonesia Syariah) (Table 6.18). Since 2012, all BPDs in all Indonesian provinces also play an important role in allocating KUR. NBFIs are not involved in this program.

KUR received by MSMEs is guaranteed (70%) by two insurance companies—Asuransi Kredit Indonesia and Perusahaan Umum Jaminan Kredit Indonesia (Jamkrindo)—and other companies that have joined the program voluntarily. Asuransi Kredit Indonesia provides two types of services: (i) credit guarantees (bank and nonbank credit, counter bank, and regional credit guarantees); and (ii) credit insurance (trade credit insurance, surety bonds, customs bonds, and reinsurance). Jamkrindo's main aim is to provide credit guarantee services, including government programs and commercial credit, to MSMEs. Its various MSME credit guarantee products include guarantees for microcredit; construction, goods, and services procurement loans; commercial credit; counter bank; multipurpose credit; distribution; Islamic financial services (*Kafalah*); and loan program credit (KUR).

Among the eight national banks providing KUR, the BRI, the leading bank, has three main objectives: (i) to give MSMEs and cooperatives better access to financing from banks, (ii) to provide lessons for MSMEs to become bankable debtors that can be served in accordance with banking commercial terms in general, and (iii) to enable financed businesses to continue to grow and develop. The BRI has two types of KUR: (i) micro-KUR for an individual running a feasible, productive microenterprise that has been in operation for at least 6 months; and (ii) retail KUR for an individual (individual person and/or legal entity) or cooperative running a feasible, productive business that has been in operation for at least 6 months. The upper credit limit for micro-KUR is Rp20 million with an effective interest rate of 22% per year, and the upper credit limit for retail KUR is Rp100 with an effective interest rate of 14% per year. Credit types are working capital credit, with a maximum of 3 years (6 years in case of renewal, suppletion, or restructuring) and investment credit with a maximum of 5 years (10 years in case of renewal, suppletion, or restructuring).

Table 6.19 provides data on the realization of KUR allocation by province during the first quarter of 2013, and shows that provinces in Java dominated these shares as of 31 March 2014. Within Java, Central Java, the largest province, had the largest share with almost Rp23.4 trillion, around 15.8% of the total KUR allocated, followed by East Java with almost Rp22.2 trillion (15.1%), and West Java with Rp18.9 trillion

Table 6.18: Realized Kredit Usaha Rakyat by National Banks, 31 March 2014

Bank	Realized KUR			
	Plafond (Rp million)	Outstanding (Rp million)	Total Debtors	Average per Debtor (Rp million)
BNI	14,336,912	3,904,556	205,550	69.7
BRI (Ritel KUR)	18,045,443	7,077,418	103,993	173.5
BRI (Micro-KUR)	75,789,311	20,643,642	9,690,827	7.8
Bank Mandiri	14,945,991	6,525,545	315,432	47.4
BTN	4,368,962	1,918,574	24,238	180.3
Bukopin	1,795,455	605,849	12,011	149.5
Bank Syariah Mandiri	3,658,132	1,387,260	52,019	70.3
BNI Syariah	245,784	109,897	1,256	195.7
Total	133,185,989	42,172,743	10,405,326	12.8

BNI = Bank Negara Indonesia, BTN = Bank Tabungan Nasional, BRI = Indonesian People's Bank (*Bank Rakyat Indonesia*), KUR = Kredit Usaha Rakyat.

Source: Komite Kredit Usaha Rakyat, Ministry for Economic Coordination. <http://komite-kur.com/article-95-sebaran-penyyaluran-kredit-usaha-rakyat-periode-november-2007-maret-2014.asp> (accessed 20 May 2014).

(12.8%). This is not surprising, since the majority of MSMEs, as well as the majority of Indonesia's poor, are found in Java, especially Central Java. Outside Java, the province of South Sulawesi had the largest share, with almost Rp8.2 trillion (almost 5.6%), followed by the province of North Sumatra with almost Rp7.3 trillion (4.9%).

With respect to the allocation of KUR by sector (as the main target of this scheme), trade (which is integrated with upward sectors) has become the dominant sector to access KUR, accounting for 50.8% of the allocation. Agriculture and fishery received 13.7%, and manufacturing 2.6%. Altogether, the amounts of KUR allocated to upward sectors (agriculture, maritime, fishery, forestry, and manufacturing) account for 31.4% of the total allocation (Table 6.20) (Muis and Sipayung 2013).

Besides producers or owners of MSMEs, Indonesian migrant workers are also targeted for KUR, as they are considered an important source of foreign currency for Indonesia. Recent information from the Ministry for Economic Coordination indicates that by March 2014 the credit plafond for 3,649 workers reached Rp46 billion (Komite Kredit Usaha Rakyat, Ministry for Economic Coordination 2014).

The KUR target for 2013 was Rp36 trillion, an increase of Rp6 trillion (20%) from the KUR target for 2012. For 2014, the government has taken

Table 6.19: Realized Kredit Usaha Rakyat by Province, 31 March 2014

No.	Province	Total		
		Plafond (Rp million)	Outstanding (Rp million)	Total Debtors
1	Nanggroe Aceh Darussalam	2,364,496	648,536	168,438
2	North Sumatra	7,264,283	2,594,090	432,277
3	West Sumatra	4,630,976	1,638,272	250,960
4	Riau	4,206,021	1,629,153	175,761
5	Jambi	2,412,055	802,431	142,784
6	South Sumatra	5,146,169	1,932,699	195,461
7	Bengkulu	1,066,015	346,883	79,026
8	Lampung	3,242,068	1,025,554	250,818
9	Kepulauan Riau	928,050	335,189	36,151
10	Bangka Belitung	641,713	269,490	27,710
11	DKI Jakarta	6,914,999	2,192,217	252,798
12	West Java	18,916,168	5,872,558	1,515,755
13	Central Java	23,296,417	6,740,265	2,463,777
14	DI Yogyakarta	2,938,643	978,422	275,517
15	East Java	22,181,907	6,763,259	1,847,612
16	Banten	3,061,934	948,978	169,733
17	Bali	3,256,654	1,079,148	241,233
18	West Nusa Tenggara	1,862,875	598,853	164,062
19	East Nusa Tenggara	1,555,844	490,150	107,329
20	West Kalimantan	3,436,226	1,646,565	121,513
21	Central Kalimantan	2,120,552	856,657	96,693
22	South Kalimantan	3,606,257	1,386,808	194,705
23	East Kalimantan	3,818,287	1,451,491	175,096
24	North Sulawesi	1,483,909	525,647	101,652
25	Central Sulawesi	1,801,367	660,456	135,676
26	South Sulawesi	8,167,028	2,434,586	569,814
27	Southeast Sulawesi	1,244,051	373,469	94,870
28	Gorontalo	744,984	209,116	65,535
29	West Sulawesi	756,396	189,670	53,338
30	Maluku	1,014,177	261,477	53,220
31	North Maluku	636,584	190,592	27,369
32	West Papua	760,537	274,249	26,214
33	Papua	1,734,640	644,805	69,633
Total		147,212,280	47,991,733	10,582,530

DI = Daerah Istimewa, DKI = Daerah Khusus Ibukota.

Source: Komite Kredit Usaha Rakyat, Ministry for Economic Coordination. <http://komite-kur.com/article-95-sebaran-penyaluran-kredit-usaha-rakyat-periode-november-2007-maret-2014.asp> (accessed 20 May 2014).

Table 6.20: Realized Kredit Usaha Rakyat by Sector, 31 March 2014

Sector	Total		
	Plafond (Rp million)	Outstanding (Rp million)	Total Debtors
Agriculture	25,220,484	9,959,299	1,659,144
Fishery	837,614	213,788	11,695
Mining	117,323	50,191	3,729
Manufacturing	4,066,523	1,673,872	216,945
Electricity, gas, and clean water	74,599	32,094	2,400
Construction	2,066,813	580,478	11,390
Trade	82,368,475	27,716,357	6,972,338
Accommodation supply	1,050,399	328,918	41,337
Transportation	2,018,075	957,995	51,466
Financing services	1,032,825	300,719	7,008
Rental	6,768,982	2,869,136	350,437
Government administration	33,741	22,648	1,694
Education services	87,212	28,436	716
Healthcare services	383,267	103,885	3,120
Community services	4,277,720	1,128,842	113,235
Individual services	145,269	53,835	1,232
Other	16,662,958	1,971,239	1,134,644
Total	147,212,280	47,991,733	10,582,530

KUR = Kredit Usaha Rakyat.

Source: Komite Kredit Usaha Rakyat, Ministry for Economic Coordination. <http://komite-kur.com/article-95-sebaran-penyaluran-kredit-usaha-rakyat-periode-november-2007-maret-2014.asp> (accessed 20 May 2014).

steps to increase the absorption rate of KUR, by, for example, expanding the scheme's coverage while maintaining its quality. One indicator adopted by the government to measure the quality of the KUR allocation is the level of so-called nonperforming loans (NPLs); fortunately, this is always low. During the first quarter of 2013, the level of KUR NPLs was 4.4% on average, below the 50.0% maximum limit determined by Bank Indonesia (Muis and Sipayung 2013).

The steps taken by the government aim to (i) improve coordination among key, related ministries and other agencies, including regional governments; (ii) encourage all key stakeholders, especially regional and

local governments, to support and promote local MSMEs more actively to prepare them to act as potential receivers of KUR; (iii) publicize and disseminate information about the scheme more aggressively, including the application procedure and potential benefits; and (iv) facilitate coordination between the implementing banks and KUR companies that provide guarantees.

Many have assessed KUR as a successful microfinance program, especially for MSEs. In October 2012, the International Micro Finance Community awarded President Susilo Bambang Yudhoyono a Letter of Recognition for his successful implementation of KUR in particular, and microfinance in general, in Indonesia. The success of KUR is not unrelated to the internationally recognized success of Indonesia, and the BRI in particular, in implementing microfinance. Indonesia has thus been mentioned as a potential “world laboratory” for microfinance.

Besides KUR, the previous cabinet under Susilo Bambang Yudhoyono also launched three other special credit schemes that provide loans for working and/or investment capital for farmers through farmers’ associations or cooperatives. The first, Kredit Ketahanan Pangan & Energi, aims to secure food and energy, and has an annual interest rate of 5%–7% for a maximum of 5 years. The second scheme, Kredit Pengembangan Energi Nabati & Revitalisasi Perkebunan, aims to support the development of energy based on plantation commodities, and has an annual interest rate of 5%–7% for 13–15 years. The third scheme, Kredit Usaha Pembibitan Sapi, aims to support seed financing for cattle breeding, and has an annual interest rate of 5%–6% for a maximum of 6 years.

Of course, whether a credit or financial inclusion program is considered successful depends on the criteria used to assess it. In the past, the government—as did governments in other countries, and even international bodies such as the Asian Development Bank and the World Bank—used only the total number of recipients and NPLs as their criteria. Thus, a credit program financing a high number of debtors or MSMEs, in combination with low levels of NPLs, is considered successful. However, this is not the right way to assess a credit program’s effectiveness. The main measure of success should be whether a recipient has become better off after using it, since the main aim of a credit program and of financial inclusion in general is not to have the highest possible number of recipients or people with access to banks, but to improve their welfare. Unfortunately, banks involved in KUR or other credit schemes in Indonesia have not evaluated the effectiveness of their schemes in terms of changes in the welfare of their debtors.

6.4.5.2 Challenges in Running Successful Microfinance Schemes

Indonesia has a long history of implementing microfinance schemes starting in the early 1970s, and the country is considered one of the few developing countries that has successfully run sustainable microfinance on a relatively large scale. However, the country still faces many challenges. According to an evaluation made by the ARCM (2005), key challenges include the following:

- (i) Several studies have demonstrated that there is still an unmet demand for microfinance services in Indonesia, as the majority of rural households still lack access to a source of funds from a semiformal or formal institution. The key microfinance providers (i.e., BRI units and BPRs) tend to cover the upper levels of MSMEs in district capitals, subdistrict towns, and economically active regions (e.g., Java and Bali) with loans of more than Rp3 million (\$320); while NGOs, cooperatives, and BKDs reach the lower end of the market (rural microenterprises), but still have a limited outreach in rural areas. The expansion of BRI units seems constrained by their “cash cow” status within the bank. BPRs mostly operate in affluent, urban areas of Java and Bali, and their expansion is limited by the high capital requirements to open new branches or operate outside a specific district.
- (ii) The supply-led, subsidized microcredit programs initiated by the government do not provide a conducive environment in which sustainable microfinance providers can operate.
- (iii) There is a lack of awareness of basic microfinance principles and their applications among government agencies, semiformal organizations, and some commercial banks that have recently entered the microfinance sector. There is still no central microfinance training provider in Indonesia.
- (iv) The provision of technical assistance and capacity building support to microfinance providers has been limited by the country’s diversity and geographical spread.
- (v) Indonesia lacks a formal credit bureau that could be used to lower risks of over-indebtedness in areas of strong competition, such as cities and towns in main districts. Banks involved in microfinance, such as BRI units and BPRs, exchange information relating to their clients on an informal basis.

6.5 Efforts to Achieve Financial Inclusion

6.5.1 Financial Education

The government has recognized that the success of financial inclusion depends on many factors, the most important being the population's level of financial literacy. This factor is crucial due to the low average level of formal education in Indonesia (most people have only a primary education). In turn, financial literacy depends on three factors: financial education, financial information, and the availability of financial tools.

Financial education, which is a continual process, is offered to the public, lower income groups, communities in remote or border areas, and persons engaged in occupations in which they are unlikely to acquire financial knowledge. Bank Indonesia made a blueprint of financial education in 2007 and created the following program timetable: education programs would be offered to the public, including students, children, and youth from 2011; to migrant workers from 2012; to fishermen, communities in border and remote areas, and civil society from 2013; to cooperatives and MSMEs from 2014; and to factory workers from 2015. Financial education is delivered in a way that is easily accepted by these different population groups. Other program activities have included (i) the distribution of leaflets, booklets, brochures, and comics from 2008 onward; (ii) an "education-mobile" in 2008–2010; and (iii) memoranda of understanding with related government agencies, including the Ministry of Education and Culture and the Indonesian Consumer Organization in 2008, and the Ministry of Manpower and Transmigration in 2011. Advertising for the Indonesian savings program, *TabunganKu* ("My Savings"), began in 2009, and it was launched in Jakarta and 41 other big cities in Indonesia in 2010. This built on a national campaign launched in 2008 called "Let's Go to the Bank," which Bank Indonesia conducted in cooperation with all commercial and rural banks, and which targeted local communities (especially workers and students). The campaign aimed to improve consumer understanding of financial services, products, planning, management, and literacy (Hadad 2010; Wibowo 2013).

Brochures of educational material have also been distributed by car to public areas, such as schools, markets, housing complexes, and office buildings in a number of cities, including Jakarta and its surrounding areas, Medan, Bandung, Semarang, Surabaya, Denpasar, and Makassar. So far, 48 kinds of brochures have been distributed on six topics: banking institutions, customer complaints and mediation, savings and investments, loans, banking services, and other information, as well as tips for addressing the global financial situation (Wibowo 2013).

The goals of financial education as formulated by Bank Indonesia are to (i) build bank-mindedness and awareness in society; (ii) build public understanding of banking products and services, and awareness of customer rights and obligations; (iii) build risk awareness in relation to financial transactions; and (iv) disseminate information about the mechanism for resolving problems and complaints with banks (Wibowo 2013).

Given these goals, it may seem that the success of the financial education program could be measured by an increased number of people with accounts in banks; that is, that a positive correlation exists between the financial education program and access to formal financial services. However, people's decisions to open bank accounts or use banks for their businesses or personal transactions are influenced by many other factors, including individual income or employment status, the availability of bank offices, and geographical issues relating to infrastructure and/or transportation. The best way to measure the success of financial education programs in Indonesia is by making field observations and interviewing new bank account holders to ascertain their main reasons for opening a bank account, a kind of assessment never conducted by the OJK or individual banks. The quantitative approach (statistical analysis) does not gauge success or failure sufficiently, and may even be misleading.

6.6 Financial Regulations and Policies

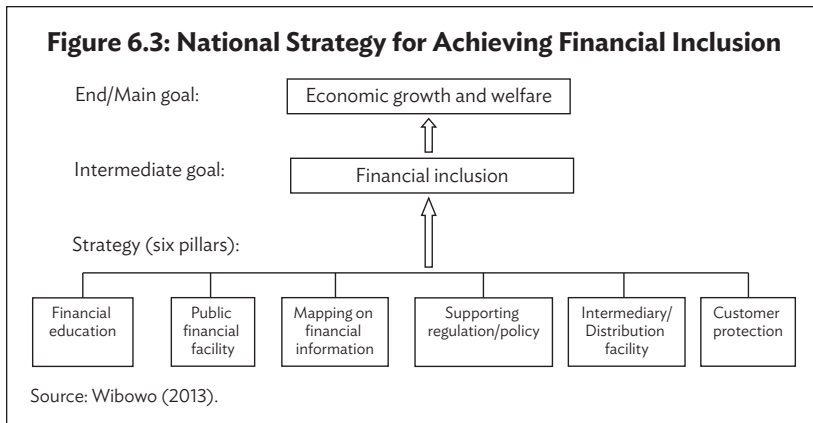
From its experience of development strategy gained during the Soeharto era (1966–1998), the government has realized that financial exclusion significantly impacts the lives of the poor. In the absence of proper storage facilities, such as a savings deposit bank account, whatever small amount of savings the poor are able to amass becomes vulnerable to theft and natural disasters, such as flooding. The cycle of poverty and financial exclusion is vicious and must be broken. To this end, Bank Indonesia and the Ministry of Finance (MOF) have launched the National Strategy for Financial Inclusion.

Bank Indonesia defines financial inclusion as broad or full public access to financial services for all, including the poor. This implies an absence of price and non-price barriers in the use of financial services. Although financial inclusion is usually linked to poverty alleviation, particularly through subsidized credit schemes, it also has strong links to financial stability (Hadad 2010).

The main goal of the Indonesian financial inclusion policy is to achieve high and sustainable economic growth and social welfare through poverty reduction, equitable income distribution, and financial

system stability. This will be achieved by creating a financial system that can be accessed by the entire population. Bank Indonesia believes that inclusive finance is an important prerequisite for reducing poverty and also sustaining the country's economic development and growth, since financial inclusion gives the population better access to financial services and enables them to contribute more to the economy. The national financial inclusion strategy comprises six pillars: (i) financial education, (ii) public financial facility, (iii) the mapping of financial information, (iv) the creation of supporting regulations and policies, (v) an intermediary and/or distribution facility, and (vi) consumer protection (Figure 6.3). The first pillar aims to strengthen financial education, especially for low-income earners in the hope of changing unproductive financial management behavior and encouraging the broader utilization of financial services. The second pillar aims to improve public access to financial services by (i) developing payment system infrastructure, (ii) utilizing information technology, and (iii) encouraging economic innovation networking at the local community level. The third pillar aims to provide better profiling of financial services and information on related services to educate the public and reduce misconceptions. Related services include: the establishment of a credit rating agency for MSMEs, a credit information bureau, a database for unbanked people compiled through a comprehensive, baseline survey; and the development of a Financial Identity Number (FIN) system. The aim of the fourth pillar is to strengthen the regulatory framework, stabilize the financial system, and function as a reference point for other institutions that issue financial policy. This framework will include (i) the regulation of multi-licensing for banks to improve the effectiveness of banking operations, and (ii) the creation of guiding principles on branchless banking to facilitate the implementation of this kind of banking. The fifth pillar aims to provide better intermediary, or distribution, facilities to increase unfinanced or unbanked people's access to formal financial services. This will be done through a number of programs, including (i) the national campaign *TabunganKu*, (ii) the implementation of "start-up" credit, and (iii) the implementation of branchless banking, a system of payment and limited financial services conducted, not through a physical bank branch, but through technology and/or third-party services. It is being developed primarily to serve unbanked people. The sixth pillar aims to provide protection to customers within the banking sector through product transparency, a special unit handling customer complaints, customer mediation, and customer education (Bank Indonesia 2013; Wibowo 2013).

In the past few years, the government has initiated and implemented a number of actions to promote financial inclusion. In June 2007, it



issued two new regulations, the Presidential Instruction No. 6/2007 relating to the real sector, and the MSMEs Development Policy, which both mention the need to strengthen the credit guarantee system for MSMEs. Two further regulations are the Presidential Regulation No. 2/2008 relating to guarantee corporations, and the MOF Regulation No. 222/PMK.010/2008 relating to the credit guarantee and re-guarantee companies. The credit guarantee company's main aim is to help MSMEs that do not have any collateral, do not have enough collateral, or have collateral, but no formal license (for instance, a land certificate).

The Financial Identity Project is a new, ongoing, innovative project carried out by Bank Indonesia to build a more systematic pathway to greater financial inclusion in Indonesia. Bank Indonesia intends to bring as many as 40 million people into the banking system. It is developing a mechanism to introduce a unique FIN for each person as a more effective, efficient, easy way of accessing financial services, especially for those who currently lack any access to banking services (the unbanked), such as MSMEs and productive poor households. The FIN will allow banks and financial service providers to access each person's financial history; it contains basic data and the financial profile of FIN cardholders based on Kartu Tanda Penduduk Elektronik (e-KTP) data. Using a single identity that also includes a financial profile will reduce repetitive administrative processes for different service requests, and will help members of the public be approved for loans (up to a specific value) much more quickly (Alliance for Financial Inclusion 2014).

The rationale for this FIN program came from a 2009 Bank Indonesia survey, which found that 43 million Indonesians did not use banks. In 2012, Bank Indonesia appointed two companies, Arah Cipta Guna and

DEFINIT, to build and implement a pilot FIN program expected to lead to large-scale implementation. The consulting work also included a survey, “Financial Identification Number Year 2012,” which began in August 2012 in six provinces (Banten, Central Java, East Java, Jakarta, West Java, and Yogyakarta). The survey aimed to collect data and assess the number of individuals and households with potential access to the banking sector. It described the respondents’ financial situations and activities. The collected data could be used to improve access to the banking sector for all (Kencana and Bisara 2010).

MFIs in Indonesia have largely operated without a comprehensive regulatory framework to guide their operations, and with little supervision from Bank Indonesia. Many operate in a distinctive way, different from both banks and savings and loan cooperatives. Many semiformal and/or informal institutions—such as LDKPs, LPDs, microfinance cooperatives, credit unions, and NGOs—fall outside the legal framework of banks, and lack a clear legal status in the financial system. This represents a potential risk for small depositors in some cases. In addition, although many government development programs from various ministries include a microfinance component, these are often managed without consideration of microfinance best practices and without coordinating with Bank Indonesia. This creates an unsustainable source of cheap funds and unfair competition for commercial microfinance providers. To regulate the financial sector, including the operation of all microfinance institutions in the country, an autonomous agency, the OJK, was established in 2011 (under Act No. 21 of 2011).

To strengthen the OJK’s role, the government issued the Microfinance Institutions Law No. 1 of 2013, on 8 January 2013. As the law did not come into effect until 2015, MFIs had 2 years to adjust to the new requirements. The law governs all aspects of MFIs operating in Indonesia, from their establishment to their areas of operation and permitted activities. The law is seen as a tool to give these institutions the support they need to provide financial and other types of support to small entrepreneurs. The law gives the OJK extensive powers to develop, regulate, and supervise MFIs. The OJK is authorized to approve the restructuring of MFIs through mergers or consolidation, as well as the liquidation of MFIs.

Under the law, several requirements must be fulfilled before an MFI can be established. It must (i) have legal status as either a cooperative or limited liability company, (ii) meet the capital requirements, and (iii) obtain a business license from the OJK. Foreign nationals, any entity owned by foreign nationals, and foreign-owned enterprises are prohibited from owning an MFI (Eddymurthy and Kolopaking 2013).

The OJK also initiated a similar program to increase public knowledge about financial literacy called the National Financial Literacy Strategy. This program has three aims: to boost financial literacy education through public campaigns, strengthen financial infrastructure, and develop accessible and affordable financial services products (Qorib and Sidauruk 2013).

6.7 Conclusions and Policy Recommendations

Following the 1997–1998 Asian financial crisis, Indonesia adopted a financial inclusion strategy as part of its inclusive national development policy to boost economic growth and public welfare. One way to achieve financial inclusion is through the ongoing process of financial education, which can change the behavior and culture of society and increase familiarization with the financial world. To guarantee the continuity and effectiveness of the education program and optimize its results, it should include the following measures.

- (i) Good coordination and collaboration must be established between stakeholders and other related parties (including those involved in education, especially primary through high school). A strong commitment among the parties is essential for success. Stakeholders with a crucial role to play include not only Bank Indonesia, the OJK, banks, NBFIs, and the Ministry of Education, but also the private sector, especially chambers of commerce, business associations, and other NGOs.
- (ii) Financial institutions must include financial education programs as an integral part of their businesses.
- (iii) The concerned parties must commit to improving continuously the efficiency of the program implementation (cost reduction).
- (iv) The program implementation should be accompanied by a dynamic, continuous campaign to encourage saving, especially targeting young people and children, to impart an understanding of good financial management to the younger generation.
- (v) The program implementation should be supported by formal financial services located in the area or by agents of the financial institutions based in the area.
- (vi) Monitoring and evaluation mechanisms should be adequate, and quantitative indicators created for them.

Several issues should be considered to ensure the effectiveness, efficiency, sustainability, and healthy development of microfinance in Indonesia. First, due to a lack of awareness of sound microfinance principles within the implementing organizations in Indonesia, there is a need for centralized training centers throughout the country, where all those involved in microfinance can receive additional training and support. Second, as most of the relatively successful microfinance programs are in Java and Sumatra, and most MFIs and related programs in Indonesia are in urban areas, coverage should be expanded to other parts of the country, especially rural communities and those in less-developed, isolated, or border regions like Papua and Kalimantan. To this end, three actions should be taken:

- (i) Financial inclusion should focus on (a) regulations, to ensure that banks maintain sound risk management without pursuing non-competitive and non-inclusive business practices; and (b) the composition of lending to increase the share of the poor or MSMEs in total credit, not only at the national level but also, and more importantly, at the provincial or district level, by increasing the aggregate level of financial intermediation. Artificially providing and administratively allocating more credit should be avoided.
- (ii) Local organizations, both formal and informal, with sufficient potential—based (a) on their current activities; (b) human resources capacity, especially with reference to financial management; (c) past experience with microfinance; and (d) business relationships with banks as microfinance providers—should be prioritized for selection and promotion as local microfinance providers. Such organizations can include local cooperatives, post offices, pawnshops, retail outlets, businesses and MSMEs, associations, foundations, NGOs, and even *arisan*. The introduction or implementation of mobile banking should also be considered a distribution channel.
- (iii) Existing local MFIs, including informal MFIs, must become more efficient and competitive. This would help them bring down interest rates on loans and capitalize on this exceptional opportunity to tap a large base of potential depositors profitably. For this, Bank Indonesia, local BRI units, chambers of commerce, and universities should provide technical assistance and capacity-building support.

Third, to support sustainable, successful microfinance programs in Indonesia, the following three steps should be taken:

- (i) All implementing institutions must operate efficiently and be independent from continued financial support from the government. To increase their overall efficiency, implementing institutions must take the following steps. First, they should adopt standards, principles, and guidelines that ensure the prudent operation of the financial institution or bank in a way that is in line with international best practices. This includes adopting standards relating to credit administration, fund management, internal control systems, and staff development. Partnerships between Indonesia's microfinance providers and external actors, particularly bilaterals and international NGOs, can serve as conduits of both international best practices and finance. Second, to expand outreach and ensure sustainability, the government should shift resources from subsidized program credits to building the capacity of existing MFIs, especially with regard to management and staff skills. Third, policies should be implemented to create competition in MFI activities, both between different MFIs for the same borrowers (i.e., horizontal competition) and between the same type of MFIs (i.e., vertical competition). This will give clients a wider range of products.
- (ii) The monetary authority or government should have full control of the growing number of MFIs and their ways of operating. This is particularly important for nonbank institutions.
- (iii) Due to a surfeit of microfinance services providers with overlapping targets, coverage, and regulations, microfinance services should be reorganized at both the national and regional levels.
- (iv) The government must provide a conducive environment, supported by law, to ensure the security of the MFIs and instill confidence in them.
- (v) Bank Indonesia should establish its planned credit information bureau as soon as possible, with offices in all cities and towns in the main districts. This could prevent over-indebtedness in areas where there is strong competition among MFIs.

The overall success of financial inclusion programs or policies depends not only on the quality of the policies themselves, but also on at least two other factors, which should be considered preconditions

of success. These are (i) better income or employment opportunities for groups targeted for financial education to enable them to save their money or open a bank account; and (ii) easy access to financial tools, institutions, and supporting infrastructure for all Indonesians, even those in remote or less developed areas.

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7

The Philippines

Gilberto M. Llanto

7.1 Introduction

Establishing “financially inclusive ecosystems” (Ehrbeck, Pickens, and Tarazi 2012) wherein financial markets provide more people, especially low-income clients, with a broad array of financial products and services at lower costs has become a rising global concern. The Consultative Group to Assist the Poor (CGAP) and the World Bank estimate that around 2.7 billion adults worldwide lack access to credit, insurance, or savings with a bank or other formal institution (Ehrbeck, Pickens, and Tarazi 2012). CGAP (2011) has stressed the importance of this access, and has argued that financial inclusion empowers the poor to manage their finances and reduce their vulnerability to financial distress, debt, and poverty. The Government of the Philippines has identified financial inclusion as an important strategy to achieve inclusive growth (Philippine Development Plan 2011–2016).

Some key issues to be addressed are the reasons why formal financial systems are not inclusive, and how they can be made so for the poor. To address these issues, policymakers and financial institutions are trying to foster comprehensive approaches that can overcome the two broad types of barriers to financial inclusion reported in the literature: supply- and demand-side barriers. Supply-side barriers comprise high transaction costs, information asymmetry, and poor regulatory frameworks that hinder the quantity and quality of financial products and services accessible by the poor. Demand-side barriers include a range of factors that have effectively excluded individuals, especially the poor, from accessing financial services: socioeconomic and cultural elements, challenges posed by the lack of formal identification systems, low levels of financial literacy, and the absence of appropriate consumer protection mechanisms (Alliance for Financial Inclusion 2010). Other factors excluding the poor from financial services are a lack of awareness

of available services, the unsuitability of certain services to the needs of low-income sectors, and the risks of dealing with poor customers (Economic and Social Commission for Asia and the Pacific [ESCAP] 2014).

This chapter discusses the current status of financial inclusion, education, and regulation in the Philippines and proposes some measures to foster financial inclusion. Financial inclusion is a major policy issue highlighting (i) financial literacy, especially financial education for the poor; and (ii) financial regulation to ensure stability amid the growing number of financial innovations designed to reach the poor.

The *Bangko Sentral ng Pilipinas* (BSP 2013: 1) defines financial inclusion as “a state wherein there is effective access to a wide range of financial services for all Filipinos.” This chapter follows this definition. “Effective access” means that financial services are appropriately designed, of good quality, relevant for actual use, and beneficial to the target market. Financial services cover a wide range of products and services such as savings, credit, payments or remittances, and insurance for different market segments, especially the unbanked. This definition conforms with that provided by CGAP and the Global Partnership for Financial Inclusion (2011: 1), which describes financial inclusion as a “state in which all working age adults have effective access to credit, savings payments, and insurance from formal service providers.”

7.2 Financial Inclusion

7.2.1 Brief Profile of the Philippine Financial System

In 2014, the Philippine banking system remained strong and stable despite external challenges, especially in international capital markets, with continuing growth in resources, deposit liabilities, and loans. The total resources of the entire banking system increased by 11.8% from P10.3 trillion (\$233.2 billion) in 2013, to more than P11.0 trillion (\$260.6 billion) in 2014. This can be attributed to growth in loans, financial assets, and equity investments. Total deposits rose to P8.52 trillion (\$192.7 billion) in the same period, a 12% year-on-year increase from the end of December 2013. The number of banking institution head offices decreased from 673 in 2013 to 648 as of the end of December 2014, signifying bank consolidation and the closure of weaker banks. Asset quality indicators also improved with the decline of the banking system’s gross nonperforming loan ratio from 2.8% at

the end of December 2013 to 2.3% at the end of December 2014. Net nonperforming loans were reduced. Capital adequacy ratios (CARs) remained above the international standards imposed under the Basel III framework, which became effective on 1 January 2014. At the end of December 2014, the average CAR of universal and commercial banks was 15.2%, while the overall CAR ratio for all types of banks was 15.6% (Table 7.1).

Table 7.1: Resources, Deposits, and Loans Outstanding, All Banks, December 2014

	All	Universal Commercial Banks	Thrift Banks	Rural/ Cooperative Banks
Number of Banks				
Total number of banks	10,361	5,833	1,920	2,608
Head offices	648	36	69	543
Other offices	9,713	5,797	1,851	2,065
Resources (P billion)	11,546.2	10,398.4	916.2	231.6
Deposit Liabilities (P billion)	8,524.6	7,680.6	699.9	144.1
Loans Outstanding ^a (P billion)	5,832.4	4,704.7	576.1	138.4
GNPLs to Total Loans (%)	2.3	1.8	4.4	11.9
NNPLs to Total Loans (%)	0.60	0.30	1.95	5.90
Capital Adequacy Ratio— Solo (%)	15.6	15.2	16.4	18.2

GNPL = gross nonperforming loan, NNPL = net nonperforming loan.

^a Total loans outstanding (inclusive of memorandum items for production and household consumption).

Source: Bangko Sentral ng Pilipinas (accessed 3 January 2017).

a) Number of banks, December 2014: <http://www.bsp.gov.ph/statistics/statpnnopbs.asp>

b) Resources: http://www.bsp.gov.ph/statistics/spei_pub/Table%2022.pdf

c) Deposit liabilities

For all banks: <http://www.bsp.gov.ph/statistics/statbskrpbs.asp>

For universal and commercial banks: <http://www.bsp.gov.ph/statistics/statbskrukbs.asp>

For thrift banks: <http://www.bsp.gov.ph/statistics/statbskrtpb.asp>

d) For rural and/or cooperative banks: <http://www.bsp.gov.ph/statistics/statbskrccb.asp>

For all banks: <http://www.bsp.gov.ph/statistics/statlophcpbs.asp>

For universal and commercial banks: <http://www.bsp.gov.ph/statistics/statlophcukb.asp>

For thrift banks: <http://www.bsp.gov.ph/statistics/statlophctb.asp>

For rural and/or cooperative banks: <http://www.bsp.gov.ph/statistics/statlophcrccb.asp>

e) GNPLs and NNPLs to total loans and capital adequacy ratios

For all banks: <http://www.bsp.gov.ph/statistics/stataqapbs.asp>

For universal and commercial banks: <http://www.bsp.gov.ph/statistics/stataqapbs.asp>

For thrift banks: <http://www.bsp.gov.ph/statistics/stataqatb.asp>

For rural and/or cooperative banks: <http://www.bsp.gov.ph/statistics/stataqarcb.asp>

7.2.1 State of Financial Inclusion

To contextualize this discussion of financial inclusion, Tables 7.2, 7.3, and 7.4 compare the Philippines with other countries in the Association of Southeast Asian Nations (ASEAN) using data from the 2011 Global Findex Report. The Global Findex website provides information on savings and loan accounts at formal financial institutions by gender, income, age group, education, and place of residence (urban or rural). The tables indicate relatively low access to and usage of financial services in the Philippines compared to Malaysia, Singapore, and Thailand, the three high–middle-income countries in the ASEAN region. Singapore has the most financially inclusive system, while levels of access to financial access in Cambodia, Indonesia, the Lao People’s Democratic Republic, the Philippines, and Viet Nam are lower than those in other countries in East Asia, the Pacific, and the world. These tables reveal the challenges that the Philippines faces in working to achieve greater financial inclusiveness.

Table 7.2: Persons with an Account at a Formal Financial Institution, by Classification, 2011
(% aged 15+)

	Gender		Income		Age Group		Education		Classification	
	Male	Female	Bottom 40%	Top 60%	Older adults	Young adults	Primary education or less	Secondary education or more	Rural	Urban
Cambodia	3.6	3.7	1.7	5.4	3.3	4.5	2.2	15.5	2.4	10.2
Indonesia	20.0	19.2	10.3	26.4	21.6	12.8	10.2	29.4	16.2	28.9
Lao PDR	27.4	26.2	20.1	31.7	28.5	23.0	22.0	34.7	20.2	32.0
Malaysia	69.2	63.1	50.1	76.9	70.5	57.1	39.7	74.1	51.8	77.6
Philippines	19.0	33.7	10.4	39.6	29.7	18.3	12.3	33.1	19.5	37.1
Singapore	98.2	98.2	97.4	98.8	99.0	94.7	94.4	99.9	NA	98.2
Thailand	72.7	72.6	61.3	79.3	75.4	59.3	63.8	91.1	70.0	81.7
Viet Nam	24.0	18.9	10.6	30.1	21.1	22.6	4.5	32.3	16.5	29.8
East Asia and the Pacific	57.8	52.1	39.3	65.9	55.9	49.9	49.7	65.0	50.1	68.7
World	54.5	46.6	40.7	58.5	54.8	36.8	36.9	66.0	44.1	59.6

Lao PDR = Lao People’s Democratic Republic, NA = not available.

Source: Global Financial Inclusion Database. <http://databank.worldbank.org/data/reports.aspx?source=1228> (accessed 27 April 2015).

Table 7.3: Persons with Savings at a Formal Financial Institution, by Classification, 2011
(% aged 15+)

	Gender		Income		Age Group		Education		Classification	
	Male	Female	Bottom 40%	Top 60%	Older adults	Young adults	Primary education or less	Secondary education or more	Rural	Urban
Cambodia	1.5	0.2	0.2	1.4	0.8	0.9	0.6	2.8	0.7	1.1
Indonesia	14.7	15.9	7.8	20.8	17.0	9.5	7.3	23.6	12.5	22.9
Lao PDR	19.8	19.0	12.9	24.1	19.6	18.7	16.2	24.6	15.7	22.3
Malaysia	40.6	30.2	22.3	44.1	39.1	26.6	19.8	39.6	29.7	40.0
Philippines	11.2	18.0	3.0	24.1	15.6	12.4	4.5	19.4	9.7	22.3
Singapore	58.1	58.7	51.9	63.1	60.2	49.9	41.6	65.8	NA	58.4
Thailand	42.8	42.8	36.4	46.5	46.4	25.4	37.1	54.7	43.2	41.5
Viet Nam	8.9	6.7	3.8	10.9	9.6	2.7	1.4	12.0	5.7	11.2
East Asia and the Pacific	28.4	28.5	16.1	37.1	30.5	19.7	23.9	37.4	24.3	40.2
World	23.9	21.0	15.3	28.3	24.8	15.0	14.5	31.6	18.9	27.3

Lao PDR = Lao People's Democratic Republic, NA = not available.

Source: Global Financial Inclusion Database. <http://databank.worldbank.org/data/reports.aspx?source=1228> (accessed 27 April 2015).

Table 7.4: Persons with Loans from a Formal Financial Institution, by Classification
(% aged 15+)

	Gender		Income		Age Group		Education		Classification	
	Male	Female	Bottom 40%	Top 60%	Older adults	Young adults	Primary education or less	Secondary education or more	Rural	Urban
Cambodia	18.7	20.1	18.4	20.4	23.6	9.5	21.2	5.7	20.6	13.4
Indonesia	9.0	8.2	6.4	10.1	10.2	3.7	7.3	10.0	8.7	8.0
Lao PDR	19.1	17.2	17.6	18.5	20.0	13.9	18.0	18.4	19.5	17.0
Malaysia	12.1	10.3	1.8	17.4	12.8	7.6	4.2	13.1	5.5	15.7
Philippines	8.1	12.8	5.1	14.9	13.3	3.0	9.0	11.2	9.8	11.6
Singapore	13.8	6.3	6.1	12.8	10.5	7.4	3.2	13.0	NA	10.0
Thailand	21.1	17.9	26.9	15.0	22.1	6.3	22.3	13.4	22.6	8.4
Viet Nam	17.2	15.2	15.4	16.8	18.4	9.8	18.7	15.2	20.7	8.3
East Asia and the Pacific	9.4	7.8	8.5	8.7	9.5	4.3	8.2	9.4	8.5	8.8
World	10.0	8.1	8.3	9.7	10.4	4.4	7.3	11.1	8.9	9.2

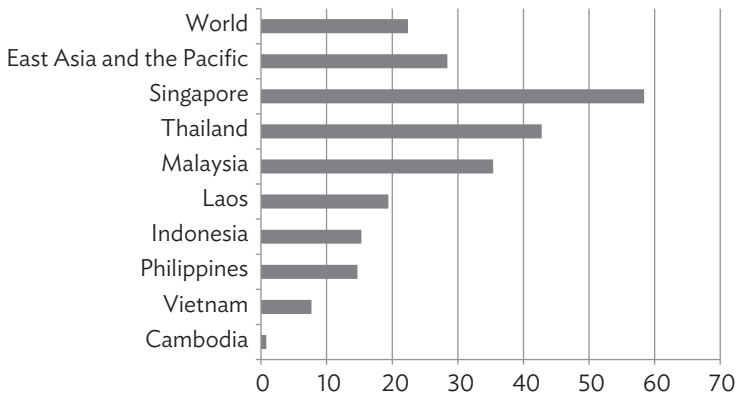
Lao PDR = Lao People's Democratic Republic, NA = not available.

Source: Global Financial Inclusion Database. <http://databank.worldbank.org/data/reports.aspx?source=1228> (accessed 27 April 2015).

The BSP's 2009 Consumer Finance Survey reported that 8 in 10 Filipino households lacked a deposit account, and 93% of those with no deposit accounts lacked enough money for bank deposits (BSP 2012). Table 7.3 and Figure 7.1, which use Global Findex data on the share of savers aged 15 and older in the ASEAN region, show that Indonesia and the Philippines have fewer such savers than the Lao People's Democratic Republic. The Global Findex data provide an overview of persons with savings in 2011. Data from the International Monetary Fund's Financial Access Survey for 2004–2013 show that the proportion of deposit accounts per 1,000 adults has been rising since 2009 (Figure 7.2). These different data sources show the status of savings from different perspectives. The data reported by the International Monetary Fund refer to the number of deposit accounts per 1,000 adults, Global Findex reports the percentage of savers aged 15 and older, and the BSP Consumer Finance Survey reports the number of households without deposit accounts. Nevertheless, the data all show that a large proportion of the population has relatively low access to deposit services.

Overall, access to loans from formal institutions is low (Table 7.4). This is substantiated by the World Bank, which reports that only 10.5% of adults in the Philippines had a loan from a formal financial institution in 2010 (BSP 2012).

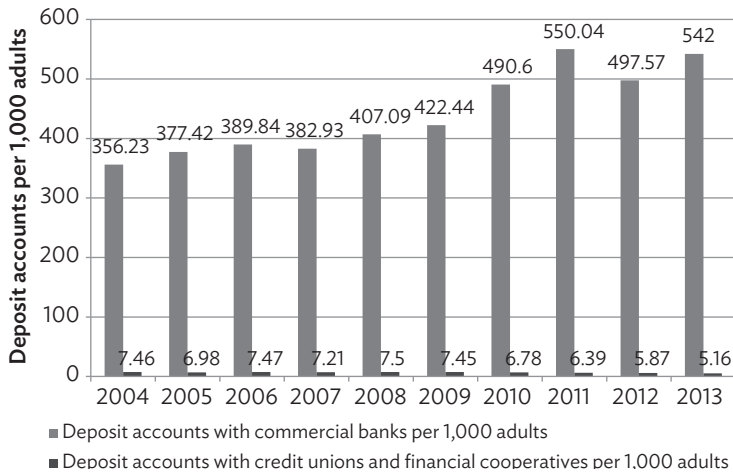
Figure 7.1: Persons with Savings at a Formal Financial Institution
(% aged 15+)



Lao PDR = Lao People's Democratic Republic.

Source: Global Financial Inclusion Database. <http://databank.worldbank.org/data/reports.aspx?source=1228> (accessed 27 April 2015).

Figure 7.2: Deposit Accounts per 1,000 Adults in the Philippines, 2004–2013



Source: International Monetary Fund (2004–2013).

Microentrepreneurs and small enterprises also suffer from limited access to a range of financial services, despite the mandatory credit allocation imposed by law. The Magna Carta for Micro, Small, and Medium Enterprises, a law passed by the Philippine Congress, mandated that from June 2008 to June 2018, banks must allocate at least 8% of their loan portfolio for micro and small enterprises, and at least 2% for medium-sized enterprises. Table 7.5 shows the compliance rate of Philippine banks to the Magna Carta.

Only rural banks consistently complied with the required 8% credit allocation from 2008 to 2014; the compliance of the universal and commercial banks fell below the required rate and declined over the period. Thrift banks' compliance also declined, and they failed to meet the mandatory allocation in 2014. From 2008 to 2012, the total loan portfolio of all banks increased by a compound average growth rate of 16.07%, but lending to micro and small enterprises only grew by a compound average growth rate of 3.05%.

In sum, in terms of usage of financial services, a relatively small segment of the population has deposit and loan accounts. While the rise in the number of savings and loan accounts provides some indication of the growth of financial inclusion, this cannot be interpreted simply as the improved accessibility of loans and deposit services. An individual

Table 7.5: Compliance with Mandatory 8% Credit Allocation to Micro and Small Enterprises (%)

Bank Type	2008	2009	2010	2011	2012	2013	2014
All	10.00	9.70	8.46	7.56	6.39	5.59	4.90
Universal and commercial banks	7.10	7.12	6.76	5.78	5.29	4.58	3.95
Thrift banks	16.35	16.12	14.02	16.23	11.26	9.80	7.36
Rural banks	51.82	41.14	34.07	29.58	22.27	26.04	24.81

Source: Bangko Sentral ng Pilipinas, Banking Statistics—Micro, Small, and Medium Enterprises—Philippine Banking System. <http://www.bsp.gov.ph/statistics/statmsmepbs.asp> (accessed 20 April 2015).

may have more than one deposit or loan account depending on his/her needs, type of business activity, or profession, among other reasons. It is necessary to implement the planned baseline survey mentioned by the BSP to ascertain exactly how many individuals have deposit and loan accounts.¹ The next best sources of information on financial inclusion are reports from microfinance institutions (MFIs) and microinsurance providers. Unfortunately, these reports are also based on the number of accounts. Nonetheless, as these institutions cater to low-income sectors, the data that they report reflect to a certain extent the progress made in expanding financial inclusion.

7.2.3 Microfinance

In the Philippines, ongoing financial inclusion of previously excluded persons stems mainly from the efforts of MFIs, especially rural banks with microfinance operations.² Microfinance loans rose continuously from P2.6 billion (\$85.79 million) in 2002 to P8.7 billion (\$196.73 million) in 2013, equivalent to an 11.6% compound annual growth rate. The number of deposit accounts increased from 34.52 million in 2009 to

¹ From an interview with Pia Roman, Inclusive Finance Advocacy staff, BSP.

² Other MFIs are credit cooperatives and other types of institutions. As no reliable data on the performance of credit cooperatives are available, their contribution to financial inclusion is not mentioned in this chapter. The supervision and regulation of credit cooperatives is weak and inconsistent; for example, there is no updated registry of functioning cooperatives or data on their financial status and performance. The Cooperative Development Authority is the government regulatory institution for cooperatives.

43.35 million in 2013, equivalent to an average annual growth rate of 7.1% (except in 2012 when it suffered a 4.3% year-on-year decline, mainly due to a decrease in the number of deposit accounts in the National Capital Region). In 2013, small savers (including those using non-stock savings and loan associations) managed to increase their savings deposits. The use of basic financial services (loans and deposits) has also expanded.

However, as banks are mostly found in high-income and urban areas, the distribution of financial services access points is unequal. The BSP notes that 43% of all deposit accounts and 67% of the total amount of deposits are in the National Capital Region. Many areas in the country remain underserved or even unserved, posing great challenges to financial inclusion. The geography of the country, an archipelago of more than 7,000 islands, is a formidable barrier to the accessibility of financial services delivered through traditional “brick and mortar” branch banking. Fortunately, modern technologies such as e-money and mobile banking can help overcome these physical barriers. E-money accounts and transactions have grown significantly in the past few years. There are now 26.7 million e-money accounts and 10,620 active e-money agents performing cash-in/cash-out transactions throughout the country (Table 7.6).

Table 7.6: Electronic Money Indicators

	2010	2013	Growth Rate (%)
E-Money Accounts (million)	19.9	26.7	34
Number of E-Money Transactions (million)	138	217	57
Value of E-Money Transactions (P billion)	220.5	348.0	58

Source: Bangko Sentral ng Pilipinas (2014).

The number of registered e-money accounts increased 34% from 19.9 million in 2010 to 26.7 million in 2013 (BSP 2015). E-money accounts in 2013 comprised 8 million mobile wallets and 18.7 million cash cards. The number of e-money transactions has also grown significantly from 138 million in 2010 to 217 million in 2013, a 57% increase; and the total value of e-money transactions rose 58% from P220.5 billion (\$4.99 billion) in 2010 to P348.0 billion (\$7.90 billion) in 2013 (BSP 2014). Available data also show that a large proportion of the population has used domestic payment services. A 2010 Bankable Frontier Associates study reported by the BSP revealed that 55% of Filipino adults have used

money transfer, loan, and bill payment services. The total size of the domestic payments market is estimated at \$3.2 billion per month and comprises an estimated 41 million users (BSP 2012). This includes the remittances made by overseas Filipino workers to their families.

The use of mobile banking to expand financial inclusion has great potential, as three out of four Filipinos are unbanked, 50% of active mobile money users are unbanked, and the low-income group uses mobile money to send and receive remittances (Demirgüç-Kunt, Beck, and Honohan 2008). Mobile banking demonstrates the advantages of using technology not constrained by poor physical infrastructure (roads and seaports) and high transaction costs in hard-to-penetrate areas. The government, especially regulators, should pay more attention to issues of connectivity, reliability, and affordability of telecommunications services, especially in areas outside the major urban centers.

7.2.4 Microinsurance

Another important area of financial inclusion is microinsurance given to low-income clients. Churchill (2006) defined microinsurance as insurance that (i) operates by pooling risk, ii) is financed through regular premiums, and (iii) is tailored to the poor who would otherwise be unable to take out insurance. Microinsurance is generally intended for those excluded from traditional commercial insurance schemes because they come from the informal sector, have irregular cash flows, or have an earning capacity that fluctuates seasonally (Churchill 2006; Llanto 2007). The Regulatory Framework for Micro-Insurance developed by the government defines microinsurance as the “activity of providing specific insurance, insurance-like and other similar products and services that meet the needs of the low-income sector for risk protection and relief against distress, misfortune or other contingent events” (Government of the Philippines, Department of Finance [DOF] 2012).³ A recent development in the Philippines is the provision of microinsurance and similar products by regular insurance companies and mutual benefit associations (MBAs) to help low-income clients deal with vulnerability risks and catastrophic events.⁴ This, together with the

³ The amount of premiums, fees, or charges computed on a daily basis does not exceed 5% of the current daily minimum wage rate for non-agricultural workers in Metro Manila, and the maximum sum of guaranteed benefits is not more than 500 times the daily minimum wage rate for non-agricultural workers in Metro Manila.

⁴ CGAP (2012) explained: “Emergencies, such as a sickness in the family, and large outlays, such as school fees, may come during lean times. Even in the best of times, poor people have less of a cushion to weather shocks.” Data on microinsurance are also limited because of inefficient data collection by concerned government agencies.

growth of microfinance, has enabled a large segment of the excluded population to access basic financial services.

Providing poor households or low-income clients with microinsurance is an important component of financial inclusion strategies. Research on microinsurance is still at an “embryonic stage,” and there remain many questions to be asked and options to be tried before solutions as to how to protect significant numbers of the world’s poor against risk can emerge (Salazar-Xirinachs 2008). However, the case for microinsurance is well stated in the literature. In reviewing the literature, Dercon and Kirchberger (2008) pointed to a body of research work (Morduch 1990; Rosenzweig and Binswanger 1993; Dercon 1996, 2004; Elbers, Gunning, and Kinsey 2007; Pan 2008) examining reasons for taking out microinsurance and the welfare gains arising from this type of social protection scheme. Poor households could be vulnerable to catastrophic shocks when risks are left uninsured. Faced with such risks, poor households may undertake costly strategies to manage their incomes and assets, such as selling earning assets, incurring costly debt, or dissaving. Significant welfare losses and forgone earning opportunities resulting from this situation could drive households to penury.

Table 7.7 lists a few instruments used by low-income households in the Philippines to cope with the negative outcomes of risk events. In the case of low-income clients, formal microinsurance can provide greater and more certain benefits than can the informal “protection” schemes devised in the informal economy, which provide inadequate cover from external shocks. Box 7.1 summarizes information on microinsurance and other activities showing the current situation and the progress made so far in extending risk protection, especially to low-income clients.

Table 7.7: Coping Instruments of Low-Income Filipino Households

Coping Mechanism	Description
Informal, on-the-spot action	Support from relatives, loans from moneylenders, sale of assets (e.g., livestock and farm animals)
Local informal “social protection” schemes	Support from rotating savings and credit associations, and other informal schemes
Institutional insurance schemes	Social security system, government service insurance system, commercial insurers (if the households can access them)
Microinsurance schemes	Schemes developed by MFIs, mutual benefit associations, cooperatives

MFIs = microfinance institution.

Source: Adapted from Llanto (2007).

Box 7.1: Microinsurance (Progress So Far)

BSP (2014) Report

In 2013, 81 banks received a “no objection” notice from the BSP to offer microinsurance, while 40 banks had already obtained the authority to market, sell, and service microinsurance products.^a

- Data from the Rural Bankers Association of the Philippines showed that the total number of clients microinsured by rural banks rose 153% from around 543,500 in 2012 to 1.4 million in 2013.^b
- According to the Insurance Commission, microinsurance coverage among Filipinos rose from 3.10 million (3.4% of the population) in 2008 to 19.95 million (20.4% of the population) in 2013. This makes the Philippines one of the top microinsurance markets in Asia. Strong collaboration between insurance providers and the regulator has contributed significantly to the rapid growth of microinsurance in the country.

Department of Finance—National Credit Council (2012)

Before 2008	July 2012
▶ Microinsurance products mostly credit life, except for MBA microinsurance products	▶ 80 microinsurance products approved (54 life and 26 non-life)
▶ Six licensed MBAs selling microinsurance products	▶ 27 licensed MBAs selling microinsurance
▶ Few commercial insurance companies with microinsurance products	▶ 28 insurance companies (16 life and 12 non-life) selling microinsurance products
▶ No microinsurance agent category	▶ 116 licensed microinsurance agents (26 rural banks and 90 individuals)
▶ 3.1 million individuals covered by microinsurance MBAs	▶ About 7.8 million individuals, including dependents, covered under microinsurance

BSP = Bangko Sentral ng Pilipinas, MBA = mutual benefit association.

^a Banks wanting to become insurance agents must obtain a “no objection” notice from the BSP and approved authority to cross-sell microinsurance from the Insurance Commission.

^b Based on data submitted by four commercial insurance companies and two MBAs, which have existing partnerships with rural banks.

Source: Government of the Philippines, Department of Finance (2012).

7.2.5 Factors Driving the Development of the Microfinance Sector

An interplay of external and internal factors drives the development of the microfinance sector.⁵ External factors are “push” factors coming from outside the sector that motivate MFIs and microinsurers to develop innovative financial products and services to expand outreach to more low-income clients. Internal factors are “pull” factors coming from within these institutions that prod them to develop internal capacities to deliver better service to clients.

The primary push factor is the government’s policy decision to make the financial system more inclusive. The Philippine Development Plan, 2011–2016 has a three-pronged financial inclusion strategy: (i) increasing the confidence of the public about the health of the financial sector, (ii) educating the public on financial instruments and their rights, and (iii) encouraging the offering of a variety of products to cater to different consumers. The BSP as the lead government institution has formulated specific financial inclusion strategies (Table 7.8).

Foremost of the push factors are the policy and institutional reforms adopted by the government with the donor community’s assistance to create a hospitable environment for microfinance. Private microfinance providers responded by developing suitable delivery techniques and appropriate products.⁶ The government (DOF—National Credit Council [NCC] and the BSP) and donors collaborated to develop a regulatory framework conducive for microfinance. These developments in Philippine microfinance are taking place in a global context in which governments and donors alike are seeking various ways to expand financial inclusion. The accessibility of information and demonstration of successful and failed microfinance experiments were important lessons for the microfinance community in the Philippines. The international donor community, enthused by the experiences of MFIs in various other countries that successfully reached out to low-income clients, invariably included microfinance in their development assistance strategies for the Philippines as an instrument for financial inclusion.

In 1997, the United States Agency for International Development provided crucial technical assistance (TA) to the DOF—NCC under the Credit Policy Improvement Project (CPIP). International and Filipino experts were made available to advise the government and emerging microfinance community on effective global microfinance practices.

⁵ In the macro sense, including microinsurance, payments, savings, and remittances.

⁶ While the discussion in this section does not list such factors exhaustively, it dwells on those deemed most critical in the development of the microfinance sector.

Table 7.8: Financial Inclusion Strategies

Specific Strategy	Instruments	Specific Target
Policy, regulation, and supervision	BSP Circulars 730, 754, and 755 to enhance the implementation of the Truth in Lending Act (RA 3765)	Ensure adequate disclosure of the true cost of credit, which protects consumers and enables them to make informed decisions about borrowing
	BSP Circular 746, which grants exemptions from the submission of documents like income tax returns and financial statements to clients	Streamline access to finance for MSMEs
	BSP Circular 694	Facilitate the establishment of microbanking offices to expand the physical network of banking offices in areas without banks or alternative access points
Financial education and consumer protection	Continued implementation of the multidimensional Economic and Financial Learning Program	Disseminate public information through campaigns and consumer education programs on economic and financial issues to promote awareness and understanding of essential economic and financial issues
	Active engagement in global discussions and initiatives on financial inclusion. The BSP currently chairs the Steering Committee of the AFI, a global network of policymakers and regulators committed to financial inclusion.	Enhance the promotion of financial inclusion initiatives
Calibrated product offerings for targeted needs	Implementation of the Credit Surety Fund ^a	Increasingly advocate MSME access to finance
	Adoption of rules and regulations regarding derivative products and trading	

AFI = Alliance for Financial Inclusion; BSP = Bangko Sentral ng Pilipinas; MSME = micro, small, or medium-sized enterprise.

^a This provides a maximum 80% surety cover for loans granted by banks to borrowers that would have difficulty assessing such credit facilities. At the end of December 2012, 26 credit surety funds nationwide had made aggregated contribution pledges of P396.621 million, of which P303.284 million has been paid (National Economic and Development Authority 2014: ch. 5).

Source: National Economic and Development Authority (2014).

The CPIP laid down the policy, regulatory, and institutional framework that resulted in the current notable performance of the microfinance sector, and was instrumental in providing good policy advice to the government. The following major reform measures benefited from the TA: the National Strategy for Microfinance, Executive Order No. 138, credit policy provisions in the Agriculture and Fisheries Modernization Act, microfinance provisions in the General Banking Act of 2000, and the Social Reform and Poverty Alleviation Act. The CPIP advised using risk-based supervision for MFIs instead of the traditional, collateral-based supervision then employed by the regulator. The General Banking Act of 2000 and National Strategy for Microfinance provided the regulatory framework for proportionate regulation and risk-based supervision adopted by the BSP for microfinance.

A companion TA was also given to credit-granting nongovernment organizations (NGOs). In 1997, a group of local NGOs organized themselves into the Coalition on Performance Standards to strengthen their respective organizations by adhering to certain benchmark performance ratios. The Coalition on Performance Standards later became the Microfinance Council of the Philippines. The credit-granting NGOs' primary objective was to achieve financial and operational sustainability while expanding coverage or outreach to targeted, small-scale clients. As a result, performance ratios became part of the regular reports made by MFIs to their boards of directors or trustees and donors. Donors also helped the Philippines' emerging microfinance sector through cheap loans, grants, and TA.⁷ Official development assistance funds performed the critical function of demonstrating that microfinance was both socially beneficial and profitable (the "double bottom line"). With success came more funding, this time from local commercial sources, private donors, and international foundations.⁸

⁷ One example is the Rural Microenterprise Finance Project (Loan 1435-PHI) of the Asian Development Bank (ADB). According to an evaluation in July 2006, "the Project demonstrated that the Grameen Bank approach could be implemented successfully nationwide. Notably, by facilitating the participation of rural banks, cooperative rural banks, and thrift banks that have emerged as major microfinance providers, the Project brought microfinance into the mainstream of the financial system. The favorable policy and legal environment, catalytic role of the Project in expanding the supply of microfinance services, and flexibility of the Project to respond to changing market needs contributed greatly [to] the Project's success." ADB and the Inter-American Development Bank both funded programs designed to provide Filipino MFIs with loans, grants, and technical assistance (ADB 2006).

⁸ Some private local examples include Banco de Oro, an important donor to the local MFI community; and the Ayala Group, a big financial conglomerate that created a foundation and later a bank oriented to provide mobile financial services to poor households and microenterprises.

Another push factor in the early days of microfinance was the government's realization that subsidized or directed credit programs (DCPs) had failed to reach their intended targets, mostly small farmers and other small-scale clients, in a sustainable manner. The fiscal cost of funding 63 DCPs (73% of the DCPs implemented by various government agencies) was as much as 1.8% of gross national product in 1996.⁹ The bulk of the funding came from foreign loans. Data from 24 reporting DCPs for 2 years (1995 and 1996) showed a total of 685,794 borrowers, an average of 29,000 borrowers per program. Of the 86 reporting DCPs, 49% had an average repayment rate of 82.6% in 1996, slightly lower than the 1995 figure of 83.9%. Some DCPs reported repayment rates of lower than 60%. There was limited outreach due to the lack of an efficient delivery mechanism, low turnaround of loanable funds (due to low repayment rates), and poor monitoring (Llanto, Geron, and Tang 1999). On the CPIP's advice, the government decided to terminate those DCPs and encouraged a market-based approach to microfinance, with private financial institutions taking the lead in developing appropriate products for the excluded.

The government undertook a series of major reforms as mentioned above. The national government and financial regulator both made an effort to understand microfinance and work toward the proportionate regulation of the sector. The regulators became open to new and innovative microfinance techniques, and allowed experimentation and innovations, with an eye to financial stability. The microfinance industry, regulators (the Insurance Commission and BSP), and an oversight agency (the NCC) collaborated toward the proportionate regulation and effective monitoring of operations. The BSP adopted proportionate regulation and risk-based supervision, giving rise to a stream of regulations that sought to enhance the capacity of MFIs (rural banks, thrift banks, and MBAs) to provide financial services to a small-scale clientele without jeopardizing their financial stability.¹⁰

The principal donors to the microinsurance sector were ADB and the Japan Fund for Poverty Reduction, which provided joint assistance from 2008 to 2012 through the Developing Microinsurance Project.¹¹

⁹ The survey conducted by Llanto, Geron, and Tang (1999) covered 86 DCPs, of which data were shared by only 63.

¹⁰ In 1999, the CPIP brought Filipino legislators, representatives of government financial institutions, and government officials to an educational study visit of exemplary Latin American MFIs in Guatemala, Peru, and Bolivia. Lessons from the study visit informed the subsequent legislation that recognized microfinance as a legitimate banking activity to be supervised by the BSP, and motivated the regulator to adopt proportional regulation as its regulatory stance.

¹¹ ADB and Japan Fund for Poverty Reduction Grant 9118.

Other donors to the microinsurance sector were (i) the German Agency for International Cooperation, which provided assistance through the Microinsurance Innovations Program for Social Security implemented by the Insurance Commission; (ii) the Rural Bankers Association of the Philippines, which received a grant from the International Labour Organization's Microinsurance Innovation Facility to help rural banks become microinsurance agents; and (iii) the World Bank's First Initiative Project, which provided the Insurance Commission with TA to enhance its financial reporting framework using information and communication technology (ICT) as a tool (Government of the Philippines, DOF 2012). The blueprints for the development of the microinsurance sector, namely the Regulatory Framework and the National Strategy for Microinsurance, were developed in 2009 with donor TA.

Thus, the present situation in which the government, financial regulators, and private sector (rural banks, cooperatives, and microinsurance providers) are collaborating to expand financial inclusion contrasts starkly with the situation from the late 1960s to the 1980s when efforts to provide low-income sectors with access to cheap credit were chiefly directed by the government. At the time, its main strategy was to use preferential credit allocation to target groups at highly subsidized rates (Llanto, Geron, and Tang 1999; Llanto 2005; Esguerra 2012). In the 1980s and 1990s, a group of various small NGOs began to provide microenterprises with microcredit and informal savings services. Today, in addition to regular banks and MFIs, other financial services providers and microbanking offices (MBOs) have become important financial services access points in areas where branch banking is not available.¹² Meanwhile, the development of appropriate microproducts, such as microdeposits, microenterprise loans, micro-agriculture loans, housing microfinance, and microinsurance guided by proportionate regulation, has provided a broad array of financial products to serve small-scale clients.

Internal factors have contributed to the significant development of the microfinance sector since 1996. Some notable pull factors¹³ are (i) the MFIs' mission-oriented goal to provide poor households and microenterprises with access to financial services, (ii) the drive to achieve operational and financial self-sufficiency, (iii) the use of effective

¹² Other providers include non-stock savings and loan associations, credit cooperatives, pawnshops, and other nonbank financial institutions, remittance agents, money changers or foreign exchange dealers, and e-money agents. MBOs are scaled-down branches that perform limited banking activities, such as accepting microdeposits and releasing microloans to microfinance clients.

¹³ These could vary across MFIs.

business models and innovations to sustain microfinance operations, and (iv) effective board governance.

A double bottom line of fulfilling a social mission and providing service in a profitable and sustainable manner appears to be a pervasive philosophy among MFIs in the Philippines. The failure of various government-subsidized credit programs has spurred local NGOs and credit cooperatives to fill this gap by reaching out to the large population of small-scale clients. Armed with a better understanding of local communities and effective business models and lending techniques, MFIs (initially NGOs and later rural banks with microfinance operations) registered expanding outreach and loan repayment rates of up to 98%. They demonstrated that it is possible to fulfill a social mission without sacrificing financial viability. Meanwhile, in the insurance sector, low-income clients had to settle for informal “insurance” against various risk events due to the failure of the government and private insurance sector to include them in mainstream insurance. Unfortunately, those informal schemes proved inadequate against catastrophic losses. Again, a sense of mission among MBAs and credit cooperatives motivated them to develop better insurance products in coordination with the Insurance Commission.

MFIs use effective business models to ensure their financial viability, including tested loan collection techniques and monitoring schemes. They began with the Grameen Bank model of group lending with a joint liability arrangement, considered the solidarity group models pioneered by Latin American NGOs, and later used the Association for Social Advancement’s modified Grameen approach of group lending, which omitted a joint liability requirement to expand outreach and maintain loan collection efficiency. Internally, many MFIs have resolved to adhere to the performance standards initially developed by the Coalition on Performance Standards and influenced by CGAP guidelines on performance and governance. MFIs’ boards of trustees or directors and international donors closely monitor the performance of the MFIs, which submit regular reports on performance, such as significant financial ratios during a reporting period (Table 7.9).

Another major internal factor explaining the development of the microfinance sector is the quality of governance of the MFIs. This has only recently surfaced as an essential component of long-term institutional success (Otero 2009), but is a critical factor for the MFIs’ success and sustainability. This is understandable in view of the mainstreaming of microfinance and the transformation of credit-granting NGOs into regulated institutions. As MFIs assume an important role in the financial system and provide financial services to a greater proportion of the population, they must maintain “high standards of performance...

Table 7.9: Some Financial Ratios Monitored and Reported by Microfinance Institutions in the Philippines

Significant Financial Ratios	Industry Ratio, as of Current Month ^a (%)	Target
1 Capital adequacy ratio	16.11	Greater than
2 Total capital to total assets	11.40	Greater than
3 Debt to equity ratio	12.75	Less than
4 Past due loans and ITL to total loans and discount	5.18	Less than
5 Total classified loans and discount to total loans	2.30	Less than
1 Loans and discount (gross) to deposits and borrowings	81.86	Greater than
2 Loans and discount + investments (gross) to deposits and borrowings	83.83	Greater than
3 Deposits to capital	720.23	Equal to or greater than
4 Primary reserves to deposits	21.60	Greater than
1 Total expenses to gross earnings for SME banks	55.34	Less than
2 Total expenses to gross earnings for microfinance banks	74.73	Less than
3 Net income after tax to average capital return on equity	6.85	Greater than
4 Net income after tax to average return on assets	0.85	Greater than
5 Net interest margin to average earning assets for SME banks	5.28	Greater than
6 Net interest margin to average earning assets for microfinance banks	9.76	Greater than

ITL = items in litigation, SME = small or medium-sized enterprise.

^a Sample industry ratios computed as of 30 June 2014.

Source: Author's compilation.

necessitating increased inputs and involvement by the board to ensure effective management” (Campion and Frankiewicz 2009: 1). The board of directors of microfinance-oriented banks in the Philippines must pass the “fit-and-proper” rule imposed by the BSP requiring directors to have professional competency, integrity, and moral fitness. The directors have generally complied with this requirement by undergoing seminars and/or training on corporate governance to prepare themselves for their tasks, and have also complied with the BSP’s requirement of having their

annual performance rated. As a result, effective board governance has enabled regulated MFIs to expand and sustain microfinance operations.

7.2.6 Obstacles to Further Progress in the Microfinance Sector

A major obstacle to further progress in the microfinance sector is political intervention. Politicians may begin to interfere with the evolving microfinance architecture that has worked so well for the country as a way to boost political capital. They might provide MFIs with substantial funding in exchange for political favors, propose populist legislation that can undo the major reforms discussed above, or even revoke good policy. One such example was an attempt by a previous administration to revoke Executive Order No. 138, which terminated DCPs. A compromise solution was to retain the executive order, but to allow direct lending by a government line department in areas allegedly not currently served by any MFI. This compromise is problematic because it eliminates incentives for MFIs to locate in these areas due to direct government intervention. These areas will therefore remain dependent on government injections of cheap funds. Inconsistent policies can also retard further progress in the microfinance sector.

The lack of proper understanding of client needs, unaddressed socioeconomic and cultural factors, and barriers posed by geography, information, and coordination problems can also be significant hurdles for further sector growth. Inadequate physical infrastructure, such as bad roads, inefficient transport, and shipping facilities, as well as problems with access to efficient telecommunications services, exacerbate the problems posed by geography.

The slow implementation of a credit information system intended to overcome clients' lack of a formal financial history is also an issue. In 2008, the Credit Information System Act was passed creating the government-owned Credit Information Corporation (CIC) to oversee the provision of positive and negative credit data on borrowers that banks can use as a basis for releasing loans and repayment interest rates.¹⁴ Banks, quasi-banks, and their subsidiaries and affiliates, life insurance companies, credit card companies, and other entities are required to submit basic credit data and updates thereon on a regular basis. The CIC may include other credit providers to be subject to compulsory participation. All other accessing entities may participate

¹⁴ The CIC was created in 2008 by the Republic Act. No. 9510, otherwise known as the Credit Information System Act.

subject to acceptance by the CIC.¹⁵ However, for a variety of reasons, the CIC has barely managed to implement its mandate. In fact, it has only just recently begun considering what kind of information technology system will form the foundation of the credit information database (Gamboa 2012).

7.3 Financial Education

The Philippine Development Plan 2011–2016 provides a blueprint for a resilient and inclusive financial system. It seeks (i) the establishment of a regulatory environment that balances financial inclusion objectives with financial stability goals; (ii) the promotion of the use of alternative products and delivery of financial services in underserved and unserved areas of the country; (iii) the promotion of financial literacy and consumer education; and (iv) the continuing development of new loan products and other banking services that aim to address the special needs of the poor, women, and persons with disabilities.

For its part, the BSP has (i) an Economic and Financial Learning Program to promote greater public awareness of economic and financial issues, and provide information to enable households and businesses to make well-informed economic and financial decisions; and (ii) a Credit Surety Program, which creates a trust fund from the contributions of a provincial government and a cooperative in the same province to encourage financial institutions to lend to MSMEs in the province using the surety cover as a collateral substitute (National Economic and Development Authority 2014). The Economic and Financial Learning Program (EFLP) is the BSP's umbrella program for economic and financial education in the country, and consists of various learning sessions designed for and targeting specific audiences, like schoolchildren, secondary and tertiary students, overseas Filipino workers, microfinance clients, and others. The EFLP does not seem to have financial literacy programs for small enterprises. Box 7.2 shows the EFLP's 2013 milestones.

The NCC and the Insurance Commission oversee financial education covering microinsurance in collaboration with the National Anti-Poverty Commission. Financial literacy training, seminars, and workshops on microinsurance are conducted separately for providers of microinsurance and clients. The modules for providers focus on their responsibilities to clients and the various prudential, market conduct,

¹⁵ For details, see the CIC website: <http://creditinfo.gov.ph/frequently-asked-questions>

Box 7.2: 2013 Economic and Financial Learning Program Milestones

- Since the EFLP's implementation in 2010, 26 EFLP seminars have been conducted in key cities and municipalities.
- A total of 38,000 participants have benefited from EFLP sessions.
- In 2013, five EFLP seminars were conducted in five provinces.
- In 2013, the BSP, in coordination with the Overseas Workers Welfare Administration, trained lecturers and providers of pre-departure orientations to overseas workers prior to deployment abroad.
- With support from the World Bank, the BSP began to prepare a baseline survey to assess financial capability and literacy.
- A total of 29 credit surety funds have been established in 22 provinces and seven cities; from the inception of credit surety funds in 2008 to November 2013, approved loans for 7,135 clients totaling P909 million have been registered.
- The BSP authorized 12 banks to take deposits in school premises; over 400,000 new accounts were opened in 2012–2013.

BSP = Bangko Sentral ng Pilipinas, EFLP = Economic and Financial Learning Program.
Source: Bangko Sentral ng Pilipinas (2013).

and good governance requirements; while the module for clients centers on the rights and responsibilities of the insured (NCC Secretariat 2010).

The BSP, NCC, and Insurance Commission have done creditable pioneering work on financial education. Financial education should not just be the responsibility of the central bank for microfinance, nor of the NCC or Insurance Commission for microinsurance. At stake is greater financial inclusion of excluded segments of the population, as this faces serious obstacles. The banking system, and particularly MFIs, should take a greater interest in financial education to help expand outreach, improve the quality of financial services, and essentially help businesses grow. MFIs can more easily achieve their double bottom line through an effective financial education program.

A major issue is the delivery of the financial education program to a wider audience. The BSP, NCC, and Insurance Commission lack the delivery structure for such an important program. The school system (primary, secondary, and tertiary levels) and civil society could be usefully harnessed to achieve more comprehensive coverage of financial education. It is also necessary to incorporate financial education into school curricula.

A crucial element of financial education is consumer protection. The BSP has acknowledged that “financial inclusion ushers [in] the

participation of clients that are less sophisticated and generally more vulnerable to predatory finance” (BSP 2013). It is imperative that consumers, especially low-income clients, are properly educated on their consumer rights and given proper access to financial institutions’ complaints desks and the BSP Financial Consumer Affairs Group.¹⁶ Too often, financially illiterate individuals have been victimized by various finance scams perpetrated by unscrupulous individuals and companies.¹⁷ Micro and small enterprises also stand to benefit from financial education, but are not currently covered by current financial literacy programs.

7.4 Financial Regulation and Supervision of the Microfinance Sector

A market-based financial ecosystem is the right environment for the microfinance sector to grow and develop. The current vibrancy of the microfinance and microinsurance markets in the Philippines is fundamentally due to the reforms pursued by the government and regulators in collaboration with private stakeholders. These have led to a greater private sector role, chiefly taken up by MFIs, in providing credit, deposit, and other services to low-income sectors. There are several types of MFIs in the Philippines: rural banks, cooperatives, credit cooperatives, and credit NGOs. Only rural banks and credit cooperatives are allowed to accept deposits.

Proportionate regulation adopted by the BSP with respect to microfinance provided the necessary impetus for the sector’s growth and development. This meant adjusting prudential norms, basically covering capital requirements, and loan provisioning, reporting, and documentation, among others, to conform to the specialized character of microfinance. CGAP (2012) pointed out that some prudential norms developed for conventional banking do not fit with the risks and requirements of microfinance, which involve different products and services. The different BSP circulars indicate how the regulator has

¹⁶ The BSP Financial Consumer Affairs Group processes 7–29 complaints, inquiries, or requests on a daily basis, 90% of which are resolved within 3 banking weeks. Simple complaints are resolved within 2 banking days, according to the BSP Financial Inclusion Initiatives 2013.

¹⁷ One example of this is the Aman Futures Group money scam that duped about 15,000 investors from Visayas and Mindanao in 2012. The pyramid scam, dubbed one of the biggest in the country’s history, is estimated to have robbed investors of P12 billion (Gutierrez 2013).

adjusted regulation and supervision approaches to enable MFI banks to expand outreach (financial inclusion), while at the same time protecting microfinance depositors and promoting the safety and soundness of the MFIs. Proportionate regulation means taking into consideration the following features of microlending methodology used by MFIs, and adjusting prudential norms: (i) low initial loan sizes, with gradually larger amounts available in subsequent loans; (ii) loan appraisal based on personal contact rather than scoring; (iii) group or individual lending based on an analysis of the borrower's likely cash flow; and (iv) an understanding that borrowers who repay their loans will have access to follow-on loans.¹⁸ Proportionate regulation means that costs are proportionate to or balanced with the risks and benefits of regulation. It seeks to achieve a desired level of financial inclusion while maintaining the stability of the financial system (Grady and Waller 2012).

As practiced in the Philippines, traditional bank supervision applies standardized procedures, and focuses on individual transactions and the adequacy of loan collateral. Banking regulations permit the granting of small, clean loans. However, in practice, there has been a regulatory bias against banks granting loans with insufficient collateral or without any form of security or collateral. Since microfinance loans are typically given without collateral, there is a risk that examiners will criticize banks making such loans. This could constrain the expansion of microlending and disadvantage low-income clients (Llanto 2001). The attitude of bank examiners has changed with the BSP's adoption of risk-based supervision for microfinance banks. At present, the regulators (the BSP and Insurance Commission) examine how MFIs and microinsurance providers identify, manage, control, and monitor risks in an appropriate and timely manner. The regulator is more concerned with a broad spectrum of risks, including credit, liquidity, operational, reputational, and interest rate risks among others, and with how the MFI deals with them rather than with documentation, such as loan collateral. A risk profile of the MFI bank is a good place to start in assessing financial conditions and performance (Llanto 2001). BSP circulars require MFI banks to observe conditions for safe and sound banking practices, risk management, internal control systems, and provisions for probable losses.

Proportionate regulation and risk-based supervision of microfinance both require a cultural change on the part of the regulators, which have

¹⁸ Recommendations for Proportionate Regulation and Supervision of Microfinance. United Nations Commission on International Trade Law Colloquium on Microfinance. 31 January 2011. <https://www.uncitral.org/pdf/english/colloquia/microfinance/LYMAN.1.pdf> (accessed 27 April 2015).

relied on traditional approaches to regulation and supervision to assess the financial health of institutions. In this regard, new and innovative ways to foster financial inclusion using emerging technologies, such as mobile phone banking, have emerged. ICT use has supported the rollout of mobile phone banking, as mobile phone penetration in the Pacific has increased from less than 10% in 2006 to an estimated 60% in 2014 (ESCAP 2014). Mobile banking solutions will require appropriate regulatory and supervisory approaches to ensure the integrity of financial services and financial stability. A survey conducted by the CGAP Technology and Business Model Innovation Program found that, at the end of 2011, there were 148 active branchless banking businesses worldwide, 26 of which had more than 1 million customers.

The Philippines has had particular success with mobile phone-based models (ESCAP 2014). E-money regulations enabled the entry of new providers, more active agents, an exponential increase in e-money accounts, and an incremental buildup of transactions. Branchless banking combining the use of retail agents and ICT to deliver financial services has also been used in the country to surmount geographical problems and reach otherwise inaccessible, poorer clients. Branchless banking is at a very early stage, and careful nurturing and adjusting is needed to make it an effective, safe, and innovative way to reach the unbanked. A regulatory gap appears to exist, as regulators are still searching for the most appropriate way to regulate these technology-enabled financial services. Regulators, including the BSP, must “define the role of mobile network operators and other actors not previously subject to financial regulation and supervision” (Ehrbeck, Pickens, and Tarazi 2012). Box 7.3 illustrates this challenge and how the BSP dealt with it.

In this regard, Ehrberck, Pickens, and Tarazi (2012) recommended proper support for the development of both front-end infrastructure (the point of contact with customers, including ATMs, point-of-sale devices, and retail agents of financial services providers) and back-end infrastructure (the foundation needed for efficient financial services, including payment switches, credit bureaus, and collateral registries).

The Insurance Commission’s Regulatory Framework for Microinsurance established the policy and regulatory environment that will encourage, enhance, and facilitate the safe and sound provision of microinsurance products and services by the private sector (NCC Secretariat 2010). The active collaboration among the DOF, Insurance Commission, and insurance community was critical in the adoption of proportionate regulation for microinsurance. Proportionate regulation led to the formalization of various informal insurance schemes provided by MFIs to clients (referred to as “members” by NGOs). To protect their loan portfolios and simultaneously provide some form of risk

Box 7.3: Bangko Sentral ng Pilipinas as an Enabler

In 2005, the BSP was presented with two e-money schemes: (i) Smart Money, which was issued by a bank; and (ii) Gcash, which was issued by a nonbank subsidiary of Globe Telecom, one of the largest mobile network operators in the Philippines. Although Gcash introduced a nonbank actor into what had been seen as the domain of licensed banks, the BSP chose to adopt an innovative product with the potential to reach unbanked populations. Using its authority to make rules as the payment system overseer, the BSP approved each model on an ad hoc basis, but only after confirming that each model mitigated identified risks. Based on its observations of the market's development over more than 4 years, the BSP issued e-money regulations in 2009 (BSP Circular 649, issued on 9 March 2009). The regulations are notable for regulating e-money as a service and not by the legal character of the e-money issuer, while still imposing conditions to mitigate the risks presented by nonbank e-money issuers. The regulations effectively created a level playing field between banks and nonbanks, and ultimately enabled a greater array of actors and products with the potential to promote financial inclusion. A total of 38,000 participants have benefited from EFLP sessions.

BSP = Bangko Sentral ng Pilipinas.

Source: Ehrbeck, Pickens, and Tarazi (2012).

protection to vulnerable, low-income clients, MFIs in the Philippines have devised informal microinsurance schemes such as in-house mutual aid or benefit funds, “credit life insurance,” and other similar schemes, mostly provided by cooperatives and NGOs (Llanto 2007). About half of the 22,000 operating cooperatives in the country provided some form of insurance to members through mutual fund schemes (Llanto, Geron, and Almario 2008). These schemes are neither regulated nor licensed by the Insurance Commission (DOF 2012). It was necessary to draw those informal schemes into a formal regulatory framework to protect consumers and build trust in insurance, whose image and reputation have suffered due to the fraudulent behavior of certain insurance and pre-need companies in the past.

Proportionate regulation appears to have worked well for the microfinance sector, as it has enabled the evolution of innovative approaches to financial inclusion. However, as the coverage and diversity of the sector increases in terms of financial products and services offered to low-income clients (such as mobile payments and remittance services), and as innovative means of service delivery (such as through MBOs) are developed, it becomes necessary to deepen understanding of the risks created by fostering “light touch” regulation, and find ways to

manage those risks. For example, MBOs are not required to have vaults for safekeeping or security guards on the premises, as are regular banks. Closer monitoring and more efficient information systems for MFIs and regulators are needed to ensure financial integrity and stability. However, MFIs' loan portfolios are not as concentrated as those of commercial banks. As credit and other risks are well distributed, the failure of an MFI bank (a relatively small rural bank) does not adversely impact the financial system as a whole. MFIs do not appear to pose a systemic risk, unlike domestic systemically important banks (e.g., universal banks) whose closure would adversely impact the economy.¹⁹ However, the reputation of microfinance is at risk from the perspective of small depositors, especially those who have hitherto been excluded. The failure or closure of MFI banks will impact the willingness of small depositors to participate in the mainstream financial system. Thus, it is necessary to balance carefully the proportionate regulation of banks engaged in microfinance with the need to protect those banks' financial integrity and stability.

7.5 Conclusion and Policy Recommendations

The Philippines' experience with microfinance shows that a conducive policy and regulatory framework plays an essential role in motivating private financial services providers to make innovative financial products and services accessible to the poor. Financial deepening among the excluded portion of the population has begun to take root, and financial inclusion has started to expand; however, policymakers and regulators still face challenges. Financial education also plays a critical role in financial inclusion. A financial education program should be provided for SMEs because small firms present excellent opportunities for inclusive growth.

The government's primary challenge is defining its role in creating broader and more interconnected ecosystems for the safe and efficient delivery of financial products to the poor (Ehrbeck, Pickens, and Tarazi 2012). The regulators (the BSP and Insurance Commission) have maintained a proportionate regulatory stance, which allows for experimentation and the pilot testing of approaches that could promote financial inclusion. They also consider the need to maintain the financial health of deposit-taking financial institutions (banks)

¹⁹ The BSP has classified at least 14 domestic banks as "domestic systemically important banks."

and microinsurance providers, and to ensure financial stability.²⁰ The government has so far largely resisted the temptation to participate directly in the microfinance market, despite a recent attempt to reintroduce DCPs. However, there is always a risk that politicians may sponsor publicly funded credit programs to meet certain sociopolitical objectives. The microfinance community should remain vigilant for such attempts to weaken the market-based microfinance ecosystem, which has so far proved to be a workable approach to financial inclusion.

Nevertheless, serious challenges remain, for which the following policy recommendations are proposed:

- (i) The BSP, NCC, and Insurance Commission should undertake financial education in cooperation with the school system at the primary, secondary, and tertiary levels. Civil society also plays a role in promoting financial education.
- (ii) Financial education should be incorporated into school curricula. Similarly, it is important to establish a financial education program for SMEs.
- (iii) Banks, in collaboration with the BSP, should create a format for the regular reporting of SME access to formal loans.
- (iv) Consumer protection should be enforced more effectively; this could be promoted through financial education for low-income clients.
- (v) The CIC should be supported and made fully operational as soon as possible. It needs good staff and substantial resources to accomplish its mandated tasks.
- (vi) Mobile banking and various types of financial innovations should be appropriately regulated and supervised to foster financial inclusion. This is necessary to balance expanding financial inclusion through emerging technologies with ensuring the stability of the microfinance sector.
- (vii) The government and regulators should support the development of back-end infrastructure, that is, the foundation needed for efficient financial services, including payment switches, credit bureaus, and a collateral registry.

²⁰ Although there is general consensus on the need for a favorable policy environment for microfinance, there is no current consensus on how to create this environment (Ledgerwood and White 2006).

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8

Sri Lanka

Saman Kelegama and Ganga Tilakaratna

8.1 Introduction

Financial inclusion has attracted much international attention since the mid-2000s and has become a priority on many international policy agendas. In the 1980s and 1990s, most international attention was focused on microcredit, that is, the provision of credit to low-income households. As the importance of other financial services, like savings and insurance, became apparent, the focus shifted to microfinance, a more holistic concept encompassing a broad range of services beyond microcredit (Armendariz and Morduch 2005; Littlefield, Helms, and Porteous 2006; Collins et al. 2009). Despite the increase in microfinance initiatives around the world and the rapid growth of the microfinance industry (Reed 2011), a considerable share of households still lacks access to financial institutions. In this context, the concept of financial inclusion has recently entered the development discourse, calling for universal access to a broad range of financial services, and bringing those currently excluded into the financial sector. As Conroy (2008: 4) argued, “while ‘microfinance’ has driven ‘micro-credit’ out of the professional discourse, ‘financial inclusion’ has not replaced ‘microfinance’ as an operational concept. Financial inclusion is the most useful frame of reference for considering how poverty might be reduced through provision of financial services. And microfinance... remains the most potent weapon available for reducing financial exclusion.”

There is no universally accepted definition of financial inclusion. The United Nations (UN) Millennium Development Goals Summit of 2010 defined financial inclusion as “universal access, at a reasonable cost, to a wide range of financial services, provided by a variety of sound and sustainable institutions.” According to the Consultative Group to Assist the Poor (CGAP), “financial inclusion means that households

and businesses have access and can effectively use appropriate financial services. Such services must be provided responsibly and sustainably, in a well regulated environment” (CGAP 2014). ACCION International defines financial inclusion as “a state in which all people who can use them have access to a full suite of quality financial services, provided at affordable prices, in a convenient manner, and with dignity for the clients. Financial services are delivered by a range of providers, most of them private, and reach everyone who can use them, including disabled, poor, rural, and other excluded populations” (Center for Financial Inclusion 2008: 1).

Stein (2010) identified three key dimensions that define financial inclusion: (i) financial products, (ii) features of financial products, and (iii) delivery channels. Pointing out that financial inclusion requires the provision of access to a range of financial products besides microcredit, including savings, microinsurance, payment facilities, remittances, and money transfer, Stein stressed the need to provide quality financial services at affordable prices in a convenient manner through a range of delivery channels, including bank branches, nonbank institutions, and insurance companies.

Financial inclusion benefits individuals, households, and the economy as a whole in several ways (UN 2006; Conroy 2008; Stein 2010). Higher levels of financial inclusion increase both economic efficiency and equity (Conroy 2008; Stein 2010). Financial inclusion can also help the poor manage their day-to-day needs, better cope with risks, and undertake investment opportunities that enable them to improve their income and assets (UN 2006; Conroy 2008; Stein 2010).

Financial education and regulation are critical factors in achieving financial inclusion. Financial literacy encompasses many concepts such as financial awareness, knowledge, skills, and capability. Users of financial services should have the knowledge, skills, and awareness necessary to make informed financial decisions. Financial education enables individuals to develop awareness about the financial products and services available to them and helps them become familiar with the characteristics and details of such products (Carpena et al. 2011). Moreover, financial literacy helps borrowers better assess their repayment capacity and thereby prevent them from over-borrowing.

Financial regulation is another important factor for financial inclusion. In many countries, formal financial institutions such as commercial banks, finance and leasing companies, and insurance companies are governed by a regulatory framework, with the central bank in charge of banking regulation, and other bodies, such as the insurance board, in charge of insurance regulations. However, regulatory and supervisory frameworks for the microfinance institutions (MFIs)

are often weak compared with those for formal financial institutions (Zhang and Wong 2014).

8.2 Financial Inclusion in South Asia: Positioning Sri Lanka

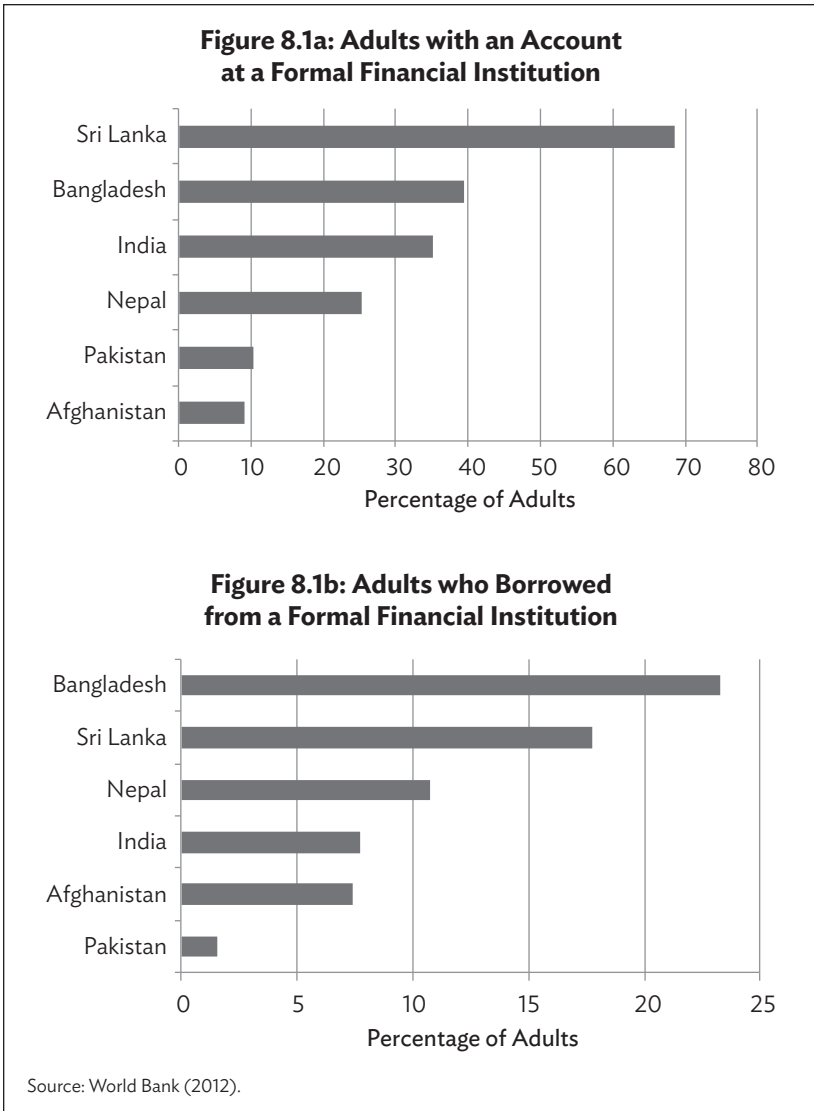
According to the Global Findex Survey 2012 (World Bank 2012), about three-quarters of the 2.5 billion people worldwide who live on less than \$2 per day do not have a bank account. Financial exclusion is most severe among women and rural residents. Only 33% of adults in South Asia have an account at a formal financial institution, the second lowest share of the world's regions; it exceeds only sub-Saharan Africa and is lower than Latin America, East Asia, and the Pacific. South Asia also has the highest gender gap in terms of access to formal financial institutions, compared with other regions. Only about 25.0% of women have access to formal financial institutions, compared with 40.7% of men.

With regard to income groups, the evidence shows considerable disparities in access to formal financial institutions—only 25.3% of the lower 40.0% of South Asia's population have formal accounts, compared with 41.0% of the upper 60.0% of the population. Education levels also impact inclusion—in South Asia, 54.2% of adults with a secondary education or more have access to formal financial institutions, compared with only 27.8% of adults with a primary education or less.

However, notable disparities exist across countries within South Asia. According to the World Bank (2012), Sri Lanka has the highest share of adults with a formal financial account (68%) in South Asia, which is much higher than in Afghanistan, India, Nepal, and Pakistan. Bangladesh has the highest share of adults borrowing from formal financial institutions, followed by Sri Lanka (Figures 8.1a, 8.1b).

To ensure financial inclusion, it is important to look beyond the role of formal financial institutions such as commercial banks. In South Asia, MFIs, including nongovernment organization (NGO) MFIs, community-based organizations (CBOs), self-help groups, and cooperatives, play a dominant role in financial inclusion, especially by ensuring access to financial services for those from low-income groups and for women. About 80% of MFI borrowers in South Asia are women.

South Asia has a long history of microfinance. Credit cooperatives have been in operation since the early 20th century in many South Asian countries. However, the modern microfinance movement originated in the 1970s. The number of MFIs and their clients grew rapidly in Bangladesh in the 1990s, and in India in the 2000s. In Sri Lanka, the microfinance sector expanded in the 1980s and 1990s, and saw further



growth in the post-tsunami period (from 2004). Other countries in the region made slower starts, but now have active microfinance sectors. At present, the outreach of microfinance varies considerably across South Asian countries (World Bank 2006). Outreach is high in Bangladesh and Sri Lanka, medium in India and Nepal, and low in Afghanistan and Pakistan. The high coverage of microfinance in Bangladesh was

achieved through a few specialized MFIs, like Grameen Bank and the Bangladesh Rural Advancement Committee, while growth in India occurred through the program linking banks and self-help groups. In Sri Lanka, high microfinance outreach is largely due to the cooperative societies and microfinance programs led by the Government of Sri Lanka (e.g., the Samurdhi program).

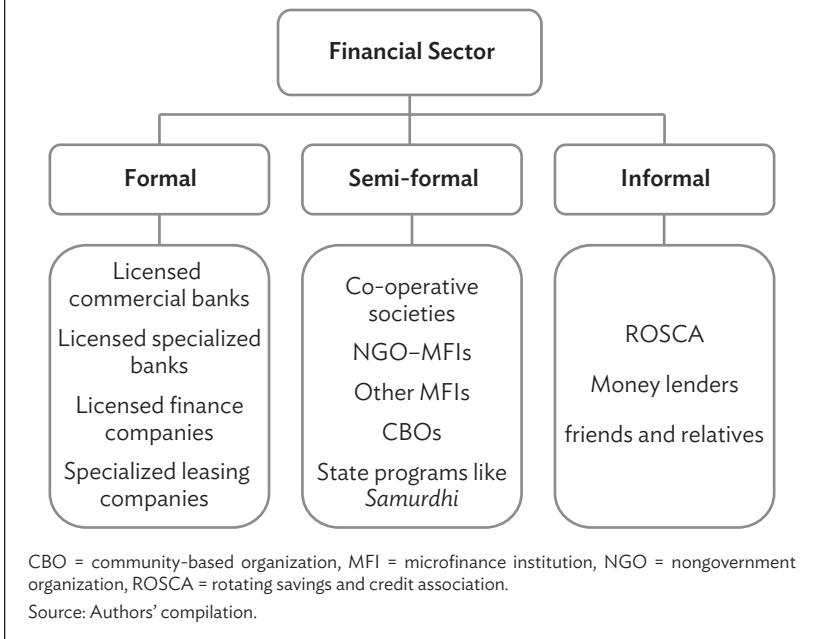
While access to financial institutions remains a challenge in South Asia, accessing multiple financial institutions for loans and savings is common in many countries or regions within countries in South Asia. Multiple borrowing (i.e., borrowing from multiple financial institutions) has become a concern in a number of South Asian countries. For instance, in Andhra Pradesh in India, a large flow of capital into MFIs resulted in aggressive expansion and over-lending of MFIs, leading to multiple borrowing and over-indebtedness among MFI clients. This led to a crisis in the microfinance sector in Andhra Pradesh and in India as a whole in 2010 (CGAP 2010; Wright and Sharma 2010). In Bangladesh, too, there is evidence of high levels of multiple borrowing and/or multiple membership among clients of MFIs like Grameen Bank and the Bangladesh Rural Advancement Committee (Chaudhury and Matin 2002; Rutherford 2006). In Pakistan, about 21% of MFI borrowers have loans from more than one MFI (Chen, Rasmussen, and Reille 2010). In Sri Lanka, multiple borrowing in the microfinance sector has been on the rise (Tilakaratna 2012; Tilakaratna and Hulme 2013) (section 8.4.2).

8.3 Financial Landscape of Sri Lanka

Sri Lanka's financial system comprises a wide range of service providers, including (i) formal financial institutions, like regulated banks and leasing and finance companies; (ii) semiformal institutions like cooperatives, NGO MFIs, CBOs, and state programs like Samurdhi; and (iii) informal sources of finance, such as moneylenders and rotating savings and credit associations. This chapter focuses on formal and semiformal financial institutions.

Sri Lanka's formal financial sector consists of 24 licensed commercial banks (LCBs) and nine licensed specialized banks (LSBs), with a network of over 6,400 bank branches and other banking outlets, and around 2,500 ATMs.¹ There are also 48 licensed finance companies and specialized leasing companies, with a combined network of over

¹ Unlike LCBs, LSBs, such as the National Savings Bank and Regional Development Bank, cannot accept demand deposits from the public or engage in foreign exchange transactions.

Figure 8.2: Financial Services Providers in Sri Lanka

1,000 branches. The banking sector has expanded notably since the mid-2000s, as have the LCB and LSB sectors, with a number of branches being opened particularly in provinces outside the Western Province (Central Bank of Sri Lanka [CBSL] 2013).

Sri Lanka's microfinance sector comprises a range of different institutions, such as cooperative societies, NGO MFIs, CBOs, development banks, and state programs like Samurdhi. The sector's history dates back to 1906, when the thrift and credit cooperative societies (TCCSs)—the pioneers of microfinance provision in the country—were started. The Multi-Purpose Co-operative Societies, which were established in 1957, and the Co-operative Rural Banks (CRBs), which were established as the societies' banking windows in 1964, were early government initiatives to improve financial inclusion in Sri Lanka (Charitonenko and De Silva 2002; Gant et al. 2002). Other important government initiatives were the Janasaviya Trust Fund (currently known as the National Development Trust Fund), which was established in 1991 as an apex lending institution for the microfinance sector, the Regional Rural Development Banks established in 1986, and the Samurdhi's Savings and Credit Program established in 1997 (Gant et

Table 8.1: Distribution of Licensed Banks and Branches

Category	End of 2011	End of 2012
Total number of LCBs	24	24
Total number of LCB branches and other outlets	5,586	5,667
Total number of LCB ATMs	2,235	2,358
Total number of LSBs	9	9
Total number of LSB branches and other outlets	812	820
Total number of LSB ATMs	180	180
Total number of bank branches and other outlets	6,398	6,487
Total number of ATMs	2,415	2,538
Total number of electronic fund transfer facilities at point-of-sale machines	27,689	27,955
Number of bank branches per 100,000 persons	16.5	16.8

LCB = licensed commercial bank, LSB = licensed specialized bank.

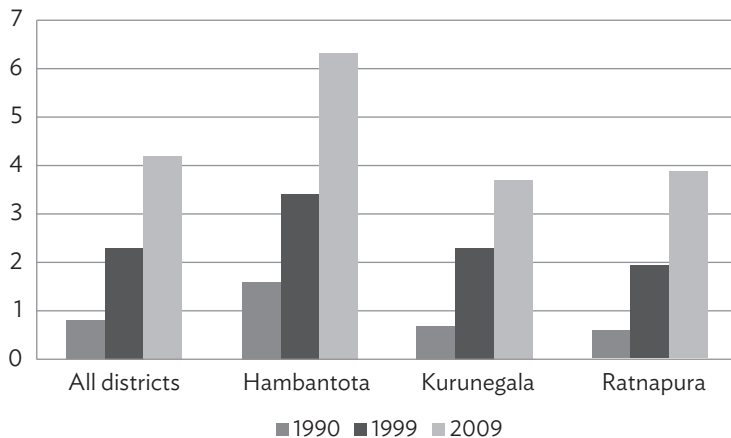
Source: CBSL (2013).

al. 2002; Institute of Policy Studies of Sri Lanka [IPS] 2005; Tilakaratna, Wickramasinghe, and Kumara 2005).

In the 1980s and 1990s, the number of NGOs providing microfinance increased and a number of commercial banks entered the microfinance sector, primarily as part of their corporate social responsibility activities, either through their own microfinance programs or as intermediaries for the credit programs implemented by the CBSL. The microfinance sector saw further growth in the post-tsunami period due to the influx of donor funds into the sector (Srinivasan and IPS 2008). MFIs have grown and expanded further since 2009, particularly in the north and east of the country.

CGAP (2006) found about 14,000 financial access points, defined as a bank, cooperative branch, or society where clients can deposit savings or withdraw loans. There were also multiple financial institutions operating in Grama Niladari divisions (Tilakaratna, Wickramasinghe, and Kumara 2005; Tilakaratna 2012). Tilakaratna (2012) found that the number of financial institutions per Grama Niladari division (i.e., density of financial institutions) increased steadily during 1990–2009, with 4.2 financial institutions per division on average; and all divisions covered by the survey had multiple financial institutions by 2009 (Figure 8.3). The density of financial institutions was particularly high in the Hambantota district in the Southern Province (with 6.3 financial institutions per

Figure 8.3: Density of Financial Institutions in Sri Lanka, 1990–2009



FI = financial institution, GN = Grama Niladari.

Note: Density of financial institutions is defined as the number of financial institutions located within a given Grama Niladari division.

Sources: Tilakaratna (2012); Tilakaratna and Hulme (2013).

division, on average). The study also found that the high and increasing number of financial institutions was closely linked to the growth and expansion of the microfinance sector. On average, there were 3.9 MFIs per division (compared to 4.2 financial institutions) in the country, and in the Hambantota district the average was as high as 5.3 MFIs.

Empirical evidence suggests a strong presence of MFIs in Sri Lanka's Southern Province, i.e., the Hambantota, Matara, and Galle districts (GTZ Promotion of the Microfinance Sector [ProMiS] 2010b; Lanka Microfinance Practitioners' Association 2010). Based on a survey covering MFIs with over 500 clients, GTZ ProMiS (2010b) found that about 24% of all MFI outlets are concentrated in the Southern Province, where only about 12% of the country's population resides (Department of Census and Statistics 2010). The Lanka Microfinance Practitioners' Association (2010) also revealed that there were many more MFI branches in the Hambantota district than in other districts.

8.4 Financial Inclusion in Sri Lanka

8.4.1 Access to Financial Institutions

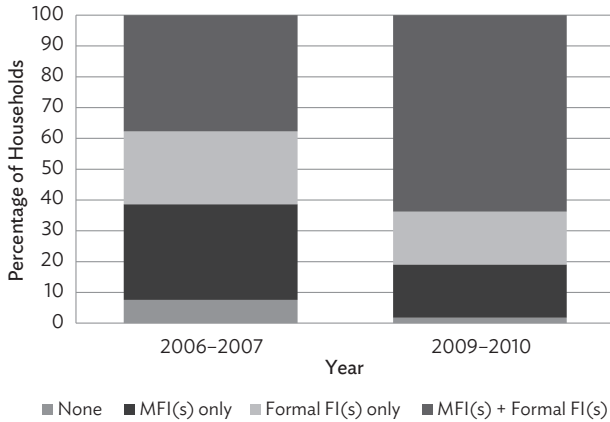
Empirical evidence suggests a high level of financial access in Sri Lanka. GTZ ProMiS (2008) found that 82.5% of households in the country accessed financial institutions (formal and semiformal) for loans and savings in 2006–2007. Moreover, a two-period survey covering 47 Grama Niladari divisions from three districts revealed that around 92% of households had accessed financial institutions by 2006–2007. This increased to over 98% by 2009–2010,² dropping the share of households that had not accessed financial institutions for loans and/or savings to around 2% (Tilakaratna 2012). The study also found that access to financial institutions was high across all income groups, with only around 2%–3% of households from the bottom two income quintiles having neither borrowed nor saved with a financial institution. This is a remarkably high level of financial inclusion for a developing country, and is much higher than in the rest of South Asia.

A considerable share of households across all income groups have accessed both MFIs and formal financial institutions like commercial banks. This is contrary to the conventional wisdom that low-income groups are excluded from the formal financial sector. As shown in Figure 8.4, about 64% of households access both formal financial institutions like commercial banks and MFIs for their financial needs, and the share of households accessing both types of financial institutions has increased significantly in recent years, from about 38% in 2006–2007 to 64% in 2009–2010. Interestingly, a considerable share of households in the lowest income groups also accesses commercial banks for their financial needs.

These findings reveal that the microfinance and mainstream financial sectors, conventionally believed to serve distinct market segments, have overlapped in Sri Lanka in recent years, serving the financial needs of a broader group of households across a range of income groups. Commercial banks and other formal financial institutions have moved down-market, providing financial services to lower income groups, while some MFIs have diversified their services and products, enabling them to attract clients from middle and higher income groups. This convergence between the two sectors has greatly contributed to the high level of financial access and increasing multiple “clientship” (i.e.,

² The first round of this survey was carried out from October 2006 to February 2007, and the second round from December 2009 to March 2010.

Figure 8.4: Share of Households Accessing Financial Institutions by Type of Financial Institution, 2006–2007 and 2009–2010
(% of households)



FI = financial institution, MFI = microfinance institution.

Source: Tilakaratna (2012).

the accessing of multiple financial institutions) in Sri Lanka's financial sector (Tilakaratna 2012).

Pawning (gold-pledged loans) is one of the key reasons for the widespread use of commercial banks among lower income households. As pawning facilities can be obtained instantly without any guarantee or compulsory savings, and involve no regular repayment schedules, low-income households use them widely to meet their emergency financial needs. Many banks have also made pawning facilities available to clients on attractive conditions (e.g., with loan extensions, possible renewals, and loan amount increases based on gold prices). However, only a handful of MFIs, such as CRBs and some TCCSs, are currently licensed to provide pawning facilities. Safe and reliable savings facilities are another reason why households across all income groups access formal banks. GTZ ProMiS (2008) found that nearly 70% of households in the lowest income quintile that have savings at a financial institution had saved with formal (state-owned) banks like the People's Bank and the Bank of Ceylon. However, only 23% of households in this quintile had accessed these banks for credit facilities (largely for pawning and subsidized agricultural loans). These banks also offer other financial services such as remittances, foreign exchange, and current account facilities that are not available from MFIs.

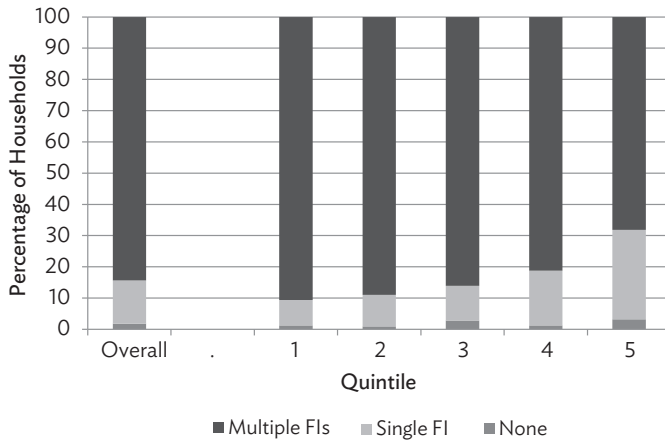
While some formal financial institutions like commercial banks have moved down-market to serve lower income groups, many MFIs have also extended their operations up-market to reach successful clients and those in middle and even higher income groups. Some MFIs, like cooperatives, offer higher rates of interest on savings than regulated banks, thereby attracting savings from members as well as nonmembers (the latter largely being better-off households). In addition, some MFIs operate during weekends and have longer working hours, providing clients with more convenient service. Such flexible services together with higher interest rates have allowed MFIs, such as CRBs and some well-developed TCCSs, to attract savings from higher income groups. Furthermore, some MFIs are gradually moving away from their initial objective of poverty alleviation or income generation among low-income groups, to become more profitable and financially viable institutions. They encourage relatively better-off households (with better repayment capacities) to join them, either by offering relatively larger loans or through special credit schemes targeting higher income groups. Such developments have led to an overlapping clientele served by both the formal financial and microfinance sectors, contributing to higher levels of financial access and increasing multiple “clientship” in Sri Lanka’s financial sector (Tilakaratna 2012).

8.4.2 Access to Multiple Financial Institutions

With the growth and expansion of financial institutions in the post-2000 period, households accessing multiple financial institutions has become a common phenomenon in Sri Lanka. Tilakaratna (2012) found that, on average, the share of households accessing multiple financial institutions for their credit and savings needs had increased from an already high level of 60.2% in 2006–2007 to around 84.0% by 2009–2010. The average number of financial institutions accessed by one household increased from 1.9 in 2006–2007 to 3.0 in 2009–2010. As shown in Figure 8.5, a large share of households across all income groups accessed multiple financial institutions, with a relatively higher share in higher income groups. For instance, around 68% of households in the lowest income quintile had accessed multiple financial institutions, compared with more than 90% in the highest income quintile. Moreover, the majority of multiple client households across all income groups had accessed a mix of MFIs and formal financial institutions like commercial banks.

Increasing levels of multiple borrowing (i.e., households borrowing from multiple financial institutions) has become an issue of concern in Sri Lanka’s financial sector. Multiple borrowing is particularly high in the microfinance sector, and has increased since the mid-2000s. As shown

Figure 8.5: Access to Financial Institutions by Income Group, 2009–2010



FI = financial institution.

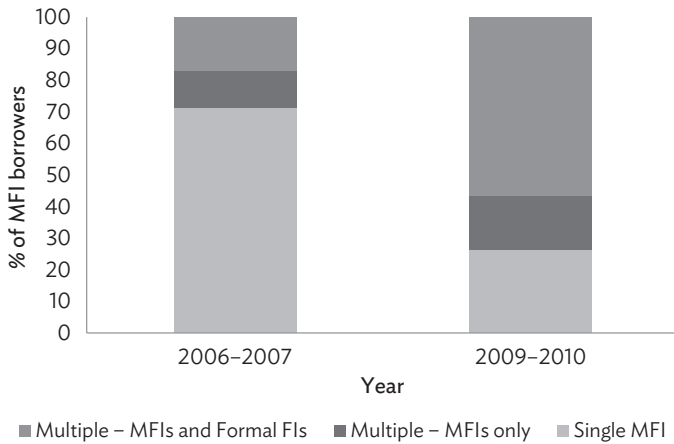
Note: Quintile 1 refers to the highest income group, while quintile 5 is the lowest income group.

Source: Tilakaratna (2012).

in Figure 8.6, about 74% of MFI borrowers access loans from multiple financial institutions. Most multiple borrowers access a mix of MFIs and formal financial institutions like commercial banks (the latter being used largely for pawning facilities). Multiple borrowing is seen across all income groups (Tilakaratna 2012, 2013; Tilakaratna and Hulme 2013).

While household access to multiple financial institutions suggests a high level of financial inclusion in the country, empirical evidence shows that household debt levels have increased, particularly among households that borrow from multiple financial institutions. Tilakaratna and Hulme (2013) found that the average debt–income ratio among MFI borrowers—an important indicator of borrower indebtedness—increased from 10.5% in 2006–2007 to 13.0% in 2009–2010, indicating an increase in the level of household debt (or indebtedness) during this period. In particular, the debt–income ratio of households borrowing from multiple MFIs and/or multiple financial institutions had increased to 15.3% by 2009–2010. Although debt levels are still at moderate levels, given the increasingly high level of multiple borrowing in the microfinance sector, careful monitoring of multiple borrowing and borrowers' repayment capacity is needed to minimize any adverse effects on borrowers, as well as on institutions.

Figure 8.6: Extent of Multiple Borrowing in the Microfinance Sector, 2006–2007 and 2009–2010



FI = financial institution, MFI = microfinance institution.

Source: Tilakaratna and Hulme (2013).

A number of factors have contributed to the high level of household financial access in Sri Lanka, key among which is the wide network of both formal and semiformal financial institutions—like banks, leasing and finance companies, cooperative societies, and MFIs—with over 14,000 access points and multiple financial institutions operating in many areas of the country. The role of the government as a provider of financial services (through state-owned banks, microfinance programs like Samurdhi, and subsidized credit programs) and as a facilitator is also an important factor. For instance, the Samurdhi's Savings and Credit Program, which operates through over 1,000 banking societies, provides credit and savings facilities for more than 2 million clients.

Another important factor contributing to the high level of financial access in Sri Lanka is the availability of a range of financial services and products, including (i) savings products such as ordinary savings, fixed deposits, children's savings, and special savings products for women and the elderly, for example; (ii) different loan types, such as housing, income-generation, and consumption loans; (iii) pawning; (iv) money transfer facilities; and (v) insurance through financial institutions. Relatively good infrastructure facilities and the country's geographic characteristics, such as its small size and high population density, in conjunction with relatively high literacy and low poverty levels, have

also contributed to the high level of household financial access, at least indirectly.

8.4.3 Recent Measures to Improve Financial Inclusion and Gaps in the System

Financial regulators and service providers have taken various measures to increase financial inclusion in Sri Lanka. According to Jayamaha (2008), recent initiatives by the CBSL and leading commercial banks have enhanced financial inclusion. Some of these measures include (i) the provision of 10% mandatory credit to agriculture by the banking system, (ii) the setting up of a credit and debit management council by the Central Bank, (iii) the upgrading of post offices to provide banking and financial services, and (iv) the setting up of agency banking through mobile phones. The CBSL has also made it mandatory for banks to open two branches in rural areas for every branch opened in metropolitan areas.

In 2002, Lanka Clear was established as a national check clearing house and inter-bank payment system; it was transformed in 2012 to a national payment infrastructure provider that basically facilitates domestic transactions via electronic payments. Lanka Clear already covers a little over half of Sri Lanka's ATMs (about 3,000) (Warushamana 2014).

Recently, commercial banks have embarked on a strategy to mobilize savings from the poor. Rural trade fairs, religious festivals, and cultural events are key events targeted for this purpose. Mobile banking units are used, and attractive interest rates are offered.³

Technology has also played an important role in banks' rural outreach. A good example of this is the National Savings Bank's "point-of-sale deposits", where bank representatives visit rural homes with point-of-sale electronic devices that connect to a well-known mobile phone network, take deposits, and provide instant electronic confirmation to the depositors. These point-of-sale devices have increased both the number and value of monthly transactions for many bank branches (Ratwatte 2013).

Commercial banks have also introduced several measures to provide financial services to migrant workers. Migrant remittances are the highest foreign exchange earner in Sri Lanka, at close to \$6 billion and amounting to 10% of the country's gross domestic product. It is

³ Hatton National Bank has successfully mobilized rural deposits through its Gami Diriya program.

estimated that close to 45% of all migrant remittances are sent through informal channels. To try to capture such transfers, commercial banks have introduced e-remittances such as internet banking and e-cash, x-press money, MoneyGram, EZ money, and Telemoney. However, no data is available on how successful these programs have been in making inroads into the informal remittance channels.

Although financial inclusion is now relatively high in Sri Lanka, the usage of information technology (IT)-based financial instruments, such as debit and credit cards, phone banking, and e-banking, remains low. According to Colombage (2011), only 0.1% of the population uses phone banking, and according to the Central Bank (2009, 2012, 2013), the value of retail transactions as a percentage of the total value of the non-cash payments share of credit cards increased marginally from 1.3% in 2009 to 1.4% in 2013. The same share for debit cards increased marginally from 0.2% in 2009 to 0.5% in 2013.⁴ These shares are very low, given that close to 1 million credit cards and 10 million debit cards were in circulation in the economy by 2013 (Warushamana 2014). Although e-banking is still in its early days in Sri Lanka, it is positively related to financial awareness, financial education, and income levels.

Another anomaly in the Sri Lankan financial system is low insurance coverage despite a high level of access to financial institutions. In the late 1990s, around 12% of the population was covered by insurance schemes (Kelegama 1998), which has shown some increase since the early 2000s, due to private participation and banks entering the insurance business. Many MFIs have also extended their outreach to new areas, including the north and east of the country in particular, and expanded their services beyond credit to savings and microinsurance, among others.

Overall, Sri Lanka has a wide network of financial institutions providing households and individuals with access to a range of different financial services such as savings (voluntary and compulsory savings, ordinary savings, and time-deposits), loans, leasing and finance services, insurance, and pawning, money transfer, and remittance facilities. Despite the growth and expansion of financial institutions, a number of gaps in the current financial system must be addressed, including those found in the cost and quality of services provided, the sustainability of financial institutions (particularly MFIs), clients' knowledge of the characteristics and details of financial services and products, and repayment capacity (i.e., financial education). The current regulatory framework and level of financial literacy are discussed in sections 8.5 and 8.6.

⁴ This estimation is based on Table 8.12 of the CBSL Annual Report (2009) and Table 8.19 of the CBSL Annual Report (2013).

It is important to note that, despite the high level of financial access enjoyed by households and individuals, many of Sri Lanka's small and medium-sized enterprises (SMEs) face barriers to accessing adequate funds. Although the available data do not adequately show SMEs' level of access to finance, several studies have identified access to finance as a key constraint faced by many SMEs in Sri Lanka (IPS 2002). High interest rates and collateral requirements are two key barriers that SMEs face in accessing finance.

8.5 Financial Regulation

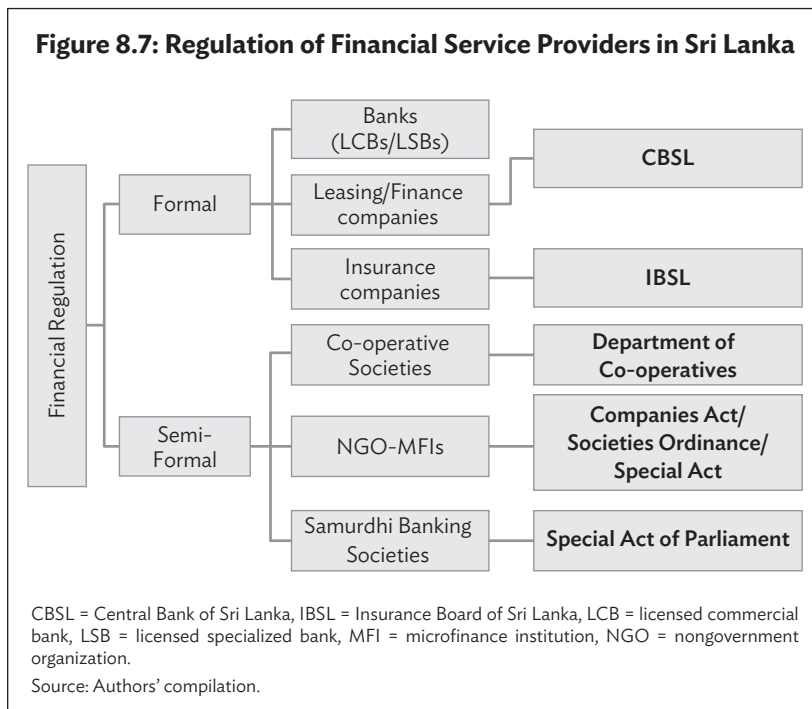
A sound regulatory framework for the financial sector is crucial to achieve financial inclusion. This section briefly analyzes the Sri Lankan financial sector by discussing the regulatory framework for the formal sector, the regulation and supervision of MFIs, and the gaps in the current framework.

8.5.1 Formal Financial Sector

The CBSL is the foremost regulatory authority for LCBs, LSBs, finance companies, finance leasing companies, and primary dealers. Since 2002, the regulatory framework and practice of bank supervision have been strengthened (ADB 2009). The CBSL initiated risk-based supervision and has introduced new risk management and governance requirements for authorized institutions. In the wake of the 2007 credit boom, the CBSL increased risk weighting for residential mortgage loans and introduced a general requirement for all performing advances. In addition, in 2002, the capital adequacy requirement was increased to 10% (CBSL 2012) of risk-weighted assets, in line with the Basel Committee recommendation that capital requirements in excess of 8% are warranted in countries where preconditions for effective banking supervision are not in place (ADB 2009). In 2008, this was developed further through the adoption of a modified version of Basel II; this had a modest strengthening effect, since the introduction of an operational risk capital levy seems to offset reductions in risk weighting significantly for certain assets (ADB 2009). The overall consequence of this has been the reduction of reporting capital adequacy by 80–100 basis points, requiring banks to hold capital to sustain the same capital adequacy proportion. However, the positive effect of firming up capital requirements is undermined by weaknesses in loan classification and provisioning.

Insurance firms are supervised by an independent supervisory authority, the Insurance Board of Sri Lanka, which was established in 2001. Contemporary approaches toward insurance regulation and supervision are developed and implemented progressively, and would be enabled by the new insurance legislation currently under consultation (ADB 2009). Although Sri Lanka has removed tariff controls, the condition introduced for insurance firms to place up to 50% of their reinsurance business with the state-owned National Insurance Trust Fund is a very substantial and direct government intervention in the industry to keep reinsurance business onshore, and may reduce insurance firms' ability to spread their risk.

Figure 8.7: Regulation of Financial Service Providers in Sri Lanka



8.5.2 Semiformal Sector

The current regulatory framework for MFIs is a rather weak and fragmented one, under which different institutions are regulated by different departments, ministries, and laws. Differences in the methods and standards of supervision, and the absence of a single regulatory

and supervisory body have resulted in a lack of uniform standards and a failure to develop a common direction (GTZ ProMiS 2010b). This is a major challenge currently facing Sri Lanka's microfinance sector.

The CBSL only regulates a few microfinance providers, like the Regional Development Bank and Sanasa Development Bank, which are categorized as LSBs. Nonbank MFIs, like NGO MFIs, cooperatives, and Samurdhi banking societies (SBSs), are governed by different bodies and acts (Figure 8.6).

NGOs involved in microfinance activities can be registered under three main acts: (i) the Companies Act No. 7 of 2007; (ii) the Societies Ordinance of 1891 (as amended by Act Nos. 17 of 1926, 14 of 1932, 55 of 1949, 16 of 1981, and 11 of 2005); and (iii) a Special Act of Parliament. Most smaller NGOs are registered under the Societies Ordinance, as it is the simplest method; registering under a Special Act is the most complicated method, requiring NGOs to arrange a bill and publish a notice in the government gazette and the newspapers. Although an NGO can operate without being registered under any of these acts, it is difficult for an unregistered NGO to attract external funds. International NGOs (INGOs) operating in Sri Lanka are not legally required to be registered under any act; however, before starting operations, INGOs normally sign a memorandum of understanding with the Ministry of Policy Planning and Implementation, or an agreement with the Director of External Resources (McGuire, Conroy, and Thapa 1998; GTZ ProMiS 2010a).

NGOs (or INGOs) are not permitted to mobilize savings from their members or nonmembers. As per the Banking and Finance Acts of 1988, an institution must be licensed as a bank or finance company to be eligible to collect deposits from members or nonmembers, even in the form of compulsory savings. Cooperative societies (TCCSs and CRBs) and SBSs are exceptions that are allowed to mobilize savings from their members (as well as nonmembers) under the acts that regulate them. However, in practice, many NGOs mobilize savings from their members as compulsory savings or loan securities.

Cooperatives such as TCCSs and CRBs are governed by the Co-operative Societies Act of 1972 amended by the Acts of 1983 and 1992, and regulated by the Department of Co-operative Development. Cooperatives registered under this act are allowed to receive deposits from both members and nonmembers. However, the lack of prudential regulation of these societies often bars them from attracting deposits from nonmembers on a large scale (McGuire, Conroy, and Thapa 1998; GTZ ProMiS 2010a). SBSs come under the purview of the Samurdhi Authority of Sri Lanka, which was established under the Samurdhi Authority of Sri Lanka Act No. 30 of 1995. Samurdhi is currently one of the largest microfinance programs in the country, with a network of 1,042

SBSs and over 34,000 village-level societies, and serving over 2 million clients. By law, SBSs are allowed to accept deposits from their members, as well as nonmembers residing within their operational areas.

The establishment of a sound regulatory and supervisory framework for the microfinance sector has long been perceived as necessary to ensure MFIs' financial soundness, and build confidence in them among depositors, borrowers, and funders. Many have argued for a strong regulatory framework to monitor MFIs (Ratwatte 2013). Sound regulation of MFIs would help them attract both external and internal resources (savings), thereby ensuring the organizations' sustainability, protecting clients, and achieving financial inclusion. The Microfinance Act of Sri Lanka that came into effect in July 2016 is expected to address many of these issues and allow the MFIs that are registered and/or licensed under this act to mobilize savings from their members and/or clients.

8.7 Financial Education

Developing financial capability and enhancing financial literacy are critical to achieve financial inclusion in a country. These factors play an important role in raising financial awareness, and increasing knowledge, skills, and capability among individuals and households. They can also help borrowers assess their repayment capacity and thereby prevent them from over-borrowing and becoming over-indebted. Financial literacy can be developed through financial education, a process in which both the client and provider play pivotal roles. Providers of financial services should be transparent and disseminate accurate information to their clients.

Empirical evidence suggests that financial education enables individuals to develop awareness about the financial products and services available to them, and helps them become familiar with the characteristics and details of such products. It is important to design financial education programs with well-defined priorities, not only to develop financial numerical skills, but also to create awareness about financial products and financial planning tools. This is likely to enhance financial literacy further (Carpena et al. 2011).

In Sri Lanka, measures to enhance financial literacy have been rather ad hoc, and there is no national financial education policy. Service providers such as MFIs and CBOs have made various efforts to increase financial awareness and develop financial skills, but, overall, financial education measures targeting low-income households remain inadequate. The CBSL also plays an important role in sensitizing the

public to the registered financial institutions (regulated and supervised by the CBSL), and the risks of investing with unregistered financial institutions, Ponzi schemes, and others. The CBSL also occasionally issues circulars and newspaper advertisements featuring registered financial institutions, and sensitizing the public to e-banking, such as savings through the mobile banking facilities of some commercial banks, e-cash remittances, and other means. Despite such efforts, the use of services such as e-payments and ATMs remains low. This is due in part to a lack of knowledge about these products among the majority of households, and low-income groups in particular.⁵ Field research confirms that knowledge about interest rates charged by financial institutions and loan repayment conditions remains very limited among low-income households.

In the above context, it is of key importance to improve financial education among households, in particular those from low-income groups. This is particularly necessary given the growth and multiplicity of financial institutions, the increase in multiple borrowing, and the consequent rise in household debt. Financial education can play an important role in helping clients understand the details of financial services and products, loan repayment conditions, interest rates, and their repayment capacity, thereby protecting them from over-borrowing and over-indebtedness.

8.8 Conclusions

Sri Lanka enjoys a high level of access to financial institutions, compared with other South Asian countries. Its financial sector comprises a wide range of financial institutions—both formal and semiformal—providing a wide variety of financial services, such as loans, savings, pawning, leasing, and finance, as well as remittance and money transfer facilities. There is evidence of multiple financial institutions operating in the majority of the country's Grama Niladari divisions, with a larger share of households accessing multiple financial institutions for their credit and savings needs. Access to multiple financial institutions is common across all income groups, and a considerable share of households across all income groups access both formal financial institutions like LCBs and MFIs. This implies that the microfinance and formal financial sectors, which served distinct market segments in the past, have converged

⁵ Financial education lags behind financial innovation and new products. The IT literacy rate is still only 35% in Sri Lanka; with the growing IT-finance nexus, financial awareness and education are becoming increasingly important.

and now cater to the financial needs of a broad group of clients. The role of the state as a provider and facilitator of financial services, the diversity of financial institutions and services, relatively high human development, and good socioeconomic conditions and infrastructure facilities are some key factors contributing to the high level of financial access in Sri Lanka.

Despite the high level of access to financial institutions for loans and savings facilities, the use of insurance services, remittances (through formal channels), ATM facilities, e-payments, and mobile banking remains low. This is partly due to a lack of awareness of these services among low-income groups. Technological innovations, such as mobile banking, can help increase financial inclusion in the country by reducing the transaction costs of reaching out to those in remote areas. The cost of taking financial services to unbanked communities is high due to various factors, such as small pockets of communities, wide geographical spread, and a lack of manpower and supervision. The challenge for banks will be to identify cost-effective and user-friendly delivery channels. For instance, a cost-effective approach could be for LCBs to use existing operators in the field, such as NGOs and moneylenders, which have firsthand knowledge of credit risks and people's consumption needs. It has also been suggested that the LCBs work to entice those people involved in *seettu* systems to move to formal banking systems (Gunawardena 2007).⁶

In the telecommunications industry, prepaid calling cards have provided rural people with access to mobile phones. Short messaging service banking using local languages may be a way to integrate e-banking with the rural population. Technology-based delivery channels have proven most effective for rural areas.

Client protection is also critical given low financial literacy levels in Sri Lanka. Standards should be set to promote transparency, fair practice, and the accountability of financial service providers. Financial literacy also needs to be improved, particularly among low-income groups. Moreover, high and increasing levels of multiple borrowing in the microfinance sector and a consequent rise in debt levels among MFI borrowers highlight the need for careful monitoring of multiple borrowing and credit information sharing among MFIs, along with client protection measures. At present, membership of the Credit Information Bureau of Sri Lanka is mandatory only for formal financial institutions such as LCBs, LSBs, and leasing and finance companies, while most

⁶ *Seettu* is the traditional system of savings and credit in Sri Lanka. For further details, see <http://www.gdrc.org/icm/inspire/womenbank.html>.

MFIs remain unintegrated in the Credit Information Bureau. MFIs are also reluctant to share client information due to the weak regulatory environment in the sector. However, given rising levels of multiple borrowing, there must be a mechanism to share the credit information of the MFIs' borrowers as well.⁷

Designing the right regulatory infrastructure and policy mix is also crucial to achieve financial inclusion. This requires finding the right balance between protecting clients and fostering an environment that encourages financial inclusion. The current regulatory framework of Sri Lanka's microfinance sector is fragmented, with different types of MFIs being regulated and supervised by different laws and bodies. Moreover, the laws largely restrict NGO MFIs from accepting deposits from their members, making them heavily dependent on external funds. In this context, it is important to allow MFIs to accept deposits from their clients to ensure the institutions' viability, while supervising them under a sound regulatory framework to enhance the depositors' credibility. Regulations should be designed to allow MFIs to raise funds from multiple sources to enable them to create a diverse mix of financial products with appropriate risk management. Policies should be designed to incentivize good financial performance; subsidies from the government and donors should be used to complement, but not compete with private capital. In addition, the regulatory infrastructure should encourage technological innovations such as mobile banking to help improve financial inclusion in Sri Lanka.

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⁷ Establishing a microfinance credit information bureau presents many challenges, even in Bangladesh, which has many years of experience with microcredit (Islam 2014).

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9

Thailand

Kanittha Tambunlertchai

9.1 Introduction¹

Financial inclusion is, and has been, an important goal in Thailand's development agenda. This is in line with the widely held view and recent empirical evidence suggesting that access to financial services positively impacts the lives, livelihoods, and well-being of low-income households, as well as the income, size, and investments of microenterprises in low-income and emerging economies (Bauchet et al. 2011; Honohan and King 2012; Cull, Ehrbeck, and Holle 2014). A recent survey by the Bank of Thailand (BOT) showed that the country has a relatively high rate (88%) of utilization of financial services (BOT 2014a). However, promoting access to appropriate and adequate financial services is still relevant in light of the country's large informal sector, persistent income inequality, a large rural population living below the poverty line, the proliferation of small and medium-sized enterprises (SMEs), and the high household debt to gross domestic product (GDP) ratio.

This chapter addresses the issue of financial inclusion in Thailand through an institutional analysis that takes into consideration the desired outcomes, as well as the actors who provide or enable the provision of financial services, and the institutional contexts, of financial regulation and education that shape financial inclusion in the country. This chapter aims to (i) provide an overview of the current status of financial inclusion, regulation, and education in Thailand; (ii) identify gaps and obstacles impeding the achievement of financial inclusion in the country; and (iii) provide policy recommendations based on (i) and (ii).

¹ The author thanks Yothin Jinjarak; the participants of the Asian Development Bank Institute (ADBI) Financial Inclusion, Regulation, and Education Conference; and the participants at the BOT Economic Seminar held in August 2014 for their helpful comments on earlier versions of this work.

In meeting these three objectives, this chapter primarily focuses on financial inclusion of the marginally and wholly excluded, not including those able to access finance, but who choose not to (the self-excluded). The targeted groups mostly comprise low-income individuals and small businesses, the majority of which operate in the informal sector. Thus, this chapter primarily focuses on the provision of products and services specific to these groups, or microfinance.

9.2 Institutional Analysis Framework and Sources of Survey Data

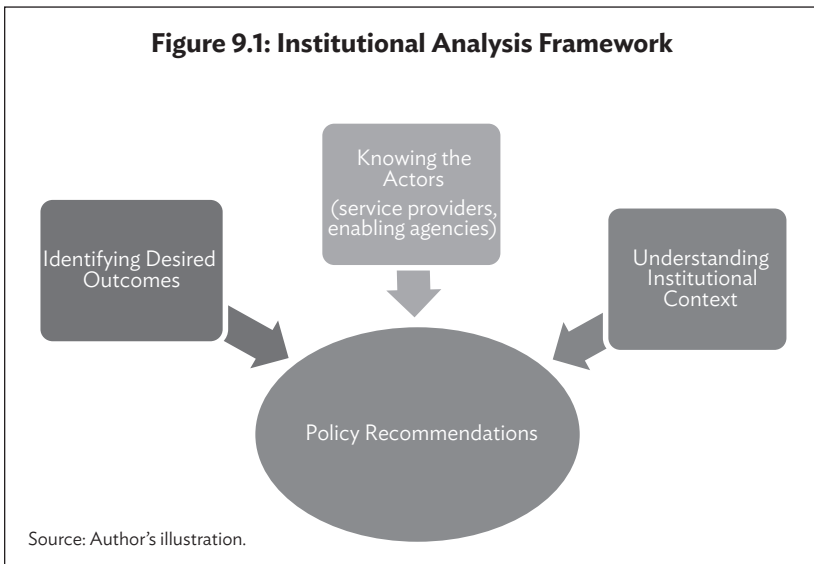
9.2.1 Institutional Analysis Framework

To understand and assess financial inclusion in Thailand in terms of access to financial services and the contexts of financial regulation and education, this chapter draws on, and adapts to suit its purposes, the conceptual framework of institutional analysis provided by the International Fund for Agricultural Development (IFAD) (2009). In this chapter, the term “institutions” is used broadly to encompass organizational actors, as well as the institutional contexts of financial regulation and education. Economists and others often define institutions as the “rules of the game” (North 1993). They are, as Douglass North (1991: 97) puts, “humanly devised constraints that structure political, economic and social interaction.” Institutions are distinguished from “organizations,” which have been described as the “players” (North 1993). Organizations are often defined as formal or informal groups or associations with clear and accepted roles, positions, and responsibilities. Organizations usually have structured relationships with each other to achieve specific objectives (Lobo 2008). These definitions are adopted here.

The issue of financial inclusion is analyzed through the lens of the institutional analysis framework proposed by IFAD for several reasons. First, there is an emerging consensus among economists and other social scientists that institutions matter, both in terms of a country’s economic performance (North 1990) and determining access to resources, which, in turn, influence incidences in poverty (Uphoff 1992; Dasgupta and Mäler 1994; Grootaert and Narayan 2004). Thus, to analyze financial inclusion, for which low-income groups’ access to financial services is key, it is necessary to analyze the institutions and actors involved. Second, the theme of microfinance in this chapter fits with the focus on

poverty, which is the objective of an IFAD institutional analysis. Third, as the issue of microfinance is multifaceted by nature, a holistic analysis is needed to comprehend and evaluate the array of institutional factors that affect the issue's many dimensions. The institutional analysis developed by IFAD does this by providing a coherent framework, which makes it possible to identify and assess the relevant institutions and organizational actors. Fourth, one of the goals of an IFAD institutional analysis is to identify development strategies that not only offer holistic solutions to the issue of poverty, but also facilitate the formulation of policies that address poverty's structural causes. This is in keeping with this chapter's third objective.

According to IFAD (2009), the central concern of an institutional analysis should be the outcomes achieved, including the desired progress to be made. Another key goal of the analysis is to identify the main service providers and enabling agencies that offer and/or foster microfinance. Their roles should be identified and analyzed to ensure an understanding of the institutional factors that influence the desired outcomes. Furthermore, since the functions and performance of these agencies depend on their institutional context, it is also important to outline and assess the underlying institutional setting. In considering financial inclusion, this institutional context includes financial regulation, which provides the regulatory context, and financial



education, which provides the enabling context. Once these components of the institutional analysis are established, strategies for institutional change can be formulated. The institutional analysis process is depicted in Figure 9.1.

9.2.2 Sources of Survey Data

A variety of databases that provide detailed information on financial access and literacy levels among individuals, households, and SMEs in Thailand were used, including the World Bank Global Financial Inclusion (Global Findex) database, and several in-country surveys of individuals, households, and SMEs.

Information on financial inclusion and financial literacy from the perspective of individuals and households primarily comes from two surveys conducted by the BOT (2014a; 2014b) and FinScope Thailand,² both of which gathered their data in 2013. The BOT survey sampled 10,613 household representatives in all regions of the country, both urban and non-urban. FinScope Thailand is a nationally representative survey of both urban and non-urban residents, and also covers all regions of the country. The FinScope survey first selected households randomly, then selected individuals within the households using a Kish grid. A total of 5,990 individuals were sampled.

Information on SMEs' access to financial services comes from two main sources: (i) a 2010 survey conducted by the Office of Small and Medium Enterprises Promotion (OSMEP) of 805 small, medium-sized, and large enterprises in three main business sectors—wholesale, retail, and service (small enterprises accounted for 85% of the sample size); and (ii) Punyasavatsut (2011), who collected data on financial access for SMEs in the manufacturing sector in 2010 (100 firms of all sizes were sampled, but SMEs dominate the sample). A third source of data focuses specifically on small enterprises, and is from the OSMEP's Microenterprises Report for 2010 (OSMEP 2010). The sample is made

² The FinScope Survey is a research tool developed by FinMark Trust. It forms part of the Making Access Possible (MAP) diagnostic and programmatic framework that supports enhancing access to financial services. MAP partners are the United Nations Capital Development Fund, FinMark Trust, and Cenfri. MAP Thailand represents a collaboration between MAP partners and the Asian Development Bank (ADB), and forms part of the ADB technical assistance for the Development of a Strategic Framework for Financial Inclusion in Thailand. The Bureau of Financial Inclusion Policy and Development hosts the technical assistance at the Ministry of Finance (MOF) in Thailand. Inputs into adapting the FinScope questionnaire to suit the Thai context come from a task force involving various key government and research agencies in Thailand.

up of 1,161 microfirms³ countrywide. Information is drawn from a review of the roles and objectives of existing microfinance organizations and enabling agencies, and from a survey of the relevant financial inclusion literature. This includes the literature concerned with access to financial services, levels of financial literacy and skills, and financial regulation.

9.3 Historical and SocioEconomic Contexts

Thailand is an upper-middle-income country with a population of 68 million and a GDP of \$395.2 billion.⁴ Initially a primarily agricultural economy, Thailand underwent rapid industrialization beginning in the 1950s. From the 1960s until the early 1990s, the country experienced sustained and rapid growth, with low and stable rates of inflation. GDP growth peaked in the early 1990s, averaging 9.1% per year in the first half of the decade. However, the 1997–1998 Asian financial crisis ended this era of rapid growth, and the country’s economy shrank by 1.4% in 1997 and by 10.5% in 1998 (Economist Intelligence Unit 2012). Although the economy has since recovered and growth has been positive, the earlier pace of growth never reappeared.

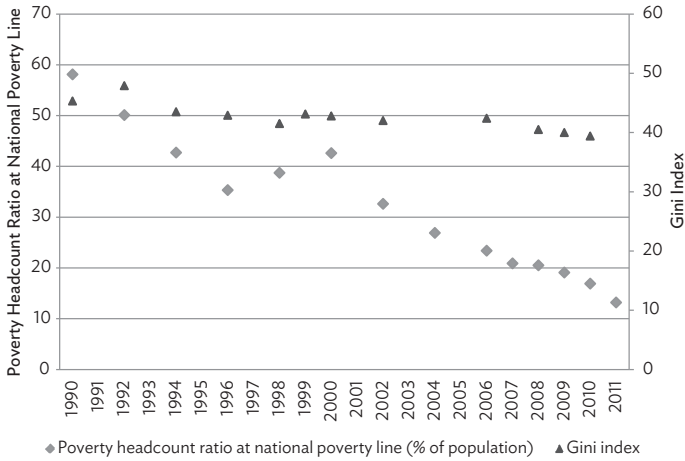
The financial crisis permanently changed the financial sector. At the height of the crisis, over 50 financial institutions were deemed insolvent and forced to close. Other institutions in the formal financial sector were acquired and recapitalized, and debt-restructuring mechanisms established. Once the immediate crisis had been contained, sector reforms were implemented, with the aim of first stabilizing the sector and then to strengthen and insulate it against any future crises. Only after the formal financial sector had been sufficiently strengthened did reform efforts begin to focus on extending financial access, on consumer protection, and on financial education.

Sustained periods of rapid growth with moderate inflation decreased the poverty rate in Thailand, with 10.5% of the population living below the national poverty line in 2014 (World Bank 2016). Despite a marked reduction in poverty rates, income inequality has persisted, and the Gini index showed little change between 1990 and 2011, despite decided declines in the incidence of poverty over the same period (see Figure 9.2). The data show that poverty is a rural phenomenon, with 88.8% of the poor living in rural areas and 11.2% living in urban areas

³ OSMEP defines microenterprises as enterprises with no more than five workers and that are not registered as companies.

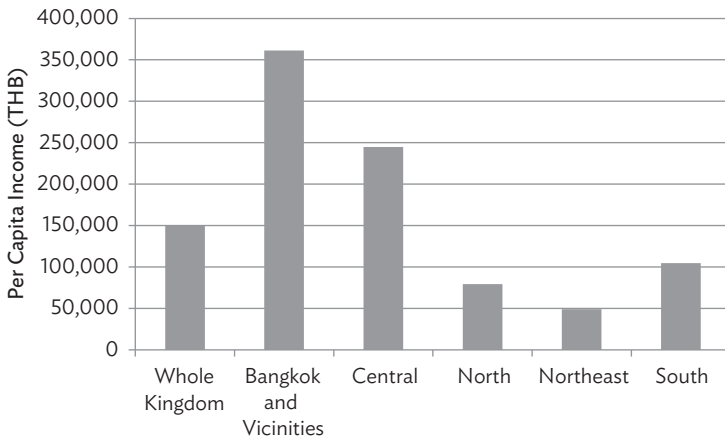
⁴ United States dollars, 2015 prices.

Figure 9.2: Poverty Headcount Ratio at the National Poverty Line and Gini Index



Source: World Bank (2014).

Figure 9.3: Per Capita Income by Region, 2010



Sources: Author's calculations; National Economic and Social Development Board (2014).

(World Bank 2014). Bangkok and the central region have the most modern industrial and commercial sectors, as well as the highest per capita income (see Figure 9.3). On average, residents of Bangkok and the surrounding provinces earn more than twice the national average, while per capita income in the central region is 1.63 times the national average. The northeast, north, and south regions, which are primarily agrarian, are the poorest; per capita incomes are one-third the national average in the northeast, half the national average in the north, and two-thirds the national average in the south. The northeast also has the highest rate of migration to other regions, while Bangkok receives the highest proportion of migrant workers (85.2%) (National Statistical Office [NSO] 2013).

Thailand has a large informal sector and a large number of small enterprises. Of its total labor force of almost 40 million people, 62.0% work in the informal sector. While only 32.6% of the total labor force works in agriculture,⁵ 62.5% of these are informal workers. The northeast and north regions, the two poorest in the country, account for the largest shares of informal workers (41.5% in the northeast and 21.4% in the north) (NSO 2011). With such a large informal labor force, and with many low-income individuals living in rural areas and working informally, financial inclusion in Thailand means providing financial services for low-income groups, informal workers, and rural residents.

As in many developing countries, SMEs form an important part of Thailand's economy, and small enterprises account for a large share of these (see Table 9.1). SMEs contribute 37% of the country's GDP, and employ 80.4% of all enterprise employees in Thailand (see Table 9.2).

Table 9.1: Numbers and Proportion of Enterprises of Different Size Categories

	Number of Enterprises	% of All Enterprises
Small and Medium-Sized Enterprises	2,739,142	98.5
Small Enterprises	2,724,902	97.9
Medium-Sized Enterprises	14,240	0.6
All Enterprises in Thailand	2,781,945	100.0

Source: OSMEP (2013).

⁵ The NSO defines the informal labor force as composed of workers who lack employment security and have no protection or benefits from their employers.

Table 9.2: Contribution to Gross Domestic Product and Share of Employment by Enterprise Size

	Contribution to GDP (%)	Share of Employment in All Enterprises (%)
Small and Medium-Sized Enterprises	37.0	80.4
Small Enterprises	24.8	71.8
Medium-Sized Enterprises	12.2	8.6

GDP = gross domestic product.

Source: OSMEP (2013).

SMEs can be found in all business sectors; the wholesale, retail, and automotive repair sector accounts for the highest number of businesses, followed by the service and manufacturing sectors. SMEs can be registered as juristic persons or not, and are mostly located in large cities such as the capital (Bangkok), the central plains, Chiangmai Province in the north, and Chonburi Province in the east (OSMEP 2013). As such, efforts to extend the provision of financial services to SMEs that are currently financially underserved or unserved should focus on service providers in more urban areas. In contrast, low-income householders, the other intended targets for financial inclusion, tend to live in rural areas.

9.4 Desired Outcomes of Financial Inclusion and Policies of the Government of Thailand

In terms of financial inclusion, the desired outcomes for Thailand can be drawn both from the international discussion on financial inclusion and from domestic development and financial sector-specific goals.

9.4.1 Desired Outcomes of Financial Inclusion: An International Perspective

The Consultative Group to Assist the Poor (CGAP), a collaboration of 34 organizations that seek to further financial inclusion worldwide, defines financial inclusion as follows:

households and businesses have *access* and can effectively use *appropriate financial services*. Such services must be provided *responsibly* and *sustainably*, in a *well-regulated environment* (CGAP, italics added).

At a high-level side-event at the United Nations Millennium Development Goals Summit in 2010, Queen Maxima of the Netherlands, the United Nations Secretary-General's Special Advocate for Inclusive Finance for Development, defined financial inclusion as

universal access, at a reasonable cost, to a range of financial services for everyone needing them, provided by a diversity of sound and sustainable institutions. Financial inclusion recognizes that people and businesses require a range of financial services in addition to credit-savings, payment services, remittances, insurance, just to name a few (Queen Maxima 2010, italics added).

Several common themes emerge from these two definitions. First, financial inclusion requires “universal access,” that is, the provision of financial services to everyone that needs them. Second, the services should be “appropriate,” or suited to the needs of the people, and provided at a reasonable cost, to ensure that expense is not be a barrier to usage. Finally, service providers should be sustainable institutions with responsible and sound practices. All must operate within a well-regulated environment.

From this perspective, the current availability of financial services, which are physically accessible to all, but not suited to the needs of some or prohibitively costly for others, cannot be considered as meeting the objective of universal access. Furthermore, the above definitions indicate that, not only do the services provided and costs matter, the quality of the financial services and service providers themselves are just as important in furthering the goal of financial inclusion.

9.4.2 Financial Inclusion from the Domestic Perspective

Domestically, financial inclusion is seen as a means of achieving higher development goals. This can be seen from the Eleventh National Economic and Social Development Plan (NESDP), the 5-year plan that sets out the country's development agenda for 2012–2016. The plan's overall development vision for the nation is to foster “a happy society with equity, fairness, and resilience” (NESDB 2012). This would

be achieved through six core strategies, two of which have identified different aspects of financial inclusion as measures for fulfilling these strategies.

The first strategy, the promotion of a just society, emphasizes the importance of providing the grassroots economy and SMEs with access to capital, enhancing SMEs' competitiveness, and improving and diversifying grassroots financing and savings institutions. The second strategy, which aims to restructure the economy to achieve quality growth and sustainability, identifies financial inclusion for both the grassroots economy and SMEs as an important strategic component. The relevant aspects of financial inclusion are (i) the promotion of equal access to financial resources at a reasonable cost; (ii) the encouragement of new financial products such as factoring and leasing; and (iii) the regulation of commercial banks with respect to risk management to incentivize lending to SMEs, entrepreneurs, and low-income groups. These have been identified as measures that would result in sustainable and equitable growth, and resilience at both the individual and societal levels.

The strategy relating to quality growth and sustainability also includes aspects of financial inclusion pertaining to the ability of microfinance service providers to maintain and sustain themselves. This would require not only increasing the capability, resources, and coverage of grassroots financial services, but also implementing mechanisms to link funds among microfinance groups and between such groups and financial institutions. These measures should be undertaken to foster sound financial management and savings habits at the household level.

In addition to the measures outlined above, financial education forms an important part of the strategy to promote equitable and sustainable growth. In light of the growing problem of over-indebtedness in Thailand, the Eleventh NESDP emphasizes the importance of promoting financial knowledge and information for both households and SMEs, and encouraging low- and middle-income households to save. More specifically, the plan identifies the provision of financial knowledge and information regarding savings, investment, risk management, personal financial planning, the preparation of income and expenditure accounts, and the risks of borrowing money outside the banking system as necessary to help prevent and resolve the problems of over-indebtedness in the country.

The themes of quality growth and sustainability were carried over to the Twelfth NESDP, 2017–2021. This plan focuses on reducing all aspects of inequality and increasing opportunities to access finance, capital, and resources for all, with a specific focus on the grassroots economy.

9.4.3 Other Government Policies to Promote Financial Inclusion in Thailand

The Government of Thailand has also implemented several other policies to promote financial inclusion through its various agencies. In 2011, the Ministry of Finance (MOF) requested assistance from the Asian Development Bank (ADB) to develop microfinance further and promote financial inclusion for individuals and households in Thailand. One of the outputs of this assistance was a National Strategy for Financial Inclusion in Thailand, which has been approved. This strategy aims to incentivize commercial banks to reach out to lower income groups.

This strategy is one of several broad reforms of the country's financial sector, as outlined in the Financial Sector Master Plans (FSMPs). The reforms are carried out in stages, with the second phase of the FSMP (FSMP II) running from 2010 to 2014, and the third phase (FSMP III) from 2016 to 2020.⁶ Under FSMP II, extending financial access is one of three important pillars of the reform process. To incentivize banks to lend to lower-income borrowers, the rules have been modified, new service providers with microfinance expertise have been introduced, and support has been provided to the specialized financial institutions (SFIs) that already offer services for lower-income borrowers (Meagher 2013). Incentives include the upward revision of the 15% interest rate cap set out in the Civil and Commercial Code for unsecured personal and microfinance loans,⁷ and the issuance of further guidelines to facilitate microfinance loan approvals by commercial banks.⁸ Financial access remains an important goal of FSMP III, which targets individuals, especially the elderly, and SMEs.

Efforts to promote SMEs in Thailand are more concerted than those to promote microfinance for individuals, and are organized through the SME Promotion Master Plan. Current policies for SMEs are detailed in the third SME Promotion Master Plan, 2012–2016, which outlines four main strategies, one of which is to promote factors conducive to the business of SMEs in Thailand. This includes promoting additional

⁶ The first phase covered the period from 2004 to 2008.

⁷ Under the Civil and Commercial Code, there is a general interest rate cap of 15% to lenders outside the formal financial sector. Under the government's 2015 Nano Finance and 2016 Pico Finance schemes, the interest rate cap for registered service providers is 36% per year (interest and fees). Before these schemes, the cap for microfinance and personal loans was 28% per year.

⁸ BOT notification no. 17/2554 Re. Policy Regarding Commercial Banks Microfinance Loans. A microfinance loan is defined as a loan of no more than B200,000 issued for occupational purposes to persons or juristic persons.

channels or opportunities for SMEs to access funds, such as through the money and capital markets, as well as other sources. The plan addresses the issue of improving collateral requirements for SMEs, and promotes the creation of a central database,⁹ which would increase the efficiency of SMEs' access to capital, as a means of improving the business environment for SMEs in Thailand.

Two recent government schemes aimed at promoting financial access for the grassroots economy are (i) the Nano Finance initiative launched in 2015, which aims to provide a maximum of B100,000 in credit for occupational purposes; and (ii) the Pico Finance scheme launched in 2016, which aims to provide B20,000–B50,000 in credit for those in need of emergency cash. Under both initiatives, registered service providers are allowed to charge a higher than usual interest rate of 36% per year (interest and fees).

To achieve financial inclusion, access to appropriate financial products and services must be coupled with adequate financial education to enable individuals and microenterprises to acquire relevant knowledge, behave desirably, and adopt an attitude conducive to using available financial services well. In an environment characterized by a proliferation of financial services and a multitude of institutions offering a wide variety of products, financial education is an important part of financial inclusion. In light of this, the MOF established the Committee on Financial Literacy in 2012 to enhance the financial capability of individuals by improving their money management abilities and financial discipline. The committee, which is chaired by the permanent secretary of the MOF, comprises public and private organizations involved in education and financial and capital markets, as well as those who work closely with the various target groups. The committee has been charged with developing a master plan for financial education in the country, gathering information on financial education, and developing a central database and channels for distributing financial education information.

9.5 Service Providers and enabling agencies

The provision of microfinance services and financial inclusion activities in Thailand has been driven primarily by government policies and implemented by government agencies. Two features characterize

⁹ Thailand already has a National Credit Bureau (NCB), which provides information on loan accounts and credit for individuals and juristic persons. However, the information only covers those from member institutions, and does not yet extend to cover the whole of the financial system.

the provision of financial services to lower-income households and small enterprises in the country. First, following the 1997–1998 financial crisis, authorities worked hard to institute regulations and implement measures aimed at insulating commercial banks against a possible repeat of the crisis, which hit the formal financial sector especially hard. Second, to meet the needs of lower-income households and small enterprises, the government has relied on other policy instruments. Government-owned financial institutions were established, and lower-tier financial institutions were encouraged and supported. These measures shaped the current financial landscape, which comprises a multitude of financial services providers of credit databases and guarantees. Classified broadly as formal, semiformal, and informal, these institutions have different characteristics and typically cater to different population groups, although there are some customer overlaps (Table 9.3). Together, they provide a wide variety of services, such as consumer loans, savings, deposits, remittances, payments, and insurance products (Table 9.4).

Figure 9.4: Landscape of All Financial Services Providers (Microfinance and Non-Microfinance) in Thailand

Sector	Key Players	Number ^a	Credit Volume ^b
Formal	Commercial banks, finance companies, credit fonciers	36 ^c	\$395.5 billion (92.7%) (non-bank \$3.9 billion)
	Specialized financial institutions (SFIs)	8	
	Non-bank financial institutions (NBFIs)	28 ^d	
Semi-formal	Cooperatives and occupational groups, savings groups for production, village funds	13,000 ^e 27,000 80,000	\$29.8 billion (7%)
Informal	Self-help/community financial organizations (Sajja savings groups, village banks, etc.)	28,000 ^e	\$1.26 billion (0.3%)

^a Numbers for semiformal and informal institutions are rounded.

^b Estimated.

^c Includes Thai commercial banks (15), foreign subsidiaries and bank branches (16), credit fonciers (3), and finance companies (2).

^d Nonbank financial institutions registered with the Bank of Thailand only. Nonbanks offering credit services not registered with the Bank of Thailand are not included.

^e Includes 7,000 cooperatives and 6,000 agricultural and occupational groups.

Source: Lewis et al. (2013).

Table 9.3: Profile of Financial Institution Clients (Loans Only)

Institution Type	Individuals Served	Average Monthly Income of Individuals Served (B)	Average Total Debt of Individuals Served (B)	Region
Commercial bank	2,088,926	27,217	176,034	Bangkok 24% Central 24% South 24%
SFI	7,146,243	17,012	189,361	Northeast 44% North 29%
NBFI under BOT	1,374,340	18,456	229,255	Central 41% Bangkok 21%
Savings group	1,566,990	14,148	237,038	Northeast 41% North 25%
Village fund	7,423,963	10,177	322,366	Northeast 51% North 32%
Cooperative	1,043,897	24,322	222,506	Central 33% North 27%

BOT = Bank of Thailand, NBFI = nonbank financial institution, SFI = specialized financial institution.

Sources: FinMark Trust (2013); Lewis et al. (2013).

Table 9.4: Financial Services Provided by Different Types of Service Providers

Institution	Consumer Loans	Microfinance Loans ^a	Deposits	Remittances	Insurance/ Risk Protection
Government					√√√
Commercial banks	√√√	√	√√√	√√√	
SFI: BAAC	√√√	√√√	√√	√	√√
SFI: GSB	√	√√	√√√	√	
NBFIs	√√√	√√√			
Credit unions/ cooperatives	√√	√	√√		
Village funds	√	√√√	√		
Moneylenders/ pawnshops	√	√√			
Post office				√√	
Private insurers					√
Community-based institutions		√√	√√		√√√
Mobile network operators				√	

BAAC = Bank for Agriculture and Agricultural Cooperatives, GSB = government savings bank, NBFI = nonbank financial institution, SFI = specialized financial institution.

^a Loans of less than B200,000.

Notes: √√√ indicates a dominant role, √√ a moderate role, and √ a small role in providing financial services.

Source: Modified from Lewis et al. (2013).

9.5.1 Formal Financial Institutions

Formal financial institutions have clear legal status and some form of oversight by financial authorities (either the BOT or MOF). These include most large, privately owned financial institutions in the country, such as commercial banks, finance companies, credit fonciers, and nonbank financial institutions (NBFIs).¹⁰ Also in this category are the eight state-owned SFIs, six of which operate as commercial banks.¹¹ Established to serve specific purposes, SFIs are typically used as tools to further the state's economic and development agenda. Their services include commercial banking services, microfinance products, and credit guarantee products.

While formal financial institutions are by far the largest in terms of both individual and collective resources and capabilities, they typically cater to large corporations and higher income households in urban areas, and provide very few microfinance services. Loan data indicate that, while the formal financial sector accounts for 93% of all credit in the country, it only provides 61% of all microloans, most of which are accounted for by SFIs (Figure 9.5). Similarly, deposit data indicate that, while bank accounts are widespread, most accounts are dormant or used for occasional transfers (Lewis et al. 2013). FinScope data indicate that many lower-income households open deposit accounts for remittance purposes, and use semiformal and informal channels for their savings needs.

Four SFIs play particularly important roles in providing financial access for lower-income households and small enterprises: the Bank for Agriculture and Agricultural Cooperatives (BAAC), the Government Savings Bank (GSB), the Small and Medium Enterprise Development Bank of Thailand (SME Bank), and the Thai Credit Guarantee Corporation (TCGC). Due to its nature as a supporting institution, the TCGC's role will be discussed in section 9.5.4.

Established in 1966 to provide credit to individual farmers and agricultural cooperatives for the purchase of agricultural inputs,

¹⁰ Smaller financial institutions that offer products similar to the large NBFIs, but to lower income groups are not included in this category. In Thailand, the term NBFIs typically refers only to large NBFIs under BOT supervision.

¹¹ SFIs that operate as banks are the Small and Medium Enterprise Development Bank of Thailand (SME Bank), the Bank for Agriculture and Agricultural Cooperatives (BAAC), the Export-Import Bank of Thailand, the Government Savings Bank (GSB), the Government Housing Bank, and the Islamic Bank of Thailand (IBank). The two other financial institutions are the Thai Credit Guarantee Corporation (TCGC) and the Secondary Mortgage Corporation.

the BAAC operates as a commercial bank, although the focus of its business is on farmers and agricultural cooperatives. In a country where agriculture accounts for 32.5% of the workforce and farming is seen as an important traditional activity, agricultural policy has an important place in Thailand. The BAAC has long played a leading role in implementing a number of the government's agricultural initiatives, or any financial policies aimed at supporting farmers. This includes granting debt moratoriums to farmers¹² and paying out agricultural subsidies; more recently, the BAAC was the primary means through which the Yingluck government paid farmers who participated in its rice-pledging scheme, which ran from the 2011–2012 to 2013–2014 planting seasons. While the BAAC's primary role was to cater to farmers, it is now the dominant formal financial institution in rural areas.

The GSB, like the BAAC, also operates as a commercial bank, but is more focused on lower-income individuals living in urban areas, such as vendors and entrepreneurs. The GSB has also played an important role in promoting savings habits. Children in Thailand typically open their first savings accounts with the GSB, since the bank has a tradition of going to schools to offer deposit services to students. As a government bank, the GSB has also been a vehicle through which government policies are implemented. As with the BAAC, the state asked the GSB to offer debt moratoriums to small farmers and people with uncertain income. To support the government's policy of promoting loans to microenterprises, the GSB operates a People's Bank scheme, which provides funds to individuals who run SMEs, owners of small, family-run independent shops, or low-income individuals wishing to start their own businesses. These schemes are implemented in addition to the usual banking services offered by the GSB.

The SME Bank was founded to promote, develop, and help SMEs establish, expand, or improve their businesses. In practice, the bank provides credit products, guarantees, and venture capital to support and promote SMEs. The Small and Medium Enterprise Development Bank of Thailand Act of 2002 also permits the bank to provide counseling services, and any other necessary services that fit the bank's objectives and are covered by the provisions of the act. As an SFI, the bank is also involved in the 2012 debt moratorium policy on performing loans of no more than B500,000, although the burden of this policy on the bank is not as great as it is on the BAAC or GSB. This is partly because, based on

¹² Although Thailand has had many debt moratoriums for low-income individuals and farmers, the debt suspension policy approved by the cabinet in April 2012 is novel in that it suspends debt for performing loans, rather than nonperforming ones.

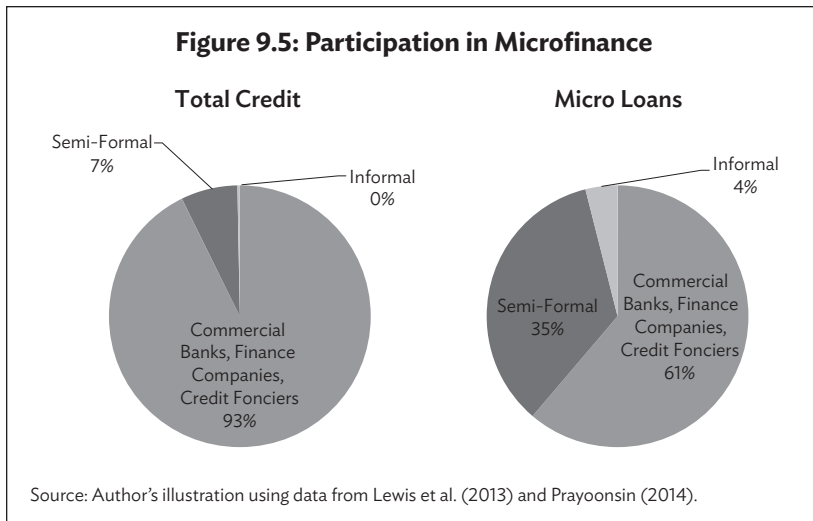
the bank's definition of SMEs,¹³ the act covers larger enterprises as well. As a result, loan sizes tend to be larger for SME bank customers than for individual clients of the BAAC or GSB.

In addition to the BAAC, GSB, and SME Bank, the Islamic Bank of Thailand (IBank), another SFI, the Krungthai Bank (KTB), and the Thai Credit Retail Bank (TCRB) also provide some credit products for lower-income groups and small-scale entrepreneurs, although the scale and scope of their microfinance operations are smaller than that of the SFIs mentioned above. As an SFI established to serve the banking needs of the Islamic community in the country, IBank's main objectives have been to serve Muslim customers and carry out government policies. The KTB is a state-owned enterprise as well as a commercial bank, and as such it also offers products to support government policies, such as offering microfinance products to low-income individuals and microenterprises. The TCRB is entirely privately owned, and occupies a niche market in targeting smaller customers and business owners than the main customers of commercial banks. However, the TCRB mainly operates in urban areas, and requires collateral for loan approvals.

In addition to deposit-taking institutions, there are also credit-only financial institutions, collectively termed NBFIs. Formal NBFIs¹⁴ are large corporations that offer personal loans, credit card services, and/or cash card products. Some companies also offer leasing and hire-purchase services. NBFIs are big providers of consumer credit, and are present mainly in urban centers. Lewis et al. (2013) reported that 75.7% of all consumer credit in the formal sector is in the hands of NBFIs. However, the average loan size for NBFIs is much smaller, being only a third of the average loan size for commercial banks in Thailand. This suggests that formal NBFIs cater to a wider base, and typically reach clients with lower incomes, than do commercial banks. Nonetheless, the products offered by NBFIs remain inaccessible to those with irregular incomes and no collateral, such as automobiles or homes. Instead, these people turn to institutions that offer services similar to the NBFIs, but are unregulated by the BOT due to the smaller size of their operations.

¹³ Small enterprises are those with at most 50 employees and fixed non-land assets valued at B50 million or less (B30 million for retailers). Thus, the banks would classify many enterprises as "small" that are still bigger than microenterprises. Medium-sized enterprises are those with 51–200 employees and non-land fixed assets worth B50 million–B200 million (B50 million–B100 million for wholesalers and B30 million–B60 million for retailers).

¹⁴ NBFIs that provide credit card services are required to register with the BOT. The company must have registered capital of B100 million or above. Personal loan service providers with registered capital of more than B50 million are required to register with the BOT.



9.5.2 Semiformal Financial Institutions

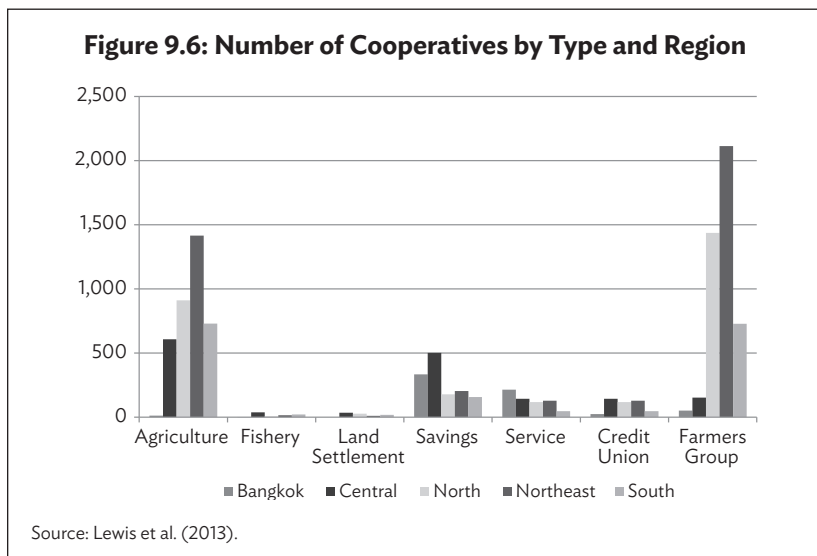
Like formal financial institutions, semiformal institutions have legal status; however, they are not regulated by financial authorities such as the BOT or the MOF. As such, many operate under nonprudential regulations.¹⁵ These institutions tend to be smaller than the formal ones, are typically member-based, and are established either by the state or under government encouragement to promote savings and productive investments at the community level or for specific professional groups. Many of these institutions also receive funding and some form of assistance from the government agencies responsible for overseeing them.

There are three main types of semiformal institutions in Thailand: cooperatives and occupational groups, savings groups for production (SGPs), and village funds. Cooperatives were created to enable their members, usually persons having the same occupation or living in the same area, to pool their resources to help each other. While cooperatives exist all over the country, the most numerous in terms of organizations and members are agricultural cooperatives and farmers' groups, which operate mainly in the northeast and north of the country (see Figure 9.6).

¹⁵ As opposed to prudential regulations, which ensure the financial soundness of financial institutions, nonprudential regulations are rules governing the operations of financial institutions, such as information disclosure, rules regarding interest rates, and market conduct.

Cooperatives primarily offer deposit and credit services to members, but differ from commercial banks in that they cater to a lower income base. Members purchase shares in the cooperatives, and subscribers typically enjoy services that are more tailored to their needs and are provided with certain welfare benefits. As financial institutions were formed to serve occupational groups, products offered by cooperatives also serve the needs of small enterprises, especially those related to agriculture. In addition, agriculture-related cooperatives and farmers' groups have a close connection with the BAAC, which extends loans to cooperatives that the cooperatives then onlend to their members. Cooperatives are overseen by the Cooperative Audit Department within the Ministry of Agriculture and Cooperatives, which assesses them on various aspects such as financial performance, prevalence of fraudulent activities, member participation, and internal management practices.

SGPs are member-based community financial organizations established in rural areas countrywide with the support of the Community Development Department (CDD), Ministry of Interior.¹⁶ SGPs, like the cooperatives, are locally run by members and periodically assessed and supported by the CDD. SGPs are most prevalent in the northeast (51% of all SGPs) and the north (21%); they cater to a lower income group than does the formal sector, and operate on a smaller



¹⁶ The CDD's primary goal is to support and develop rural communities.

scale than do most cooperatives.¹⁷ While CDD assessments indicate that the performance of the majority of SGPs is sound, this varies greatly among different SGPs. As such, the CDD is encouraging the groups to come together to network at the district, provincial, and regional levels to share knowledge and experience, and improve overall performance (Lewis et al. 2013).

The village fund is a community-based and -run financial institution launched by a government initiative in 2001, which provided B1 million in seed funds per village for village-based financial institutions. A direct initiative of the prime minister at the time and with start-up funds readily available, the village fund's uptake was immediate and far-reaching, with 80,000 villages countrywide each having a fund. The village fund is overseen by the National Village and Urban Community Fund Committee, which reports directly to the prime minister or a person appointed by the prime minister for that purpose. The National Village and Urban Community Fund Office sets guidelines, but village fund operators are not required to report to them. As such, there is little information on the income, expenditures, overall performance, and sustainability of village funds at the central level.

Money from the village fund is primarily used to provide rotating credit to members of the village community, and while it is possible to save with the village fund, few people do. A village fund loan can be used for any purpose, but is typically small—around B10,000–B20,000—in keeping with the lower incomes of village fund borrowers. Users mostly live in the northeast and north regions, where penetration by formal financial institutions has been limited. Menkhoff and Rungruxsirivorn (2009) showed that the fund has had some success in reaching those who had previously limited access to credit and had to rely on informal moneylenders for loans. Nonetheless, the total debt burden held by village fund users is B322,366, the highest of all categories of financial institutions presented (Table 9.3). This is a cause for concern, as village fund users have the lowest income, but largest debt burden of all institutional categories in Table 9.3.¹⁸ In addition, since the village fund only allows up to B50,000 in loans at a given time, the total debt incurred by village fund users must come from multiple sources, one or a few of which could be unregulated, informal moneylenders.

¹⁷ Calculations based on figures from the CDD indicate that the average size of SGPs is around 130 members per group, while the average size of a cooperative is 1,600 members per group.

¹⁸ NSO Socio-Economic Survey data from 2010 indicate that the majority of village fund loans are repaid in full, with only 7.7% of borrowers overdue on their repayments. This could be because eligibility to take out new loans depends on the repayment of old loans.

9.5.3 Informal Financial Institutions

Informal financial institutions are typically initiated by community members to serve the financial needs of the community. There is no legislation for their establishment, and such institutions are not subject to regulation. While financial institutions in this category vary greatly in the scale and scope of their operations and level of organization, they are typically smaller than those in the formal and semiformal groups and are based at the village level. *Sajja* savings groups, for example, are community-based financial institutions that encourage people to save by making a pledge to save a small amount regularly. Once the member has demonstrated the ability to save, loans can be taken out. As organizations created and owned by the community, *sajja* savings groups are better able to cater to the financial needs of their members, and successful *sajja* savings groups have been known to invest their profits in welfare funds to serve their community members. These include funeral, medical expenditure, disaster, elderly, and educational funds, as well as others. The range of services offered depends on the scale and success of the group's operations, as well as the needs of the group members.

There are a variety of informal providers, including self-organized funeral funds, which are popular in the northeast and north; other self-help groups; and local moneylenders. Also in this category are the NBFIs, which do not meet the minimum capital requirements to be overseen by the BOT. These service providers are largely unregulated, as they are created by local communities and there are usually no agencies overseeing their operations. This also means that they have no checks on their performance, and are not subject to any interest rate or fee caps imposed by the BOT. This exposes their clients to risks of institutional failure. Clients of informal moneylenders face high costs for financial services and often harsh loan collection practices.

In sum, informal savings groups are able to reach further than formal and semiformal financial institutions, provide financial services at reasonable costs, and offer welfare benefits to their members. Nonetheless, the institutions themselves and their clients are put at risk by a lack of (i) systematic guidelines governing the soundness, sustainability, and transparency of their operations; (ii) control over the interest and fees charged; and (iii) guidance on appropriate market conduct.

9.5.4 Enabling Agencies and Supporting Mechanisms: A Credit Database and Credit Guarantees

The existing institutional arrangement of the agencies supporting microfinance reflects the long history of state involvement in this sector. One main obstacle to providing microfinance services, especially in terms of loans, is the high transaction costs resulting largely from information asymmetries between suppliers and potential clients. This makes it difficult for potential service providers to assess the risks of microfinance loans, and often leads to collateral requirements that low-income households and SMEs cannot meet. The problem is particularly acute for formal financial institutions that have limited experience assessing the risks associated with loans to low-income individuals and SMEs, and thus exclude such clients from formal financial services.

The National Credit Bureau (NCB)¹⁹ helps alleviate this problem by collecting credit information from member financial institutions, and supplies members with credit reports, including both consumer and company credit history, upon their request.²⁰ All commercial banks in Thailand and three SFIs—the Government Housing Bank, GSB, and SME Bank—are shareholders and members of the NCB. The BAAC, one of the largest microfinance service providers in the formal financial sector, has recently joined the NCB (*Prachachat Turakij Online*).

As the NCB can only collect information from members that are large formal sector institutions, the existing credit database provides little credit information on low-income individuals and microenterprises (OSMEP 2012). This presents an obstacle to risk assessment, and often prompts banks to require real estate and/or a guarantor as collateral, which many low-income clients and small firms cannot provide. To address this problem, the BOT and MOF have encouraged the BAAC to join the NCB. The issue of establishing a credit database for SMEs has been raised in the SME Promotion Master Plan (2012–2016); and there have been talks, training sessions, and workshops in preparation for establishing such a database for the implementing agencies, such as the TCGC, BOT, and OSMEP.²¹

¹⁹ The NCB began as a central credit registration operated by the BOT in 1964, and gradually evolved into the present-day NCB.

²⁰ Individuals and companies can also ask to see their own credit reports from the NCB.

²¹ Some of the activities include (i) a brainstorming workshop on a credit risk database at the OSMEP by Japanese academics; (ii) a joint workshop between ADBI, the BOT, and the Japan Financial Services Agency in Thailand; and (iii) the visit and consultation of the TCGC, MOF, and BOT on credit risk databases, credit guarantee systems, and SME financing at ADBI.

To address the credit constraints of SMEs, the government established two SFIs—the SME Bank and TCGC. The SME Bank was created to offer loan products tailored to the needs of SMEs, and also undertakes projects related to the collateralization of non-real estate assets, such as machinery and intellectual property. Machinery capitalization allows the use of machinery registered with the Ministry of Industry’s Central Machine Registry as collateral for financing, while intellectual property uses registered patents, utility models, trademarks, and copyrights as collateral (Organization for Small and Medium Enterprises and Regional Innovation of Japan [SMRJ] et al. 2012). Moreover, the legal framework for secured lending, which allows non-real estate assets to be used as collateral for financing, has been under discussion since 1998 (SMRJ et al. 2012; Toomgum 2014). The Business Collateral Act was passed into law in November 2015, with many of its provisions becoming effective in July 2016.

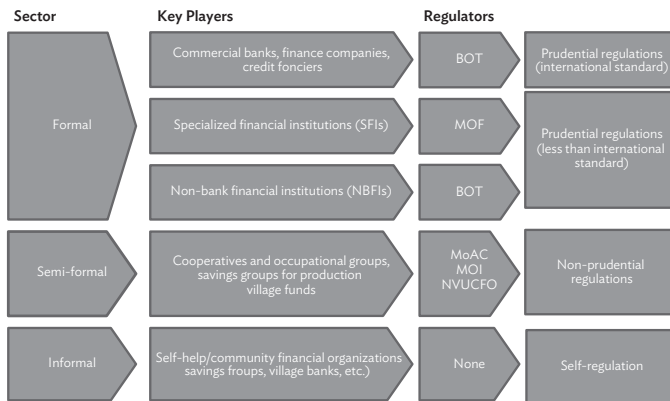
The TCGC offers a variety of credit guarantee products tailored to different types of SMEs—including microenterprises, newly established SMEs, and regular businesses—that help them obtain commercial bank loans, and charges a fee for its services.²² In 2009, the TCGC implemented the portfolio guarantee scheme as part of the government’s economic stimulus measures in the face of the global financial crisis, and the scheme was also used to help SMEs after the 2011 flood.²³ In general, the NCB and TCGC are both supporting institutions that help facilitate credit access. Nonetheless, there is still room for improvement, especially in terms of the existing credit database’s scope of coverage, and the establishment of an SME credit database.

9.6 Regulatory Context

The main institutional context shaping the provision of financial services in Thailand is regulation, as this shapes the key aspects of the desired outcomes of financial inclusion: financial institutions’ soundness and sustainability, and the provision of a well-regulated environment within which the service providers operate. In this regard, Thailand has several regulatory agencies overseeing the many tiers of service providers, including formal, semiformal, and informal financial institutions (Figure 9.7).

²² Fees, the amount of credit guarantee, and the period of guarantee vary depending on the product type.

²³ The scheme is currently operating for a limited 5–7 year period.

Figure 9.7: Regulation of Financial Services Providers in Thailand

BOT = Bank of Thailand, MOAC = Ministry of Agriculture and Cooperatives, MOF = Ministry of Finance, MOI = Ministry of Interior, MOInd = Ministry of Industry, NVUCFO = National Village and Urban Community Fund Office.

Note: The MOInd oversees two specialized financial institutions: the Small and Medium Enterprise Development Bank of Thailand, and the Thai Credit Guarantee Corporation. Prudential regulations ensure the financial soundness of the financial institution, and nonprudential regulations govern the operations of financial institutions, such as information disclosure, rules regarding interest rates, and market conduct.

Source: Adapted from Prayoosin (2014).

Formal service providers are mainly regulated by two key financial authorities—the BOT and MOF. The BOT supervises and regulates privately owned formal financial institutions, such as commercial banks, finance companies, credit fonciers, and large NBFIs, which are important providers of consumer loans in urban areas. The BOT's authority also extends to state-owned banks, which were not established to serve specific purposes (non-SFIs).²⁴ Regulated entities are required to follow BOT regulations, such as reporting and capital adequacy requirements aimed at increasing transparency and ensuring the soundness and sustainability of financial institutions. The BOT also has the power to monitor consumer protection, and the 2007 Financial Institution Business Act gives the BOT residual authority to address financial activities when they affect the country's overall economy (Meagher 2013).

Following the 1997 Asian financial crisis, which severely hit Thailand's formal financial sector, several reforms were implemented to

²⁴ These are the TMB (formerly the Thai Military Bank), and KTB.

strengthen the sector and to prevent any potential repeats of the crisis. With the formal financial sector greatly strengthened compared with the post-1997 crisis period, financial reforms from 2004 to the present set out in the three phases of the FSMP (I, II, and III) began to include provisions to downscale banks to promote financial inclusion. In 2006, a BOT notification authorized personal loan business during the reform period (Meagher 2013), with provisions for a cap on interest and fees for unsecured loans to control costs for potential consumers in this segment. In FSMP III (2016–2020), the focus of financial inclusion is on expanding access to appropriate financial services for individuals and enterprises. Access for enterprises mainly focuses on SMEs, while access for individuals focuses more on encouraging the provision of financial services that meet the changing needs of consumers, especially Thailand's aging population, which is increasing.

The MOF is primarily responsible for regulating state-owned SFIs, although it delegates the task of examination to the BOT. While the MOF generally uses BOT regulations as guidelines for supervising SFIs, they provide for the fact that the state asks SFIs to help implement development policies (Meagher 2013). While the BOT is responsible for examining SFIs, it cannot sanction SFIs that fail to follow their rules and regulations. This power rests with the MOF, which can act on the BOT's recommendation. The existing regulatory structure and the SFIs' role in implementing the government's development policies expose SFIs to certain risks, as *de facto* SFIs operate under weaker prudential regulations than commercial banks (IMF 2013). The SFIs' performance in terms of soundness and sustainability is generally weaker than that of commercial banks, as they are obliged to help implement government policies aimed at helping low-income individuals and small businesses (Lewis et al. 2013).

Financial institutions operating in the semiformal financial sector are not required to abide by prudential regulations, but operate under nonprudential regulations (Figure 9.7).²⁵ Although such entities have legal status and their performance is supervised by relevant government agencies, in practice the standards and requirements imposed on them are not as stringent as those imposed on formal service providers. One feature of the regulatory regime in this sector is the diverse array of regulations regarding the sustainability and soundness of institutions imposed on different types of service providers. There are no centrally determined nonprudential regulations for the institutions in this sector;

²⁵ Again, nonprudential regulations are rules governing the operations of financial institutions such as rules regarding information disclosure, interest rates, and market conduct. They do not govern provisions for the financial soundness of institutions.

the authority to issue rules lies with the overseeing agency. As many types of semiformal institutions are overseen by different agencies, they are subject to different requirements with varying degrees of stringency. Performance also varies, even within the same type of institution. For example, information from the Cooperative Promotion Department shows greatly varying performance among different cooperative types: agriculture-related cooperatives have a lower pass rate (64%) according to the standard set by the Ministry of Agriculture and Cooperatives than do nonagricultural cooperatives (79%) (Cooperative Promotion Department 2012).

The CDD within the Ministry of Interior assesses SGPs twice a year, rating them on a scale of 1 to 3 with 3 being the highest score. The results indicate that 90% of SGPs are sound (scoring 2 or 3) (Lewis et al. 2013). Village funds have also been assessed, although not regularly. Nonetheless, the data show that the village fund has a low rate of nonperforming loans. Boonperm, Haughton, and Khandker (2013) reported that over 90% of loans taken out from the village fund are repaid in full. However, this could be because eligibility to take out new loans depends on the prompt return of old loans, and, once these are returned, new loans can be taken out immediately. This setup provides incentives for village fund borrowers to borrow from other sources to pay back the village fund on its due date, then re-borrow from the fund the next day to pay back the loan, a practice not uncommon in Thailand.

Provisions for the regulation and supervision of financial institutions in Thailand gradually become less stringent as financial institutions progress from formal to semiformal to informal categories. In the informal sector, there is no designated authority to oversee the diverse range of service providers that offer financial services to some of the lowest income households and microenterprises in the country. As such, these service providers are unregulated. While the Civil and Commercial Code caps interest rates for informal lenders at 15%, in the absence of a designated regulator, interest rates can far exceed this and even the higher cap for personal loans; moreover, debt collection practices are often harsh. Thus, the soundness and sustainability of financial services providers in this category vary greatly, and any regulatory structure governing this sector is largely self-imposed (Figure 9.7).

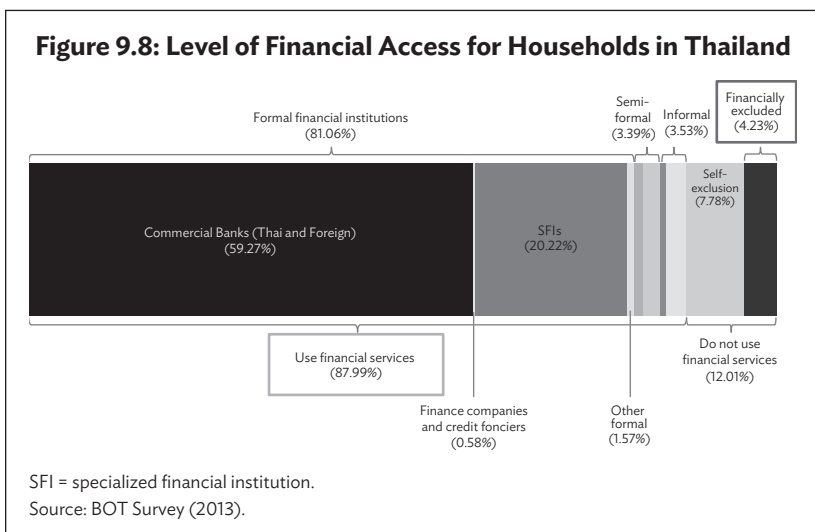
9.7 Financial Inclusion in Thailand

Given the policies that promote financial inclusion for both individuals and SMEs, and the variety of service providers and enabling agencies that govern the provision of microfinance services in the country, this

section considers the status of financial inclusion in Thailand in terms of financial access for both households and SMEs.

9.7.1 Status of Financial Inclusion for Individuals and Households

Data from the 2013 BOT financial access survey reveal that households in Thailand have a relatively high level of financial inclusion, with a utilization rate of 88% for all types of service providers. Financial exclusion, defined as when entities wish to utilize products, but lack access, is 4% among Thai households (see Figure 9.8). The FinScope survey of individuals found an even higher rate of utilization of financial services (formal or informal), at 99%.²⁶ Findings from in-country surveys corroborate the Global Findex data.²⁷ According to the World Bank dataset, the percentage of those aged over 15 with access to accounts at formal financial institutions in Thailand is 78.1%, which is higher than the regional average for developing countries (68.8%). Global Findex data also show that Thailand performs well in terms of access to credit and deposit products from formal financial institutions.

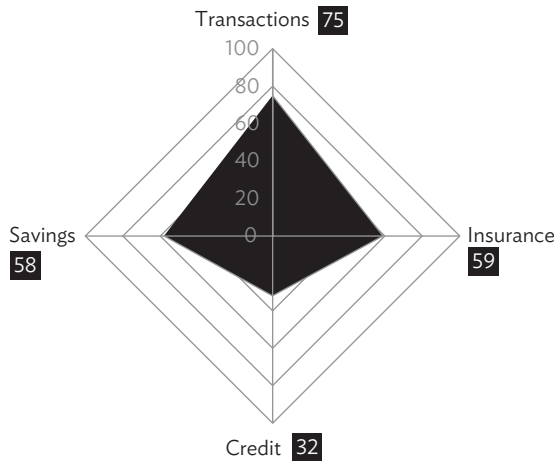


²⁶ FinScope defines financial exclusion as when individuals do not use any financial products (either formal or informal) to manage their financial lives.

²⁷ The latest available data at the time of writing are for 2011.

In terms of access to services by type, FinScope Thailand found that access to transaction services is highest (75%), followed by insurance products (59%), most of which are provided by the government through such mechanisms as the Universal Health Coverage scheme, the National Welfare fund for the employed and self-employed, and the civil servants' pension scheme. Similarly, 58% of the population have access to savings products; however, only about one-third of respondents (32%—the lowest level) reported access to credit products (Figure 9.9).

Figure 9.9: Landscape of Financial Access by Product Category



Source: FinMark Trust (2013).

Although Thailand is doing relatively well in terms of overall financial inclusion, comparison with data from a previous BOT survey in 2010 indicates that there is a growing unmet demand for financial services. This is especially true for households in the lowest income group. There are also regional variations in terms of access to financial services. The BOT survey found that Bangkok and the central and north regions have relatively higher levels of access than do the northeast and south. FinScope also found that a relatively higher proportion of the population in the south and northeast regions use informal financial institutions as their main source of financial services. While overall formal financial access is high in the central region, those who use only informal financial services is also fairly high (4%).

Financial access to different product types also varies from region to region. The BOT found that unmet demand for savings products is increasing, and that the groups with the highest levels of exclusion in terms of savings are those who are in the lowest two income tiers, live in non-municipal areas, and reside in the northeast and central regions. FinScope found that inhabitants of the central, northeast, and south regions have relatively high exclusion rates in terms of savings, although those in Bangkok are not far behind.²⁸ The mix of usage is also different; those in more urban areas prefer to save with formal financial institutions, whereas those in less urban areas prefer to save with informal institutions. Regionally, the northeast has by far the largest uptake of informal financial services, followed by the north.

The BOT also found an increase in unmet demand for credit products. This was largest among medium-income households in Bangkok and the central region, which have relatively higher incomes per capita and are more urban than the other regions. FinScope data also reveal that a larger proportion of those in municipal areas are excluded from credit, and that, in addition to problems of exclusion in Bangkok and the central region, those in the south also have relatively low levels of access. This could be due to a wider variety of service providers in non-urban areas, resulting from the combined efforts of various government agencies to develop rural areas, thereby improving the financial access of the rural population.

The BOT also found an increase in unmet demand for remittances, which was largest among low- to medium-income groups and households in the northeast region. Respondents reported that problems with usage include high fees (49%) and service points being far away, inconvenient, and too few (24.56%). This could be due to the large geographical expanse of the northeast region, which has many remote areas. Furthermore, the northeast is home to many migrant workers who work in more urban areas and send remittances home. Therefore, the large proportion of remittances going back to the northeast could also be part of the reason why the region stands out.

Thus, in terms of financial access for households and individuals, the surveys indicate that, while Thailand is doing relatively well compared with its peers, gaps still exist between supply and demand for financial services. Data show that those who face the most problems accessing financial services are those in the lowest income group and living in the northeast and south of the country. While this is generally true for savings and remittance products, access to credit is more difficult for those in the medium-income group living in more urban areas.

²⁸ According to FinScope, the percentage of excluded entities is 28% in Bangkok, 39% in the central region, 36% in the northeast, and 36% in the south.

9.7.2 Financial Inclusion Status for Small and Medium-Sized Enterprises

From the perspective of enterprises, the OSMEP survey found that while enterprises in all size categories—small, medium, and large—use loans from formal financial institutions as a source of capital, a lower proportion of small enterprises use such funds as their main source of capital. Small enterprises also utilize a diverse range of funding sources other than loans from financial institutions. When asked about their main source of capital, small enterprises reply that they use the company’s profits, money from personal savings or from family and friends, and loans from other informal sources. While medium-sized firms also report using money from personal savings or from family and friends, they do not rely on informal sources as the main source of capital for the company (Table 9.5).

Table 9.5: Main Source of Capital by Enterprise Size
(% of responses)

Source of Capital	Enterprise Size		
	Small	Medium	Large
Loans from formal financial institutions	35.74	72.00	53.33
Accumulated profits	31.98	26.67	46.67
Personal savings, relatives, or friends	30.78	1.33	0.00
Partners	1.05	0.00	0.00
Informal lenders	0.45	0.00	0.00

Source: OSMEP (2013).

The diversity of fund sources used by smaller enterprises was also made apparent from another question that asked firms about their main sources of circulating capital. Large firms mostly use accumulated profits and loans from formal financial institutions. Medium-sized enterprises show a similar tendency, with 64% replying that they use accumulated profits, and 36% loans from formal institutions. Small enterprises, however, use a more diverse range of funds; in addition to accumulated profits, and loans from financial institutions, small companies also use the owner’s savings or borrow from family and friends, business partners, and other informal channels (Table 9.6).

Table 9.6: Main Source of Circulating Capital by Enterprise Size
(% of responses)

Source of Circulating Capital	Enterprise Size		
	Small	Medium	Large
Loans from formal financial institutions	21.20	36.00	27.27
Accumulated profits	74.74	64.00	70.45
Personal savings, relatives, or friends	3.61	0.00	0.00
Partners	0.30	0.00	2.27
Informal lenders	0.15	0.00	0.00

Source: OSMEP (2013).

Punyasavatsut (2011) reported the same trend among SMEs in manufacturing, with large firms having a higher debt-to-equity ratio than smaller firms, suggesting that small firms may face more difficulties accessing external funding. By empirically analyzing factors that determine access to credit from formal financial services providers, this chapter finds that firm size, business capabilities, and profit margins positively impact access.

When the OSMEP survey asked firms if they had ever borrowed from informal sources, only SMEs replied affirmatively, with more medium-sized firms replying positively than small firms (see Table 9.7). However, when considered together with earlier responses regarding their main channels of funding and sources of circulating capital, this information indicates that informal sources remain an important source of financing for a small proportion of small enterprises. In the OSMEP survey of microenterprises, those who borrow from informal moneylenders cite the speed of loan approvals as their primary reason for doing so. Other reasons include uncomplicated procedures, the ability to borrow without collateral requirements, familiarity with moneylenders, and the

Table 9.7: Experience with Informal Loans
(% of responses)

Experience with Informal Loans	Enterprise Size		
	Small	Medium	Large
Borrowed from an informal source	18.60	27.63	0.00
Never borrowed from an informal source	81.40	72.37	100.00

Source: OSMEP (2013).

inability to borrow from formal financial institutions. Nonetheless, the benefits of borrowing from the informal sector come at a high cost. The majority of microenterprises that borrow from formal sources pay no more than 20% interest, whereas the majority of those that borrow from informal sources pay rates higher than 40%.

When asked about their experience with loans and loan approvals from formal financial institutions, all of the large and medium-sized firms replied that they have experience with requesting and being granted loans, whereas only 62.6% of small firms reply the same. This means that 37.4% of small firms have not been granted loans by formal financial institutions. The top reasons cited for not having been approved for loans included a lack of or insufficient collateral, not having a business plan, and being a new enterprise (having no previous payments record). Similarly, microenterprises cite insufficient evidence and insufficient collateral as the top two reasons for not having been granted loans by formal financial institutions.

Table 9.8: Experience with Formal Loans
(% of responses)

Experience with Formal Loans	Enterprise Size		
	Small	Medium	Large
Have received loans from a formal financial institution	62.58	100.00	100.00
Have never received loans from a formal financial institution	37.42	0.00	0.00

Source: OSMEP (2013).

Thus, the OSMEP survey and Punyasavatsut (2011) both imply that small enterprises face the most problems accessing funds from formal financial institutions. Data from both sources and from the survey of microenterprises all suggest that, for a small proportion of small enterprises, informal sources remain an important source of financing despite high interest rates. As such sources are largely unregulated in terms of business and market conduct, institutional soundness, or consumer protection, small firms are more exposed than larger enterprises to exorbitant charges, rough collection practices, and other malpractices.

In summary, while firms of all sizes in Thailand have relatively good access to credit products, a gap remains in the provision of services catering to the needs of small enterprises. This gap is evident

from these enterprises' greater reliance on informal sources of funds, such as the owner's own savings, family and friends, and unregulated moneylenders. Therefore, to realize the goal of furthering financial inclusion for businesses, it is necessary to develop products suitable to smaller companies, which often have inconstant income streams and little collateral. Ensuring the observation of appropriate practices regarding the soundness of institutions, interest rates, fees, and collection practices, among others, is also crucial to ensure access to quality services for small enterprises.

9.8 Financial Education in Thailand

9.8.1 Financial Literacy

As financial inclusion requires not only access to financial services for households and businesses, but also the effective use of appropriate services, financial literacy is an important part of promoting financial inclusion. To use available financial services optimally, users should have not only the relevant knowledge, but also desirable behavior and the right attitude.

Surveys of financial literacy in Thailand revealed that, overall, Thailand's performance in 2013 was comparable to the average score of the other surveyed countries. According to the BOT's 2013 financial literacy survey (BOT 2014b), which uses a questionnaire modified from the Organisation for Economic Co-operation and Development's survey, the country's overall financial literacy score is 58.5%. This is slightly below the 62.3% average from the Organisation for Economic Co-operation and Development's sample of 14 countries from four continents (Atkinson and Messy 2012). In another survey conducted by MasterCard, which surveyed 27 markets in 2013, Thailand's score on the MasterCard Financial Literacy index is 68 points out of 100 (Choong 2013). This is about the same as the average score for countries from Asia and the Pacific region in the sample, which was 66 points in the 2013 survey.

When the overall score is broken down into the three main components of financial literacy—financial knowledge, behavior, and attitude—the BOT results show that individuals in Thailand scored lowest on knowledge (46.8%). This is especially true for the calculations of various types of interest, with respondents having most difficulty with compound interest calculations. The survey also found that awareness of the deposit insurance policy and understanding of the time value of money remain limited.

In terms of financial behavior and attitude, Thais exhibit some favorable tendencies, especially in terms of saving actively, setting long-term financial goals, striving to achieve those goals, and refraining from borrowing to make ends meet. This finding is corroborated by the MasterCard financial literacy survey, which showed that Thais scored higher than average in financial planning, including aspects related to the respondents' concept of and ability to make long-term plans for financial needs.²⁹ The FinScope survey also found some favorable tendencies. When asked whether they think carefully before making a spending decision, the overwhelming majority replied that they do. A similar proportion replied that they adjust their expenditures in accordance with their incomes, know their financial situation, and like to be in control of their finances. Thais also know that budgeting can help them keep track of how much they can spend (Table 9.9).

Table 9.9: Favorable Financial Behavior and Attitudes

	% who agree with the statement
You think carefully before making a spending decision.	92.0
You adjust your expenses according to your income.	86.5
You know your financial situation.	89.6
You like to be in control of your finances.	89.0
Budgeting can help you keep track of your finances.	90.2

Source: FinMark Trust (2013).

Despite many positive findings concerning financial literacy, the BOT and FinScope surveys also made some worrying findings. The FinScope survey found that more than half of the population is unsatisfied with their current financial status, and that about a quarter of the population often spends more money than they have available. Many see dealing with finances as stressful or burdensome. The survey also found that only a third of Thais keep track of their income and expenditures on a monthly basis (Table 9.10). This is especially striking, as 90.2% of the population reply that they know the benefits of budgeting, but only about a third actually do so. This result is corroborated by the BOT survey, which found that 93.5% of the respondents score zero on “being responsible and having a household budget.”

²⁹ This part of the survey also assesses the respondents' knowledge of financial products and services.

Table 9.10: Unfavorable Financial Behavior and Attitudes

	% who agree with statement
You are unsatisfied with your current financial status.	55.9
You often spend more money than is available.	24.9
Dealing with finances is stressful/burdensome.	60.7
You keep track of your income and expenditures on a monthly basis.	32.7

Source: FinMark Trust (2013).

The results also reveal differences in terms of financial literacy across regions and income groups. The BOT survey found that people in the northeast score lowest on financial literacy. People from the north, northeast, and south also score low on financial knowledge, although they score high in terms of financial behavior. Conversely, the central region scores high in terms of financial knowledge, but low in terms of financial behavior. The survey also found that areas with fewer financial transactions typically have lower financial literacy scores.

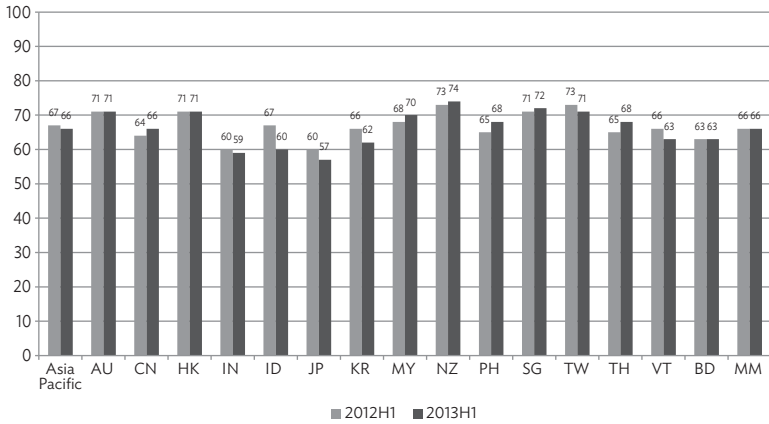
9.8.2 Over-Indebtedness

The worrying tendencies revealed in the BOT and FinScope surveys are balanced by findings from the MasterCard survey that Thailand's rate of improvement from 2012 is the highest in the region (Figure 9.10). However, the current situation is still a cause for concern given the current level and trend of household over-indebtedness.

Household debt to GDP was 82.3% in Thailand in 2013, an increase from 60.0% in 2010. The ability of households to pay off their debts has deteriorated, with the household debt–disposable income ratio increasing from 90% in 2010 to 120% in 2013. Examination of the data over the longer term corroborates this short-term trend. Statistics obtained through the NSO Socio-Economic Survey (SES) show that household debt increased steadily from B68,405 per household in 2000 to B134,900 per household in 2011 to B156,770 in 2014, more than doubling in 15 years. However, households' ability to pay off their debt has not changed much in the same period.

According to the 2014 SES data, approximately 49.1% of households in Thailand are in debt. A higher proportion of rural households are indebted than are urban households (Figure 9.11); however, debt per household is higher for urban households than for rural ones

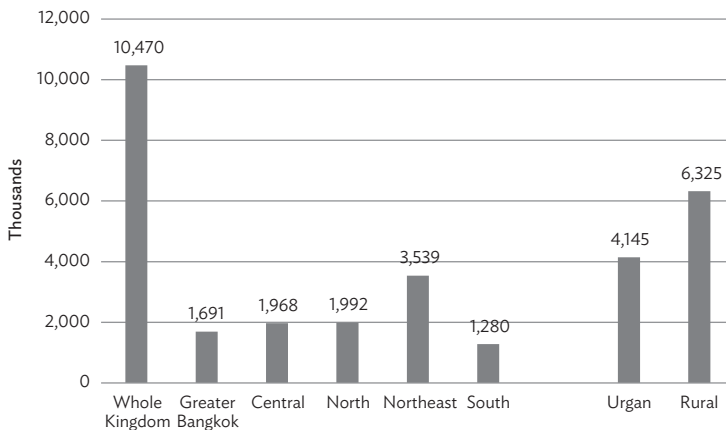
Figure 9.10: MasterCard Financial Literacy Index, 2012 and 2013



AU = Australia; BD = Bangladesh; CN = People’s Republic of China; H1 = first half of the year; HK = Hong Kong, China; ID = India; IN = Indonesia; JP = Japan; KR = Republic of Korea; MM = Myanmar; MY = Malaysia; NZ = New Zealand; PH = Philippines; SG = Singapore; TH = Thailand; TP = Taipei,China; VT = Viet Nam.

Source: Choong (2013).

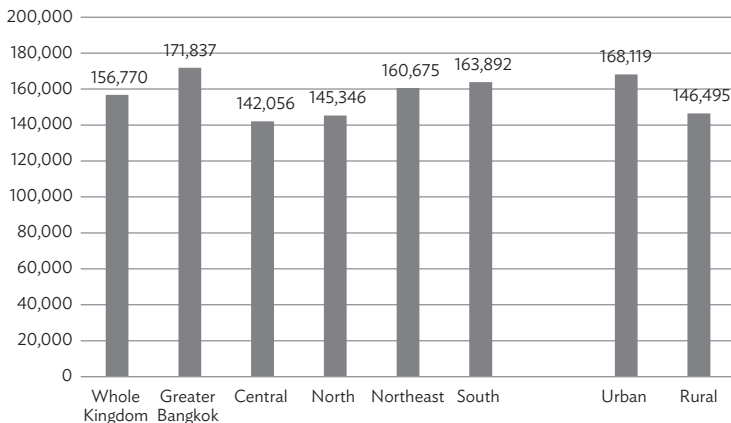
Figure 9.11: Indebted Households by Region and Rural-Urban Split (%)



Note: Greater Bangkok includes Bangkok, Nonthaburi, Pathum Thani, and Samut Prakan.

Source: NSO SES Data (2014).

Figure 9.12: Average Debt Per Household by Region and Rural-Urban Split
(B)



Note: Greater Bangkok includes Bangkok, Nonthaburi, Pathum Thani, and Samut Prakan.
Source: NSO SES Data (2014).

(Figure 9.12). In terms of overall debt, the northeast has the largest proportion of indebted households, followed by the north and south. Again, in all regions, the rural population has a higher proportion of indebted households than does the urban population. This is especially true in the northeast and north. In the northeast, 58% of urban households are indebted, but an overwhelming 73% of rural households carry debt burdens. In the north, the urban–rural split is 49% to 61%. The high and rising levels of indebtedness and over-indebtedness of rural households show a worrying trend. The government recognized concern over household over-indebtedness in the Eleventh NESDP (section 9.5.2).

There is scope for financial education to foster the necessary knowledge, behavior, and attitudes to move toward full financial inclusion in the country; this is clear from (i) the rising household debt–disposable income ratio, which indicates that the ability to pay off debt is declining while debt is increasing; (ii) the weakness of financial literacy measures, especially in terms of the ability to calculate interest; (iii) the low proportion of the population who keep track of their finances; and (iv) the high proportion of respondents who admit that dealing with finances is stressful or burdensome. This is in line with policies outlined

in the Eleventh NESDP, which stresses the need to provide financial knowledge and understanding, and foster saving habits among Thais as a means of combating the over-indebtedness problem.

9.8.3 Financial Education for Individuals and Small and Medium-Sized Enterprises

Current financial education providers in Thailand include commercial banks, SFIs, independent organizations, civil society and nonprofit organizations, and informal providers. For commercial banks, the provision of financial education is typically a part of their corporate social responsibility measures. These financial education programs are small in scale, and target students and/or potential users of formal financial products. Financial education is also provided by independent bodies such as the Stock Exchange of Thailand and the Securities and Exchange Commission, which are independent regulatory agencies. Their programs aim to foster long-term saving habits among Thais and to target potential investors in the stock market.

Government agencies and civil society organizations provide financial education targeted at debt management, consumer rights, and low-income households. The GSB and BAAC have been instrumental in carrying out the government's "Debt Doctor" program. Launched in 2010, the scheme aims to train villagers to act as counselors for individual debt resolution in their local communities. GSB personnel provide training, while the BAAC and GSB share operating costs.

A number of government agencies provide education and assistance for SMEs in Thailand. For example, the OSMEP operates Front Service and SME clinics that provide training, activities, information, and advice on various aspects of SME operations, including financial access and financial management and budgeting practices. The Institute for Small and Medium Enterprise Development, a public organization established with seed funding from the government, provides various training activities for SMEs that incorporate budgeting and financial management. With the groundwork laid under FSMPs I (2004–2008) and II (2010–2014), commercial banks have begun downscaling toward SMEs, and some banks have begun to offer financial education tailored specifically for this target group.

In addition to this, the BOT also provides some financial education content for SMEs on its financial knowledge website. With its five-year strategic plan on financial consumer protection (2012–2017), the BOT has begun to place more emphasis on promoting financial education related to consumer protection. The BOT opened its Financial Consumer

Protection Center in 2012 to equip consumers with adequate financial knowledge to enable them to know their rights and responsibilities as consumers of financial services, keep consumers from falling prey to fraudulent practices, and help them make informed decisions.

Civil society groups and nonprofit organizations, such as the Kenan Institute Asia, Thailand Research Fund, Khom Loy Foundation, and Step Ahead Foundation, also offer financial education programs tailored to the needs of the low-income group. The Kenan Institute trains at-risk women in Bangkok, and runs programs to train young adults, college students, and professional workers, as well as SMEs. The Thailand Research Fund engages local government officials and provides incentives for villagers to record their income and expenditures. In many areas of the country, influential community leaders have also been providing low-income households with financial education. These roles are generally taken by development monks in many rural areas where Buddhist temples remain at the core of the community (Diaz and Achavanuntakul 2013).

While there are many providers of financial education, the existing programs are generally small in scale and target young adults or potential users of formal financial services. Programs targeting lower income households and microenterprises face similar problems. With the exception of the government's Debt Doctor program, which covers the whole nation, programs are still small in scale, with many offered on a project-by-project basis. Given the high and rising household debt-to-GDP ratio, and the prevalence of indebted households in rural areas, which have lower levels of income and financial literacy, there is still a need for more financial education programs addressing debt prevention and management that specifically target low-income households. Financial education in terms of consumer protection is also an important aspect missing from most financial education programs in the country. While the BOT has taken a leading role in this aspect, other agencies should also play a larger role, since other agencies in the formal, semiformal, and informal sectors have a wider reach than the BOT. Thus, while Thailand is doing relatively well in terms of financial literacy compared with other countries, much remains to be done.

9.9 Conclusion and Policy Recommendations

Institutional analysis as applied to the financial inclusion situation in Thailand reveals that the country has done well compared with many other countries, both for lower income households and small enterprises. This has been achieved primarily through government encouragement

and initiatives, and has resulted in a multitude of service providers that cater to different population subgroups.

Despite current achievements in terms of financial access, when evaluating the current situation against the desired outcomes, it is clear that gaps still exist between existing conditions and the envisaged goal of financial inclusion. Surveys find a growing unmet demand for financial services in Thailand. Access to financial services, while high, is not universal, and rural and low-income households in certain regions are more excluded than others. Small enterprises also find it hard to obtain credit, and have had to rely on a variety of sources for funds. Utilizing the services of unregulated informal institutions exposes these enterprises to exorbitant interest rates and potential breaches of consumer protection practices. The country's existing condition also indicates that there is a problem with high and rising household over-indebtedness. The problem is more prevalent in rural areas where credit for low-income individuals and small enterprises is more readily available due to a number of initiatives and financial institutions that have been encouraged to fill the gaps left by commercial banks and other privately owned formal operators. This trend is especially worrying given the low financial literacy score of low-income households and those in rural areas, and the limited number of programs currently addressing issues of debt prevention and management.

In terms of the regulatory context, especially rules and regulations to ensure the soundness and sustainability of service providers, it is found that this is characterized by a lack of uniformity in rules and supervision, with formal financial institutions having the most stringent rules governing service provision, the soundness of institutions, and costs to clients. Semiformal institutions have their own sets of standards, which are generally less stringent than those governing commercial banks and SFIs, while the informal sector is largely unregulated and not subject to any prudential or nonprudential regulations. This creates an uneven playing field among different providers of financial services, and puts more formal financial institutions at a disadvantage to other groups in terms of the provision of financial services that cater to the needs of low-income households and small enterprises.

In light of these findings, the following policy recommendations are proposed:

- (i) Expand financial services to meet growing and unmet demand, especially from low-income individuals and small enterprises, to prevent people from turning to informal moneylenders. This is especially true for loan products in urban areas that cater to low-income individuals and microenterprises.

- (ii) Extend financial access to unbanked and underserved segments using existing channels that operate in close proximity to these groups, such as the SFIs and village funds. Service innovations such as mobile and/or agent banking models could also be explored to extend the reach of financial access.
- (iii) Strengthen the governance of SFIs in carrying out government initiatives, of semiformal institutions and of informal institutions. This could be accomplished through regulatory reforms to provide a graduation path for community-based financial institutions.
- (iv) Consider establishing a new regulatory structure to oversee microfinance. This could be done by establishing a new microfinance regulatory agency that gathers the expertise of several agencies in one place, or by establishing a special committee comprising existing regulators that serve the same purpose. The new institution would be charged with gathering information on microfinance, collecting and distributing information on best practices, issuing guidelines for appropriate conduct, training microfinance institutions and staff, and conducting research to promote financial inclusion.
- (v) Develop financial education programs that highlight the risks of over-indebtedness and aim to prevent people from going further into debt, to supplement the government's Debt Doctor initiative. Financial education in terms of consumer protection should also be emphasized.

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FINANCIAL INCLUSION, REGULATION, AND EDUCATION

Asian Perspectives

Financial inclusion is receiving increasing attention as having the potential to contribute to economic and financial development, while at the same time fostering more inclusive growth and greater income equality. However, although substantial progress has been made, there is still much to achieve. East Asia, the Pacific, and South Asia combined account for 55% of the world's unbanked adults, mainly in India and the People's Republic of China.

This book surveys the experience of some developed and Asian emerging economies to assess factors affecting the ability of low-income households and small firms to access financial services, including financial literacy, financial education programs, and financial regulatory frameworks, and identify policies that can improve their financial access while maintaining financial stability. It identifies successful experiences and important lessons that can be adopted by other emerging economies. The studies cover the experiences of Germany, the United Kingdom, Bangladesh, India, Indonesia, the Philippines, Sri Lanka, and Thailand.

The book takes a practical and holistic approach to issues related to financial inclusion. For example, innovative methods of promoting financial access, such as mobile phone banking and microfinance, require corresponding innovations in regulatory frameworks, perimeters, and capacity. Moreover, programs in the areas of financial education and consumer protection are needed to enable households and small firms to take full advantage of improvements in financial access.

About the Asian Development Bank Institute

The Asian Development Bank Institute, located in Tokyo, is the think tank of the Asian Development Bank. The institute aims to identify effective strategies to improve policy and development management in Asia and the Pacific. We work with an extensive network of partners in the region and globally to influence policies on poverty reduction, inclusive growth, the environment, regional cooperation, infrastructure development, middle-income countries, and private sector development.

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