GPFI Global Partnership for Financial Inclusion

G2012 MÉXICO

October 29, 2012
Basel, Switzerland

1st Annual GPFI Conference on Standard-Setting Bodies and Financial Inclusion

Financial Inclusion: A Pathway to Financial Stability? Understanding the Linkages

Hosted by

FINANCIAL STABILITY INSTITUTE

BANK FOR INTERNATIONAL SETTLEMENTS

Session 3

Financial Inclusion—A Pathway to Financial Stability?

Understanding the Linkages

David Porteous
BFA
October 29, 2012
Basel

The evidence of linkages so far

- **GPFI White Paper 2011:**
  - Financial inclusion changes the nature and possibly the level of risks to stability, integrity and protection
  - Applying *proportionality*—the balancing of risks and benefits against costs of regulation—as a means of managing this.

- **CGAP Brief 2012:**
  - Surveys cross-country evidence of linkages
  - There is a lack of rigorous measures of inclusion hence limited evidence to date; however, "they are interrelated and under the right conditions, positively related. Yet failings on one are likely to lead to problems on others."

The I-SIP project

- **Goals:**
  - To explore the linkages at a deeper level among financial **inclusion (I)** and the other core objectives: financial **stability (S),** financial **integrity (I)** and financial consumer **protection (P)**
  - To extend the evidence base for regulators, supervisors and the SSBs about how best to incorporate financial inclusion objectives into their work
- **Structure:**
  - Funded by the **UK Department for International Development (DFID)**
  - Rapid research conducted by **CGAP,** *GPFI Implementing Partner*
  - Research team led by consulting firm **BFA** with SA-based partners Cenfri and Centre for Affordable Housing Finance
  - With the cooperation and support of **South African National Treasury.**

South Africa: Linkages in practice

Why South Africa?

- Represented on all five standard setting bodies –BCBS,CPSS, FATF, IAIS, IADI*
- Has designed & implemented financially inclusive policies over a long period;
- Has recognized financial inclusion as a national objective;
- Has good sources of data that have tracked financial inclusion over time.

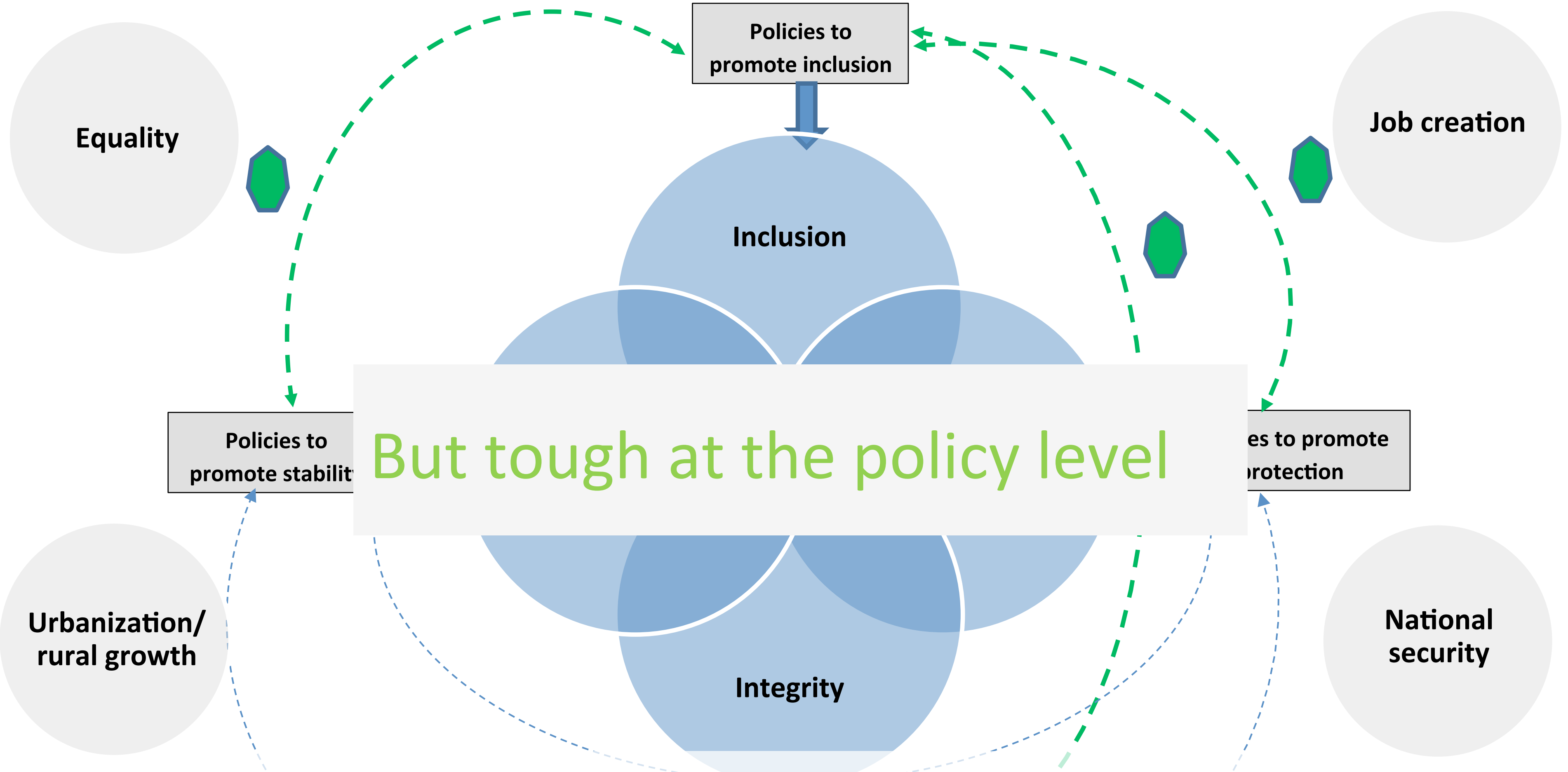
SA National Treasury's
A Safer Financial Sector to Serve South Africa Better (2011)

Four Priority Policy Objectives:

1. Financial stability
2. Consumer protection and market conduct
3. Expanding access through financial inclusion
4. Combating financial crime.

The "Red Book" explicitly recognizes that the four objectives *"interact with one another, often generating difficult decisions for the policy maker. In particular, there are multiple trade-offs and competing objectives which must be managed."(p7)*

Linkages: Complementary at the outcome level



But tough at the policy level

“Financial inclusion contributes to financial stability…Less than fully effective inclusion can and has led to financial sector instability” ***IAIS Consultation Document***

Outcome level: Inclusion → stability

- **Diversification:** An inclusive financial sector will have a *more diversified, stable retail deposit base* which should increase systemic stability. Similarly, inclusion may improve the diversification of lenders' loan portfolio away from large borrowers, thereby reducing systemic risk.

- **Social stability**: An inclusive financial sector with a *broad base of clients across a society is more likely to have greater political legitimacy* and thereby decrease the risk of political and social instability (which in turn could lead to financial instability).

- **Economic stability**: An inclusive financial sector is associated with a *more inclusive society in which individuals have more ways to generate income and manage risks*, thereby potentially enhancing economic stability which is an essential component of financial stability.

Outcome level: Stability → inclusion

- **Trust building:** Stability builds *consumer trust in the financial sector* as a whole, making it more likely that individuals will want to be included.

- **Affordability:** Stability can positively impact factors (such as inflation and pattern of interest rates) that *can reduce key prices*, potentially making financial services more affordable to poor people.

Policy level: defining the linkages 'zones'

Impact on financial inclusion

Impact on financial stability	Negative	None	Positive
Positive			
None			
Negative			

There can be trade-offs…

Trade-off zones

Impact on financial inclusion

Impact on financial stability	Negative	None	Positive
Positive	Stability enhancing, inclusion reducing		
None		Ineffective policy	
Negative	Lose-lose		Inclusion enhancing, stability reducing

…but could there be synergies too?

Impact on financial stability \ Impact on financial inclusion	Negative	None	Positive
Positive		**Stability without inclusion tradeoff**	**Synergy**
None			**Inclusion without stability tradeoff**
Negative			

The I-SIP proposition involves optimization of linkages on any measure: both ex ante and over time

Impact on financial stability	Impact on financial inclusion: Negative	Impact on financial inclusion: None	Impact on financial inclusion: Positive
Positive	Stability enhancing, inclusion reducing	**Stability without inclusion tradeoff**	**Synergy**
None		Ineffective policy	**Inclusion without stability tradeoff**
Negative	Lose-lose		Inclusion enhancing, stability reducing

Common categories of inclusion-related policies

Category	Potential linkages
1. Tiering of product standards	'Lowered' standard brings integrity or protection risk
2. New tier of financial providers	New exposures, not well understood at first Pressure on supervisory capacity
3. Social lending	If directed and if mispriced for risk, may threaten solvency and stability
4. Enabling new delivery channels	May bring new unaddressed consumer protection issues; also risks not well understood by providers or supervisors

Our five South African examples

Category	South African examples		Potential Linkage
1. Tiering of product standards	C. Mzansi basic bank accounts, 2004→	Ex post	I←→I

Our five South African examples

Category	South African examples		Potential Linkage
1. Tiering of product standards	**C. Mzansi basic bank accounts, 2004→**	Ex post	I←→I
2. New tier of financial providers	D. Cooperative Banks 2007→; E. Microinsurance policy 2004→	Ex post Ex ante	I←→P, S

Our five South African examples

Category	South African examples		Potential Linkage
1. Tiering of product standards	**C. Mzansi basic bank accounts, 2004→**	Ex post	I←→I
2. New tier of financial providers	D. Cooperative Banks 2007→; E. Microinsurance policy 2004→	Ex post Ex ante	I←→P, S
3. Social lending	**A. Affordable housing lending under Financial Sector Charter 2003→**	Ex post	I←→S (P)

Our five South African examples

Category	South African examples		Potential Linkage
1. Tiering of product standards	**C. Mzansi basic bank accounts, 2004→**	Ex post	I←→I
2. New tier of financial providers	D. Cooperative Banks 2007→; E. Microinsurance policy 2004→	Ex post Ex ante	I←→P, S
3. Social lending	**A. Affordable housing lending under Financial Sector Charter 2003→**	Ex post	I←→S (P)
4. Enabling new delivery channels	B. Innovative payment approaches for small lending 1993 →	Ex post	I←→S

Example A: Social lending: Affordable housing lending

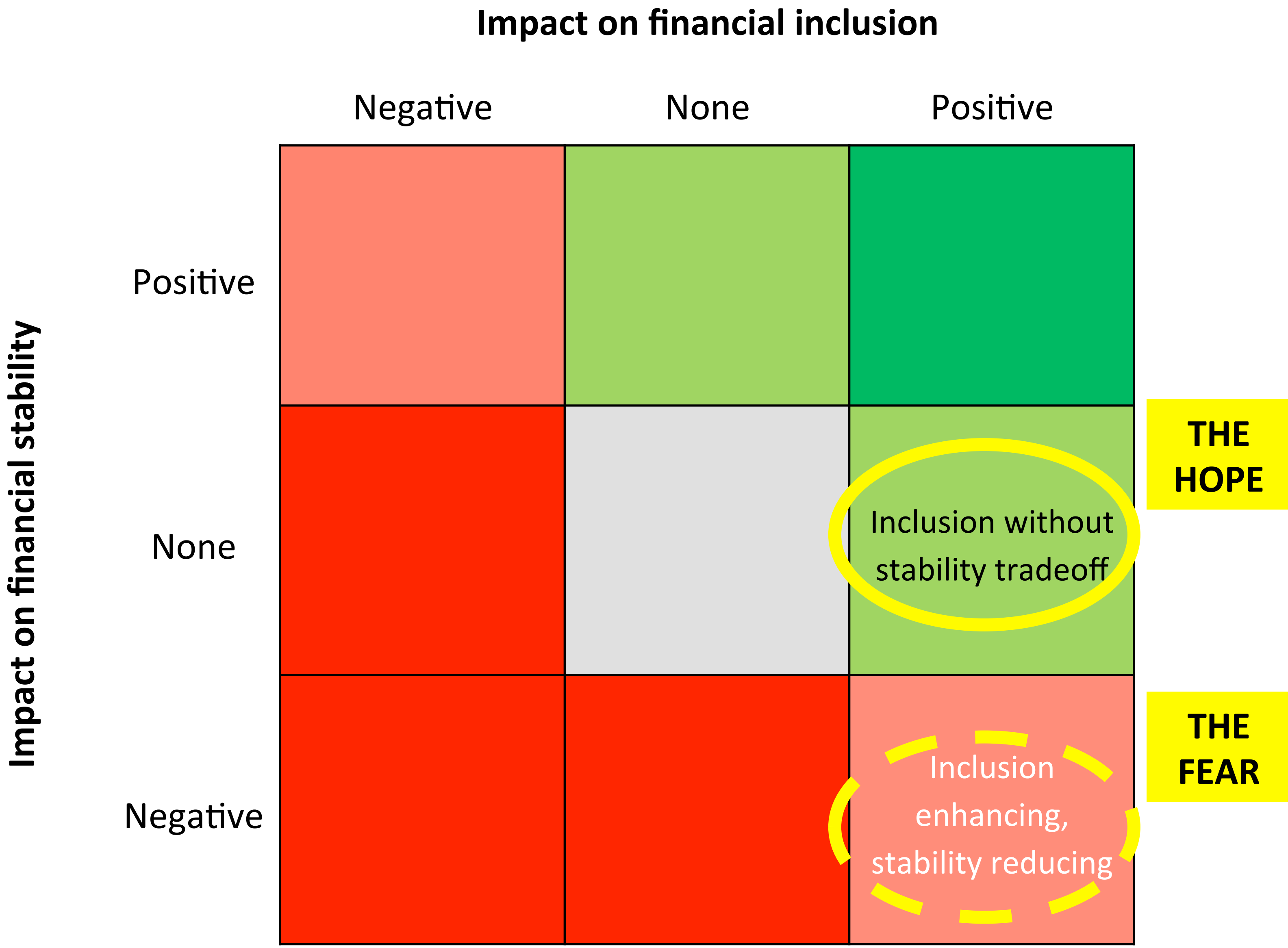
Intervention:

- SA banks set targets for new affordable housing loans in the Financial Sector Charter with threat of imposition of US-style Community Reinvestment Act
- Target lending set of US$5.25bn
- Target households: monthly income from $187 to $875 = 4 million households or ~44% of population

Main linkage identified:

Banks' exposure to affordable housing loans brings risks to financial stability?

A. Expectations: Affordable housing lending



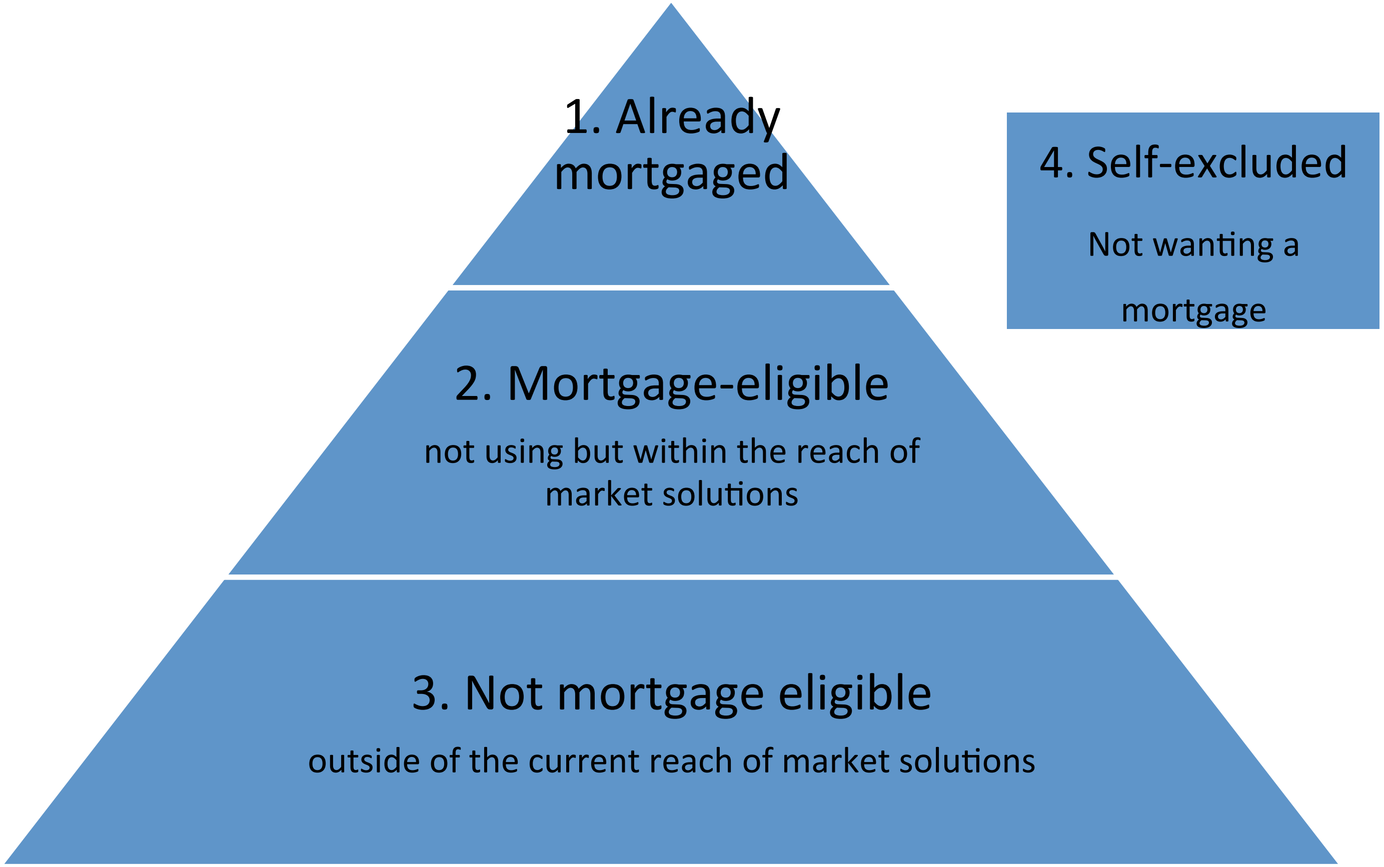
Example A: Social lending: Affordable housing lending

Managing the linkages:

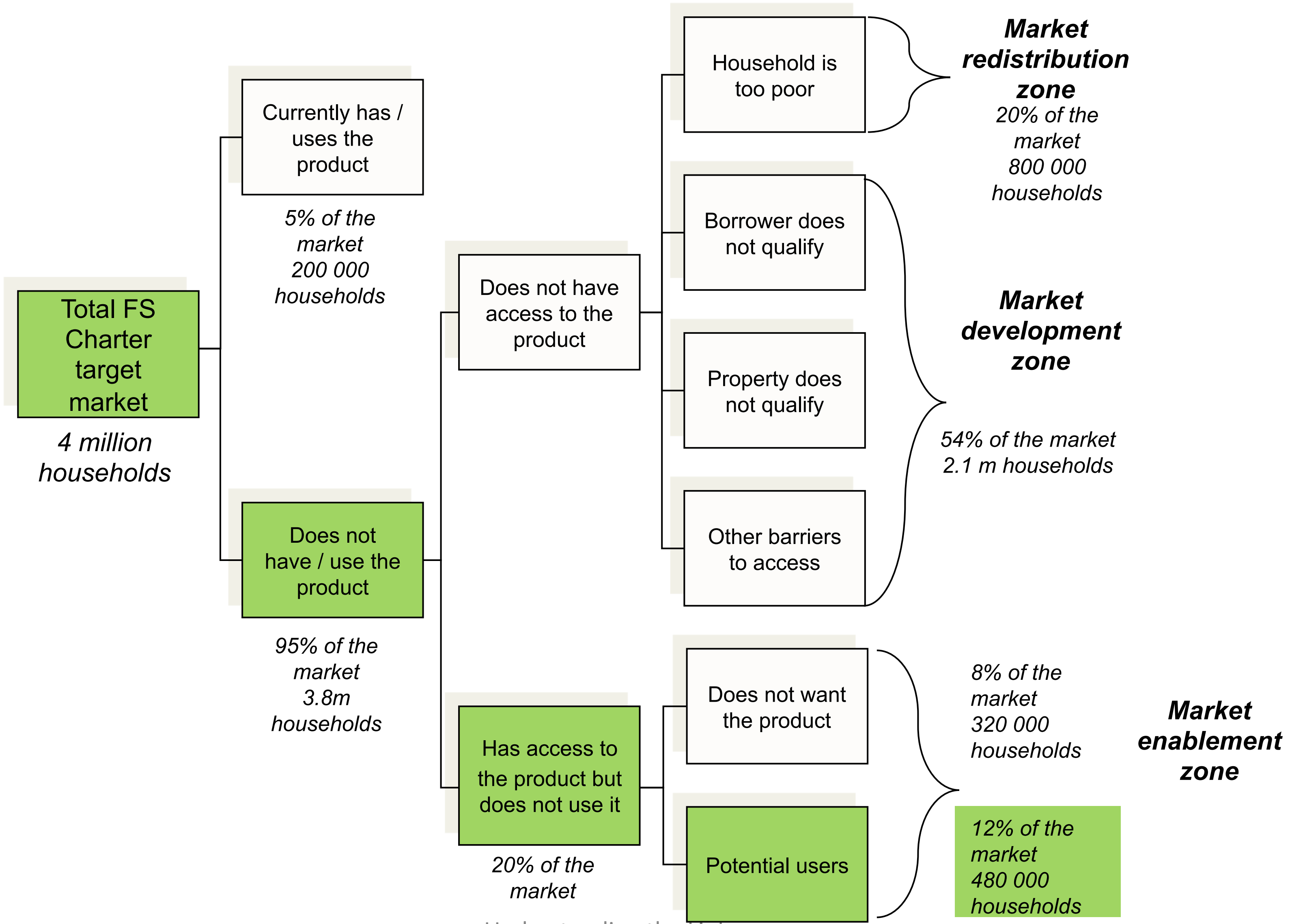
- Banks proposed the target themselves, aligned with their perceived risk
- Code of mortgage lending practices agreed
  - Affordability tests
  - Consumer education
- Processes of managing default in concentrated areas had been improved as result of experiences
- Volume of lending not considered systemically significant
  - small fraction of total banking assets of $173 billion (2003)
- Definition of target market clearly based on having income to repay
  - Access frontier approach to estimate size of market
- Note linkages to urbanization and development usage policies in land markets

A. Affordable housing lending: segmentation

The access frontier approach applied to mortgage lending
Meltzer 2011



A. Affordable housing lending: segmentation



A. Affordable housing lending

Outcomes for Financial inclusion:

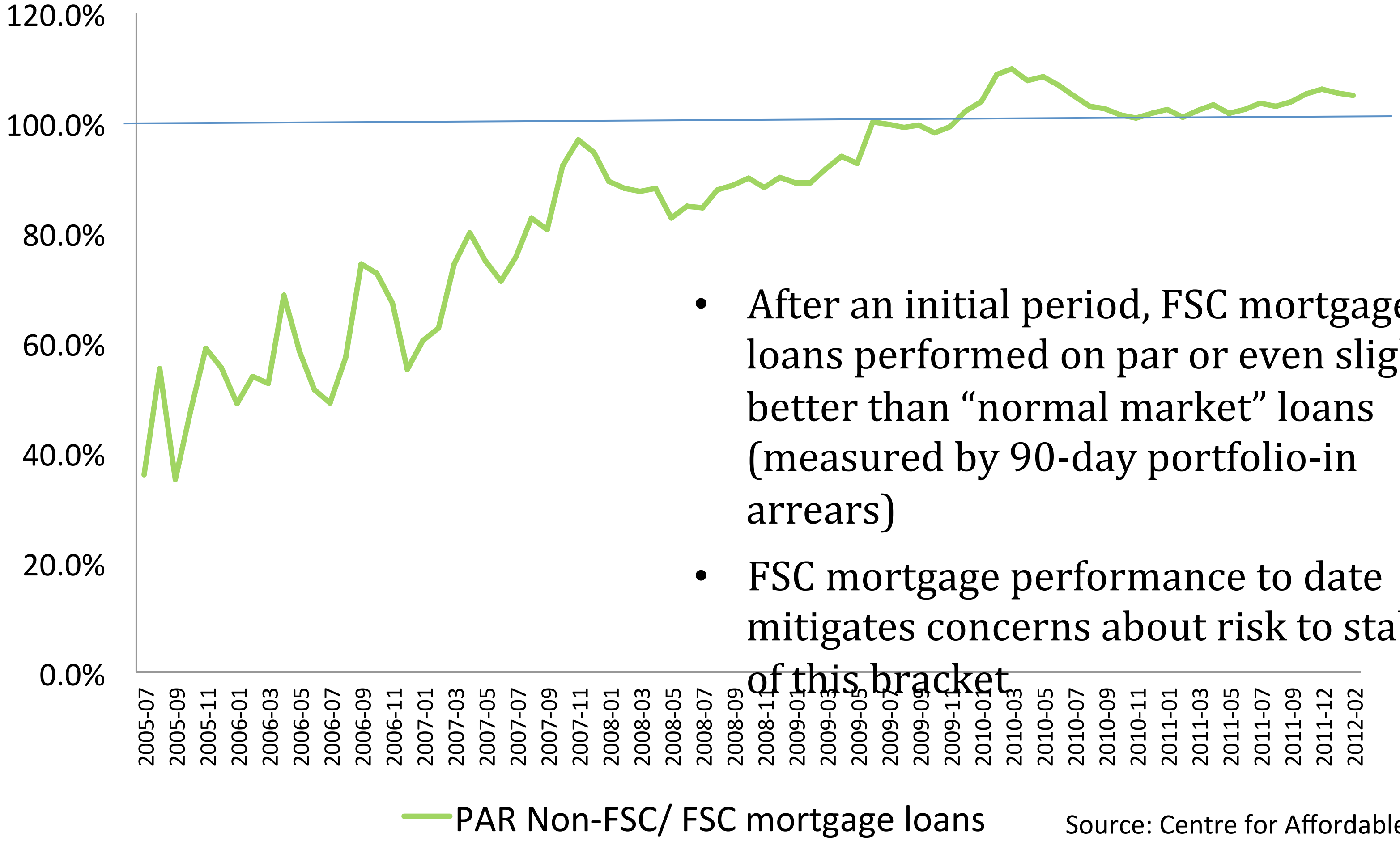
- Banks lent \$3.5 billion in mortgages or 234,638 loans in the five years to Dec 2008
- Remaining target met through other types of housing-related loans, including wholesale loans to residential developers and social housing institutions.
- By end 2008, loans to FSC target market made up 2.7% of all mortgage credit by value & 9.8% by volume

Outcomes for Stability

- 2009 Global crisis led to general credit stress - NPLs peaked at 5.9% of GDP in 2009 (previous 5-yr average ~2%)
- Did home loans to the affordable market under the Charter perform worse than mortgages in general? Did they expose the financial system to additional stress?

A. Outcomes: Affordable housing lending

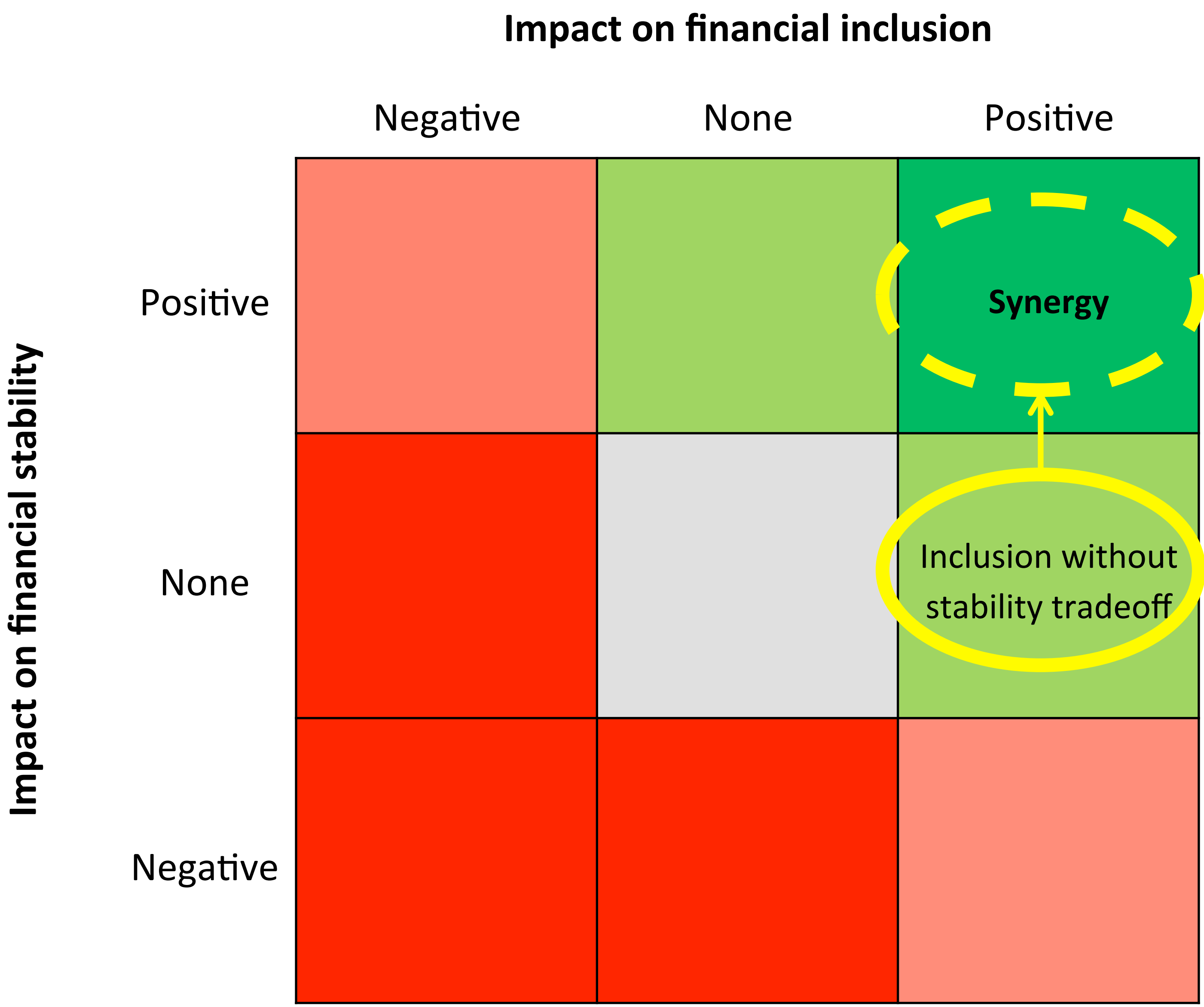
Relative performance of Charter and non-Charter residential mortgage loans



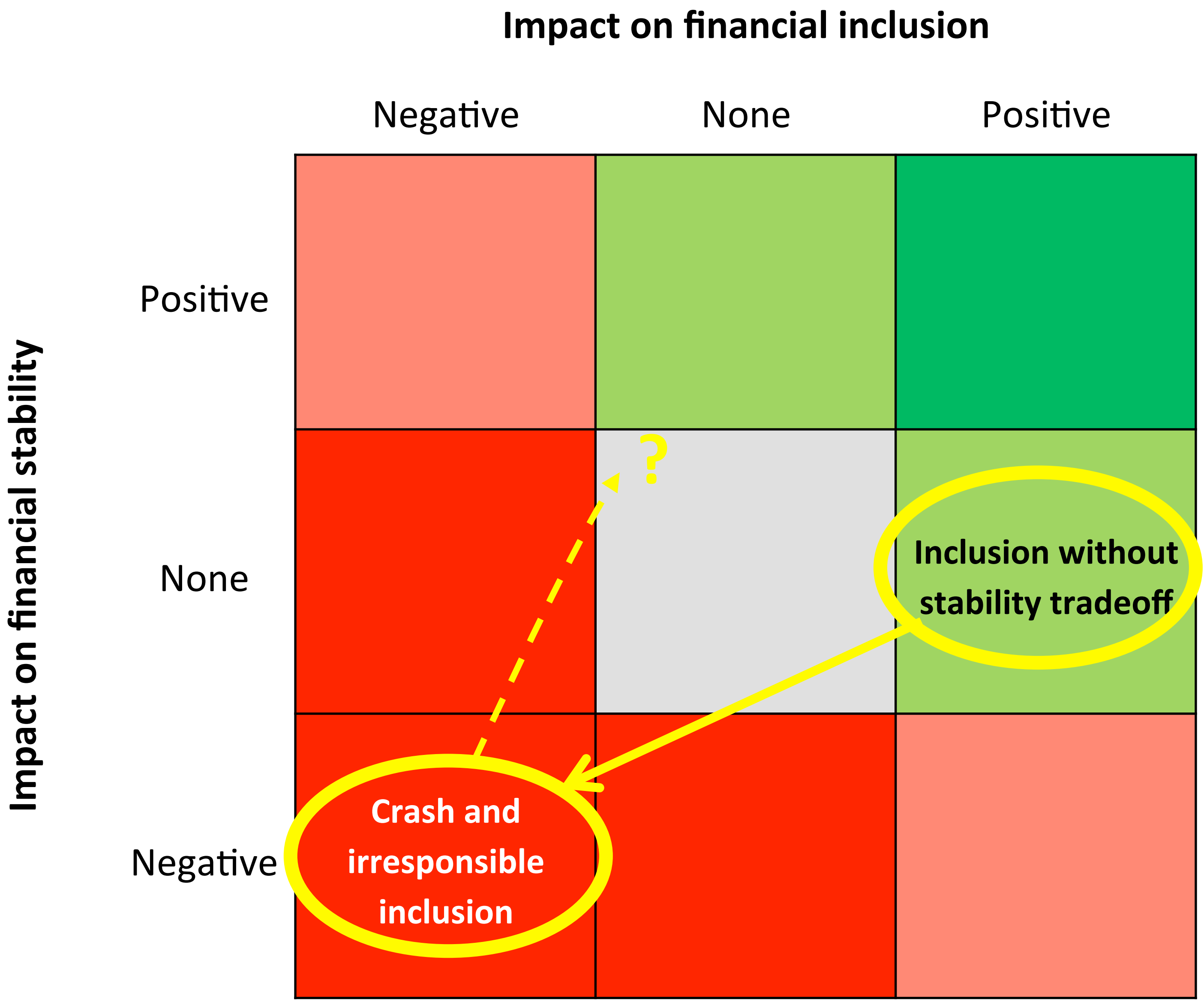
- After an initial period, FSC mortgage loans performed on par or even slightly better than “normal market” loans (measured by 90-day portfolio-in arrears)
- FSC mortgage performance to date mitigates concerns about risk to stability of this bracket

Source: Centre for Affordable Housing Finance 2012

A. Outcomes: Affordable housing lending



Example B: Outcomes: Payment mechanisms for small loans

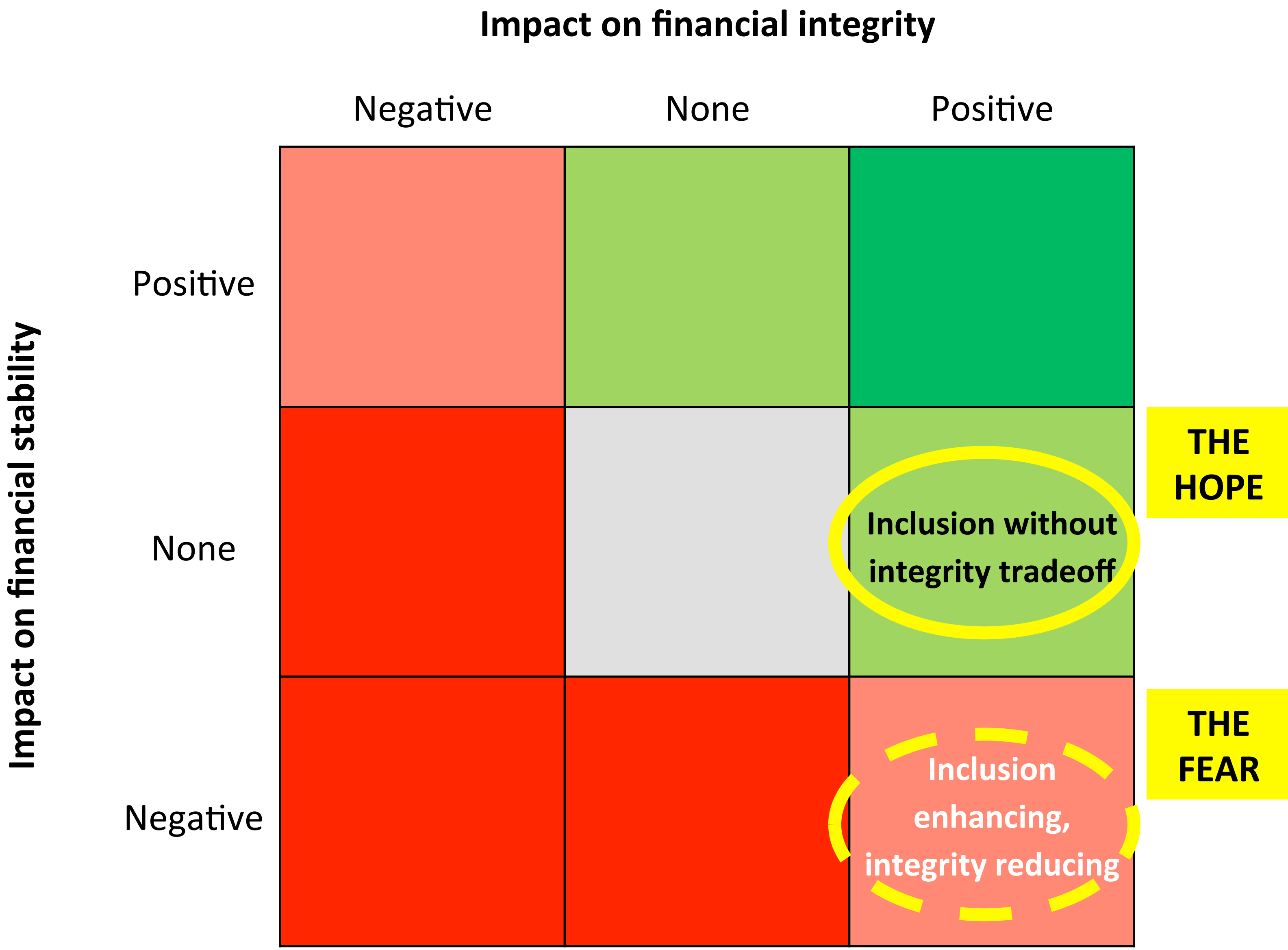


Example C: Tiering of product: basic bank account

Intervention: In 2004, the Banking Association approached the Financial Intelligence Center (FIC) and Ministry of Finance to seek an amendment to the newly promulgated KYC regulations in order to enable the launch of a new class of basic bank accounts called '*Mzansi*' targeted at unbanked people

Linkages identified: Card-based mass bank accounts were not contemplated in South Africa's recently passed main AML-CFT legislation passed in 2001. In addition, South Africa had joined FATF in 2003, and was as a result subject to increased scrutiny for its enforcement of AML-CFT laws. Specifically, while Exemption 17 already exempted low risk accounts from the need for address verification as part of KYC procedures, it did not cater for debit card-linked products (due to their use outside of South Africa) and clients were still required to provide an address. Changing or widening any exemption was therefore to be carefully considered.

C. Expectation: Mzansi basic bank account



Example C: Tiering of product: basic bank account

Managing linkages:

1. A clear definitional framework was created for 'first order transactional products'
   - Geographic access
   - Product features
   - Pricing: no monthly fee; free basic transaction bundle

2. A series of meetings between Banking Association and FIC, mediated by National Treasury to identify risks and how to manage them, through limits on:
   - One accounts per person at same bank
   - International usage
   - Transaction values and balances

   Leading to the promulgation of a revised Exemption 17

   Note: important linkages to Competition Policy

C. Mzansi basic bank account

Outcomes for *Financial inclusion:*

Review by BFA (2009) found:

- 2009 banking industry target for active new accounts were met
- 72% of Mzansi accounts were opened by people who had never been banked before; and
- 61% of Mzansi account holders were from the targeted low income groups.

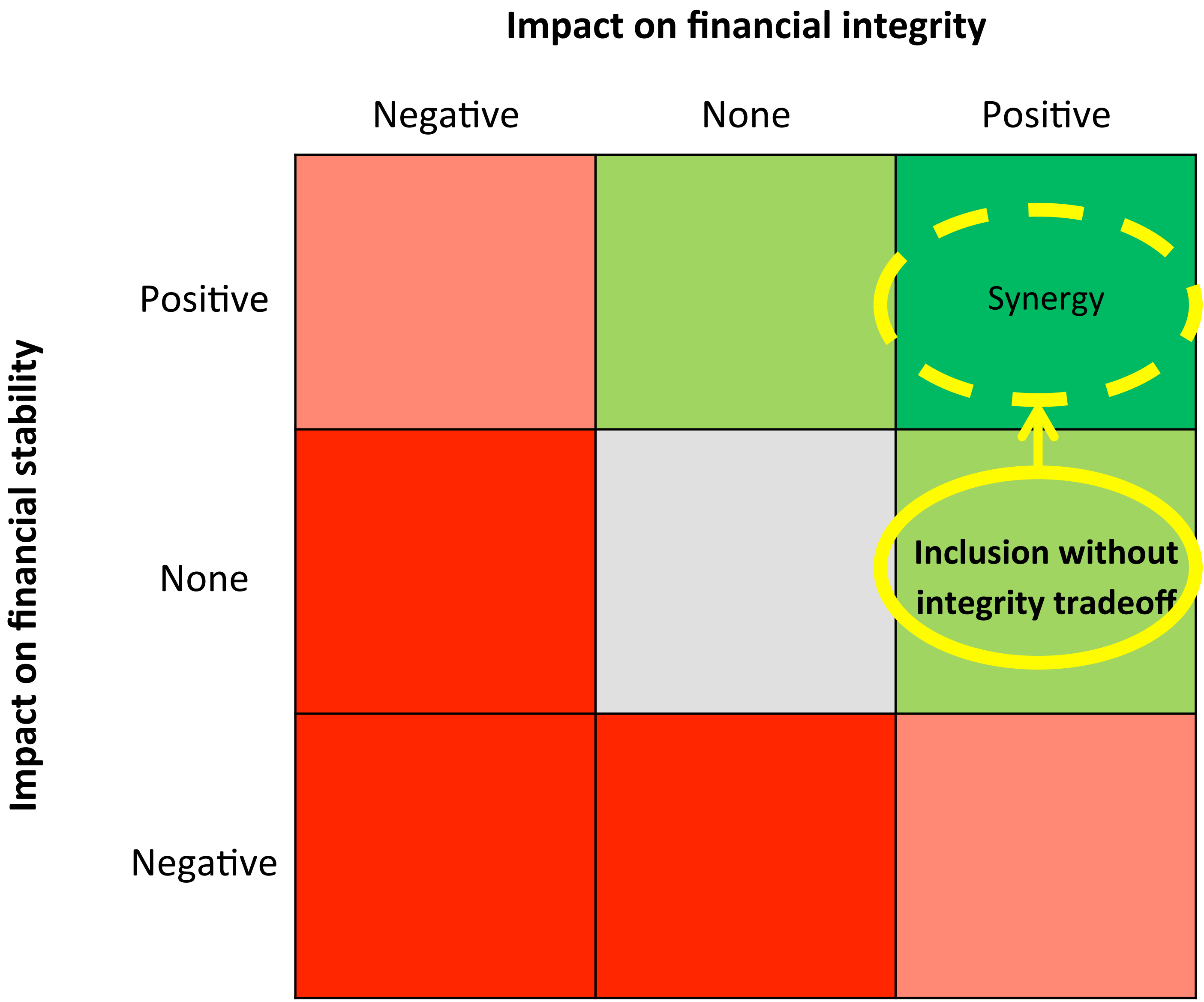
Since then:

- 2011: 3.2m active users (1/6 of banked)
- While Mzansi brand is no longer promoted, the accounts have also had a demonstration effect leading to other bank products

Outcomes for Integrity

- de Koker (2009): some evidence that accounts opened under the exemption had been abused for criminal purposes, the levels and incidence were low.
- Neither banks nor the FIC have gathered systematic data which would enable comparison of whether Mzansi accounts as a category have been used for ML/TF
- However in 2012, banks & FIC staff reported no grounds for special concern with Mzansi accounts as a category.
- 3.2m people added to formal financial system, reducing risk of exclusion and enhancing integrity

C. Outcomes: Mzansi basic bank account



I-SIP Guidance Statements

1. **Collaboration to identify linkages**
   A proportionate approach first requires *inter-agency collaboration to identify* the linkages between a proposed policy and I-SIP objectives, as well as with national objectives beyond I-SIP.

2. **Linkage framework**
   A linkage framework is a structured approach to identify and assess the potential risks and benefits of defined policy objectives that arise in the implementation of a specific measure. A linkage framework enables linkages to be optimized, helping to avoid false or unnecessary tradeoffs between objectives and to maximize synergies among them.

3. **Definitional framework**
   A clear definitional framework for financial inclusion that includes definitions at the national, policy and product levels is needed to establish priorities, to avoid both irresponsible and misguided inclusion, and to measure progress.

I-SIP Guidance Statements

4. **Segmentation on policy relevant basis**
   Segmenting the market according to whether clients are currently served with formal financial services, within reach but not using formal financial services, outside the current reach of formal financial services, or 'self-excluded' improves the understanding and calibration of the I-SIP linkages.

5. **Data to calibrate linkages**
   Policy relevant data should be collected on a regular basis to calibrate linkages ex ante and then monitor them in practice.

I-SIP Guidance Statements

6. Structured consultation

Structured consultation with providers in proportion to the scale of the proposed changes helps to identify and understand linkages.

7. On-going review and adaptation

Optimization of I-SIP linkages requires a commitment by policy makers to *adapt policy and regulation over time* in light of the evidence collected and outcomes observed.

Conclusions

- Tradeoffs among I-SIP objectives are not inevitable; synergies may be achievable
- ‘More’ is not always better—whether in data, consultation, inclusion by the numbers alone or indeed in the achievement of any one I-SIP objective
- **For national policy makers:** optimization of linkages among I-SIP and other national objectives is not easy and requires the understanding and consideration of the linkages in each case.
    - Tentative I-SIP methodology provides some pointers
- **For SSBs:** illustrates how in practice the independent objectives advanced by each SSB interact in a wider whole in the context of a particular domestic policy agenda.