GPFI Global Partnership for Financial Inclusion

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Plenary Session 3:
Financial Inclusion – A Pathway to Financial Stability? Understanding the Linkages

Issues Paper

Introduction

International standard-setting bodies (SSBs) and national policy makers – including financial regulators – pursue the core objectives of financial stability, financial integrity and financial consumer protection. The G20 leaders have recognized and endorsed financial inclusion as a pillar of the global development agenda and have called upon five global standard-setting bodies (SSBs) to step up their work in this area, consistent with their core mandates. At the same time, a groundswell of countries have introduced financial inclusion as a domestic policy objective. These advances challenge financial regulators to consider how to optimize the linkages among the four distinct policy objectives – financial inclusion (I), financial stability (S), financial integrity (I) and financial consumer protection (P) (collectively, I-SIP). This topic – optimizing linkages among the I-SIP policy objectives – is the subject matter of the third Conference Plenary "Financial Inclusion - A Pathway to Financial Stability? Understanding the Linkages" and this Issues Paper.

In some cases, it appears that the I-SIP objectives may be mutually reinforcing and interdependent: no long-term stability, for example, without inclusion, coupled with effective financial consumer protection and prevention of financial crime.[1] However, concrete evidence of these linkages has generally not been systematically collected, often leaving policymakers to face choices (i.e., between inclusion, on the one hand, and stability on the other) that are unnecessarily framed as tradeoffs.

[1] The four terms – financial inclusion, financial stability, financial integrity, and financial consumer protection – can have varying definitions, depending on the context. The 2011 white paper prepared on behalf of the GPFI "Global Standard-Setting Bodies and Financial Inclusion for the Poor: Toward Proportionate Standards and Guidance" defines financial inclusion as "a state in which all working age adults have effective access to credit, savings, payments, and insurance from formal service providers. 'Effective access' involves convenient and responsible service delivery, at a cost affordable to the customer and sustainable for the provider, with the result that financially excluded customers use formal financial services rather than existing informal options." Global Partnership for Financial Inclusion. "Global Standard-Setting Bodies and Financial Inclusion for the Poor – Towards Proportionate Standards and Guidance." 2011. (http://www.gpfi.org/knowledge-bank/white-papers/global-standard-setting-bodies-and-financial-inclusion-poor). The term "financial stability" is rarely defined, but is generally understood to refer to a lack of financial instability. "Financial integrity" is used by some to refer broadly to the absence of all financial crime, including money laundering, financing of terrorism, financing the proliferation of weapons of mass destruction, fraud, theft, corruption, forgery, and others, but can also be used to focus on a narrower subset of financial crimes. "Financial consumer protection" is essentially concerned with the market conduct of financial service providers vis-à-vis customers.

Part 1. Background

In May 2012, the UK Department for International Development (DFID) funded GPFI Implementing Partner, the Consultative Group to Assist the Poor (CGAP), to conduct rapid research to explore the linkages among the I-SIP policy objectives in order to build a deeper understanding by examining the experiences in South Africa, a country with significant experience in crafting and implementing financial inclusion measures. The project's goal was to commence the building of understanding and evidence of these linkages that can be drawn on by regulators, supervisors and the SSBs as they incorporate financial inclusion objectives into their work.[2] To that end, the project strived to articulate a practical methodology for optimizing the I-SIP linkages that could be applied and further developed in other countries.

DFID selected South Africa as the subject of the research for several reasons: (i) it is a member or associate member of the SSBs most relevant to the I-SIP objectives;[3] (ii) it has a more than decade-long history in the post-Apartheid period of pursuing a variety of financially inclusive policies; and (iii) it has good sources of data that have tracked aspects of financial inclusion over time. Also supporting the selection of South Africa, the research revealed early on that the four I-SIP objectives correspond with the four pillars of South Africa's national financial sector policy, as articulated in the 2011 policy document of the National Treasury: "A safer financial sector to serve South Africa better."[4]

Based on interviews with the South African financial regulators as well as research of both primary and secondary sources with respect to selected South African examples of financial inclusion measures, the study found demonstration of positive I-SIP linkages, one clear negative linkage, and one example of no meaningful increase in financial inclusion (and no meaningful impact on stability, integrity or protection objectives). The outcome of the study suggests the need to consider the four I-SIP objectives collectively rather than independently, as is commonly the case, so that *linkages among them can be optimized*. The study's written report[5] proposes that a proportionate approach to any financial inclusion intervention (and its regulatory and supervisory design and implementation) should involve understanding the risks and benefits to stability, integrity and protection and *optimizing* the I-SIP linkages (maximizing synergies and minimizing tradeoffs and other negative outcomes). The report also offers a working proposal for a methodology to undertake such an approach.

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[2] The research was led by the consulting firm Bankable Frontier Associates (BFA) and included both BFA and CGAP staff and consultants as well as research input from two South African think tanks: the Center for Affordable Housing Finance (a division of FinMark Trust) and Cenfri.

[3] The five SSBs are the Basel Committee on Banking Supervision (BCBS), the Committee on Payment and Settlement Systems (CPSS), the Financial Action Task Force (FATF), the International Association of Deposit Insurers (IADI), and International Association of Insurance Supervisors (IAIS). South Africa is also a member of the Financial Stability Board and co-chairs its Regional Consultative Group for Sub-Saharan Africa, together with Kenya.

[4] National Treasury Policy Department, Republic of South Africa. 2011. "A safer financial sector to serve South Africa better: 2011." Pretoria: National Treasury. 23 February 2011. (http://www.treasury.gov.za/documents/national%20budget/2011/A%20safer%20financial%20sector%20to%20serve%20South%20Africa%20better.pdf)

[5] Forthcoming on http://www.dfid.gov.uk, http://www.cgap.org and http://www.gpfi.org.

Key messages based on the South Africa study:

- The South African examples demonstrate that tradeoffs among the I-SIP objectives are not inevitable and that synergies are achievable.
- Optimization of linkages is not an easy process and is not likely to occur without explicit attention by policymakers.
- Optimization of linkages requires a clear articulation of policy objectives, a gathering and analysis of data across agencies to assess the risks and benefits to I-SIP objectives as well as broader policy objectives (economic development, increased welfare, increased efficiency), private sector input, and ongoing evaluation and adjustment.

Part 2. Theoretical Framework for Thinking about I-SIP Linkages

There is increasing consensus that, at the level of outcomes, financial inclusion should reinforce the other three objectives and is in turn reinforced by them. For example, the newly approved "Application Paper on Regulation and Supervision of Inclusive Insurance Markets" states categorically: "Financial inclusion contributes to financial stability. It is an important element in delivering fair, safe and stable financial markets in a jurisdiction. Less than fully effective inclusion can, and has, led to financial sector instability."[6] This view is supported by hypotheses about linkages between inclusion and each of the others. Consider the following statements about the *linkage from stability to inclusion*, again at the outcome level:

- Stability builds consumer trust in the financial sector as a whole, making it more likely that individuals will want to be included.
- Stability can positively impact factors (such as inflation and interest rates) that can reduce key prices, potentially making financial services more affordable to poor people.

The reverse also applies, from *inclusion to stability*:

- An inclusive financial sector will have a more diversified, stable retail deposit base, which can increase systemic stability. Similarly, inclusion improves the diversification of lenders' loan portfolio away from large borrowers, thereby reducing systemic risk.
- An inclusive financial sector 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.
- An inclusive financial sector has the potential to enhance economic stability, which is an essential component of financial stability.

Similar pairwise outcome linkages with financial inclusion can be posited for both *integrity* and *consumer protection*:

- Integrity is likely to promote more trust in financial institutions and the system as a whole, therefore encouraging more usage and greater levels of inclusion.

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[6] International Association of Insurance Supervisors. 2012. "Application Paper on Regulation and Supervision supporting Inclusive Insurance Markets." Basel: IAIS. October 2012, p. 7. (http://www.iaisweb.org/Application-papers-763)

- Inclusion increases the ability to apply and enforce consumer protection norms—after all, users of informal financial services are by definition not protected.

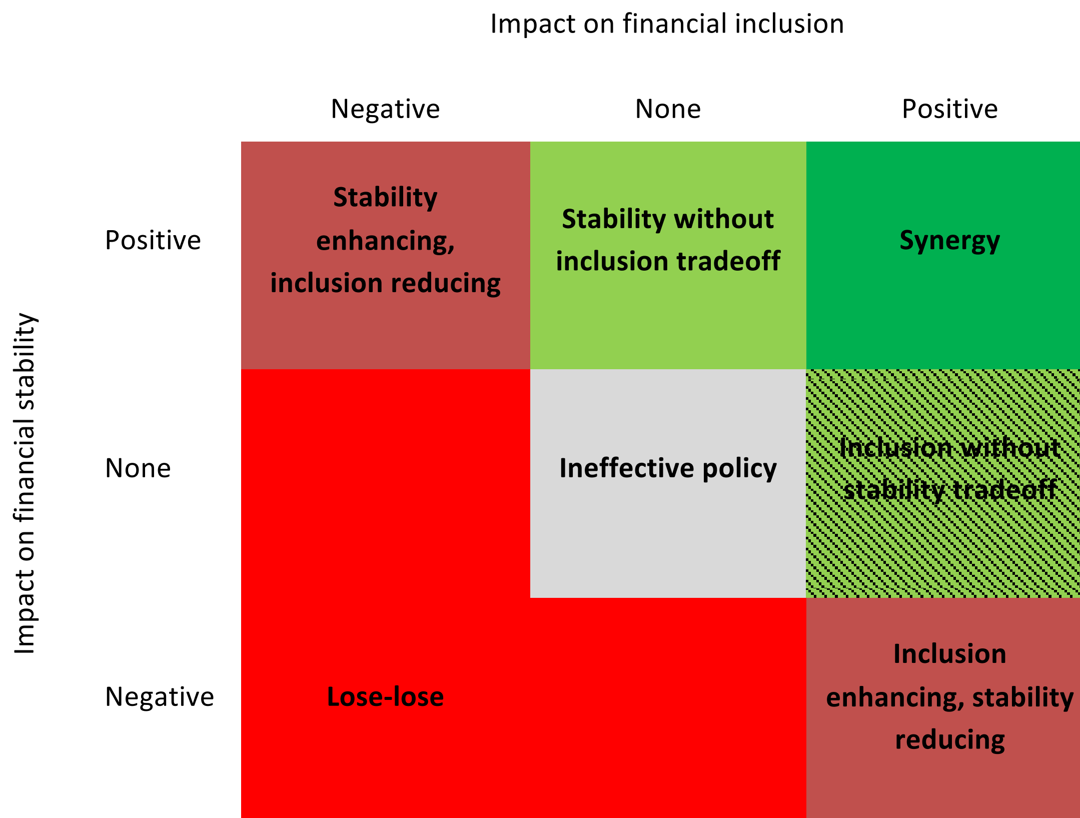
These statements demonstrate a strong case for the ultimate alignment between the objectives of financial inclusion, stability, integrity and protection in the long term. However, the growing body of empirical evidence to substantiate the theory is far from complete[7] and further econometric research, not addressed in this rapid research exercise, would be valuable.

In practice, *the risk of negative linkages certainly exists at the level of policy interventions,* i.e. that one is achieved at the cost of another, or that neither is achieved. This risk is heightened when independent agencies or even departments within the same agency are responsible primarily for one objective only. *As a result, inter-agency coordination is required if the linkages are to be understood and linkage-optimizing policy developed and implemented.*

The focus of the study and this paper is on the "pairwise" linkages between financial inclusion and each of the other three (stability, integrity and protection), not on the inter-SIP linkages in general, which have been considered elsewhere. Using inclusion on the horizontal axis and stability on the vertical axis as an example, Figure 1 below shows the possible combinations from such an assessment of linkages. For each objective, the linkage could be negative (i.e., a tradeoff, where the achievement of one objective negates achievement of the other), neutral (no effect) or positive (i.e., a synergy, where achievement of one supports achievement of the other objective). The tradeoff zones, shown in red below, indicate where a positive result in terms of one objective is achieved at the cost of another; light green demarcates zones where one is achieved without negatively impacting another. Dark green marks the zone of complementarity, or synergy of objectives. In theory, a policy that would have no effect on either would be ineffective (light grey) and therefore not considered further; and the same, even more so, would apply to policies located in the dark red zones where there is loss for no gain. Policymakers concerned about all four I-SIP objectives will want to approach policy interventions so as to optimize the I-SIP linkages (by minimizing tradeoffs and maximizing synergies), thereby moving toward the darker green zone of the table and avoiding 'negative outcome' red zones.

[7] See, e.g., Robert Cull, Aslı Demirgüç-Kunt, and Timothy Lyman. 2012. "Financial Inclusion and Stability: What Does Research Show?" CGAP Brief. Washington, D.C.: CGAP. (http://www.cgap.org/publications/financial-inclusion-and-stability-what-does-research-show-0)

Figure 1: Possible pairwise linkage zones *(inclusion and stability depicted)*



Of course, governments pursue financial inclusion, stability, integrity and inclusion to achieve broader policy objectives (economic development, enhanced welfare) that may be of higher priority on the national policy agendas than the I-SIP objectives. In addition, some important national policy priorities (for example, control of immigration) may not relate closely to – and may even conflict with – the I-SIP objectives and can prevent optimization of linkages among them.

Part 3. I-SIP Analysis of Selected South African Financial Inclusion Measures

The study in South Africa commenced with a survey of a range of financial inclusion measures undertaken over the past dozen years, resulting in the selection of five examples for in-depth analysis: four *ex post* and one *ex ante*. The four *ex post* examples studied were: (i) the passage of the Cooperative Banks Act 2007, creating a new tier of regulated institution to permit formalization of existing informal providers and the establishment of new financial cooperatives, (ii) a 2004 amendment to the KYC regulations that enabled banks to offer simplified "Mzansi" bank accounts for the unbanked; (iii) the commitment by banks to provide affordable housing loans under South Africa's Financial Sector Charter, (iv) and the permitting by government of payroll deductions (for government employees) for repayment of small loans. The *ex ante* example – a new microinsurance policy framework – also introduces a new tier of regulated financial institution.

The study sought to understand in each case: (i) whether the I-SIP linkages were considered at the time of the intervention; (ii) what was done to mitigate potential I-SIP risks; and (iii) as far as the available data allowed, what linkages have been manifest to-date. (Where data were lacking, policy

maker interviews informed the analysis.) Two examples illustrate an awareness of linkages, a process for assessing the risks and benefits of the measure to other objectives (integrity, stability), and indications of positive linkage outcomes:

Inclusion – integrity linkage: In the case of the Mzansi bank accounts – an initiative of South Africa's big four retail banks to open 2.2 million active new bank accounts in four years[8] (at a time when there were only 12 million banked people in the country) – the integrity concerns had to considered up front because the existing AML/CFT verification and address requirements would have prevented the product from reaching the target customers. Following a series of meetings among the Banking Association, Financial Intelligence Center (FIC),[9] and the National Treasury, the banks agreed to adjust the product design to reduce risk and the FIC agreed to amend the AML/CFT requirements accordingly. The Mzansi case is viewed as a successful financial inclusion intervention: 6 million accounts were opened in the four-year target period; 72% of Mzansi accounts were opened by people who had never been banked and 61% of account holders were from the targeted low-income groups.[10] In addition, banks (including Mzansi issuers) have launched similar low value accounts that take advantage of the revised AML/CFT requirements. From the perspective of the banking sector and the regulator, the Mzansi accounts have not resulted in increased integrity problems and may have had a positive outcome for financial integrity in South Africa.

Inclusion – stability linkage: In the case of the affordable housing finance, the South African banks agreed to targets that were set forth in the country's Financial Sector Charter. Although the regulators had been concerned about stability risks of such loans, these risks were not discussed during the Charter deliberations, mainly because the banks' target was aligned with their own risk assessment: the volume of lending was very small relative to both total bank assets and residential real estate loans. The financial inclusion outcome was largely successful (as measured against the target) and, based on limited data (i.e., comparison of 90-day portfolio in arrears for Charter loans versus higher priced property markets), the outcomes for stability appear to be positive.

One example illustrates a *negative inclusion – stability linkage*: The South African government, as an employer, permitted payroll deductions from civil servant salaries specifically for scheduled payments on unsecured small loans that were to be used only for housing purposes (i.e., the intent was to encourage lending to an excluded group). Due to abuse by lenders (who extended loans for other purposes, prioritizing their loan repayments over others) and the pent-up demand for credit, the situation produced widespread overindebtedness, especially among government employees. The government withdrew its permission with respect to payroll deductions, causing an increase in payment defaults on loans and ultimately the failure of a large bank and a run on deposits in the country's fifth largest bank. The government issued a guarantee on deposits of that bank and stopped the run. In 2006 (six years after the withdrawal of salary deduction facilities for small loans

[8] This initiative was designed to meet the banking sector target – set forth in the 2003 Financial Sector Charter – to provide 80% of lower-income adults with effective access to basic transactions and savings accounts by. The Financial Sector Charter – a voluntary agreement of the financial sector institutions in South Africa - is focused on Black Economic Empowerment.

[9] The FIC is the regulator responsible for AML/CFT compliance.

[10] Although 42% of accounts opened at the private banks were dormant within four years, this ratio was no higher than for the nearest equivalent account types and in half of the cases, the account became dormant as a result of the customer transitioning to a higher order product.

to state employees), two new payment instruments were designed to permit bank clients to authorize debits to their accounts on a randomized, non-preferential basis for certain payments, including insurance premia and loan repayments. This case illustrates the risks of negative outcomes when linkages are not understood or considered when designing a policy measure.

Part 4. ISIP Methodology: Guidance Statements for Optimizing I-SIP Linkages

Beyond demonstrating the value of considering the I-SIP linkages when undertaking financial inclusion initiatives, the South African research informs a working proposal for a methodology to optimize the I-SIP linkages in the case of such initiatives. The methodology is outlined in the form of seven guidance statements:

Guidance Statement #1*: *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.

The principle of proportionality—the balancing of risks and benefits against costs of regulation and supervision—is the key to optimizing the linkages among I-SIP objectives.[11] When the objectives and the linkages go beyond the mandates of one particular agency,[12] application of a proportionate approach requires communication and collaboration across the relevant agencies to ensure that the risks and benefits are identified and understood.[13]

In South Africa, cross-agency communication and collaboration was critical in each example, either for the problems caused due to its absence or for the success with its presence (as demonstrated by the Mzansi example). In the Mzansi case, a solution was not reached until such collaboration was forced by one of the parties involved.

***Guidance Statement #2:* 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.**

The objective of using a linkage framework in the I-SIP context is to highlight the need for modifications in order to achieve the best possible outcomes for all four I-SIP objectives (i.e., optimization), avoiding false or unnecessary tradeoffs and minimizing the risk of unintended consequences and other negative outcomes while maximizing the possible synergies among objectives. (Figure 1 above refers to pairwise linkages; a depiction of three-way or four-way I-SIP linkages would require three or four dimensions.) A linkage framework should focus on the short and medium terms, when linkages can be actively monitored and managed.

[11] See G20 Principles for Innovative Financial Inclusion: "Proportionality: Build a policy and regulatory framework that is proportionate with the risks and benefits involved in such innovative products and services and is based on an understanding of the gaps and barriers in existing regulation." (http://www.gpfi.org/knowledge-bank/publications/g20-principles-innovative-financial-inclusion)

[12] While I-SIP objectives are at the heart of financial authorities' objectives, they do not exist independent of wider national policy objectives (increased welfare, economic development) and other financial sector objectives (improved efficiency and competition in financial markets). Any analysis of linkages should consider these broader objectives as well.

[13] See Principles 1 and 6 of the G20 Principles for Innovative Financial Inclusion. (http://www.gpfi.org/knowledge-bank/publications/g20-principles-innovative-financial-inclusion)

The Mzansi example illustrates the effort, when designing a new policy measure, to assess up-front the risks and benefits. The result was a modification by the banks in the product design to address potential integrity risks of an adjustment to the AML/CFT rules tailored for the Mzansi accounts and similar products that would appeal to and reach the non-banked. In the low-income housing finance example, the banks limited the scope of the measure (specifically, the total amount of such loans that would be extended in a specified period) to ensure that the risks were manageable.

Guidance Statement #3: **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.**

To be applied meaningfully in the context of identifying and assessing I-SIP linkages, financial inclusion requires more than a general national definition that sets forth an overall vision (but is too general to guide applied decision making). Specificity and clarity in policy-level definitions will assist in clarifying, and ultimately reflect, the priority areas – both in terms of targeted customers and type of financial services (i.e., savings, payments, insurance, credit). Such specificity will provide the means for avoiding irresponsible or misguided inclusion where a new product or service is not needed or helpful to those who are excluded. Finally, clear definitions with set targets are essential to efforts to measure progress.

The Mzansi accounts and the low-income housing loans both involved specific targets that served at least one of the three stated goals – i.e., prioritization, responsible financial inclusion, means of measuring progress. In contrast, the permitting of payroll deductions for small loans suffered in all three respects due to the failure to articulate up front a specific financial inclusion objective.

Guidance Statement #4: **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.**

Dividing the population into four main segments for a given product market[14] and understanding the characteristics and determinants of each segment will help in the design of a given policy intervention as well as the understanding of its anticipated impact (including the size of the target group).

The Mzansi accounts and the low-income housing loans both involved segmentation of the market, a careful calibration of integrity and stability linkages, and successful achievement of all objectives (inclusion and integrity for the Mzansi; inclusion and stability for the housing loans). In contrast, the permitting of payroll deductions for small loans did not. As a result, the payroll deduction mechanism was misused by lenders and the result was irresponsible financial inclusion (in this case, overindebtedness) and financial instability.

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

[14] Financial inclusion efforts should respond to the financial service needs of the population being addressed. For some, this may mean that priority should be given to savings products and services; for others, the priority may be for insurance or payments and transfers or credit products.

Enabling meaningful market segmentation and assembling a linkage framework requires the collation of datasets that monitor policy relevant indicators over time. Both policy-specific and nationally representative data should be collected. [15] Determining which data are relevant for purposes of shaping a policy intervention, measuring progress, and correcting course (as necessary) is a challenge, as data collection is costly and unnecessary data can be distracting.

The Mzansi account and the housing finance examples were designed based on both demand and supply-side data. The banks were able to keep track of progress, measured (i) in the Mzansi case, by the number of accounts opened and their usage and (ii) in the housing finance case, by the total principal amount of loans extended to the target clients.

Guidance Statement #6: **Structured consultation with providers in proportion to the scale of the proposed changes helps to identify and understand linkages.**

In the process of identifying the nature and assessing the extent of linkages among the I-SIP objectives, consultation with financial service providers – and in particular, those who would be critical in the implementation of a proposed policy intervention – helps to surface new perspectives and reduce the risk of unintended consequences.[16] Such stakeholders can be prompted specifically to give their views on whether and if so how a proposed policy or regulation would affect the achievement of other specified objectives, as well as their commercial appetite to enter the market or offer the type of service in question. However, more consultation between policy makers and the private sector is not always better, as consultation carries costs in time and resources for both policy makers and financial service providers. The level of consultation should therefore be calibrated to the scale of proposed changes at different stages in the design and implementation of a new policy intervention.

The Mzansi accounts and the low-income housing finance examples both illustrate the intensive involvement of the private sector in shaping a financial inclusion measure. Through this process, the linkages to integrity and stability were managed throughout.

Guidance Statement #7: 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.

Optimization of linkages among I-SIP objectives – that is, maximization of synergies and minimization of tradeoffs and other negative outcomes – requires an ongoing process of testing and learning, well beyond a pilot phase alone.[17] Evidence collected through data monitoring (Guidance Statement #5), insights resulting from broad-based inter-agency collaboration (Guidance Statement #1), and perspectives gained from appropriately scaled consultation with financial service providers (Guidance Statement #6) should inform a structured, periodic policy review process whereby the

[15] See the G20's Basic Set of Financial Inclusion Indicators, which includes indicators of access to, and usage of, financial services.
(http://www.gpfi.org/sites/default/files/G20%20Basic%20Set%20of%20Financial%20Inclusion%20Indicators.pdf)

[16] Such consultation is called for in Principle 6 of the G20 Principles for Innovative Financial Inclusion.
(http://www.gpfi.org/knowledge-bank/publications/g20-principles-innovative-financial-inclusion)

[17] Principle 7 of the G20 Principles for Innovative Financial Inclusion encourages a 'test and learn' approach to innovation through which regulators create space by exemption, waiver or forbearance to allow experimentation on a limited scale. (http://www.gpfi.org/knowledge-bank/publications/g20-principles-innovative-financial-inclusion)

changing nature and extent of linkages can be assessed and action taken as necessary to adapt policies. Without such adaptation, even the most carefully designed policy, which has identified and calibrated all relevant linkages ex ante, may result over time in unnecessary tradeoffs or other negative outcomes or the underachievement of potential synergies among I-SIP objectives.

The housing finance example illustrates the ability to adapt a measure in light of availability of data and involvement of providers: as noted above, the banks were unable to meet the target ($5.25 billion in loans) due to lack of available affordable housing; in response, they extended new types of housing-related loans to the target market and made wholesale loans to residential developers and social housing institutions. The payroll lending example also illustrates the positive linkages that can result from initially negative inclusion and stability outcomes. The new payroll deduction mechanisms (which allowed clients to authorize debits to their accounts on a randomized, non-preferential basis) have introduced a more stable, fair collection mechanism that is subject to regulatory oversight.

Conclusion

The South African examples demonstrate that tradeoffs among the I-SIP objectives are not inevitable. Indeed, the examples show that synergies *are* achievable between financial inclusion and the other three I-SIP policy objectives: stability, integrity and consumer protection. This does not mean that tradeoffs are always avoidable. However, synergies are more likely to result when the approach taken focuses consciously on the potential to optimize linkages in the pursuit of all four I-SIP objectives, as well as the other broader policy objectives to which they contribute such as economic development, increased welfare, and increased efficiency.

The South African examples also suggest that optimizing I-SIP linkages is not an easy process, and is not likely to occur without explicit attention. An approach based on the Guidance Statements comprising the I-SIP methodology may help both national level policy makers and the SSBs to translate the principle of proportionality into practice and increase the chances of maximizing synergies and minimizing tradeoffs and other negative outcomes in the pursuit of a financial inclusion agenda.