



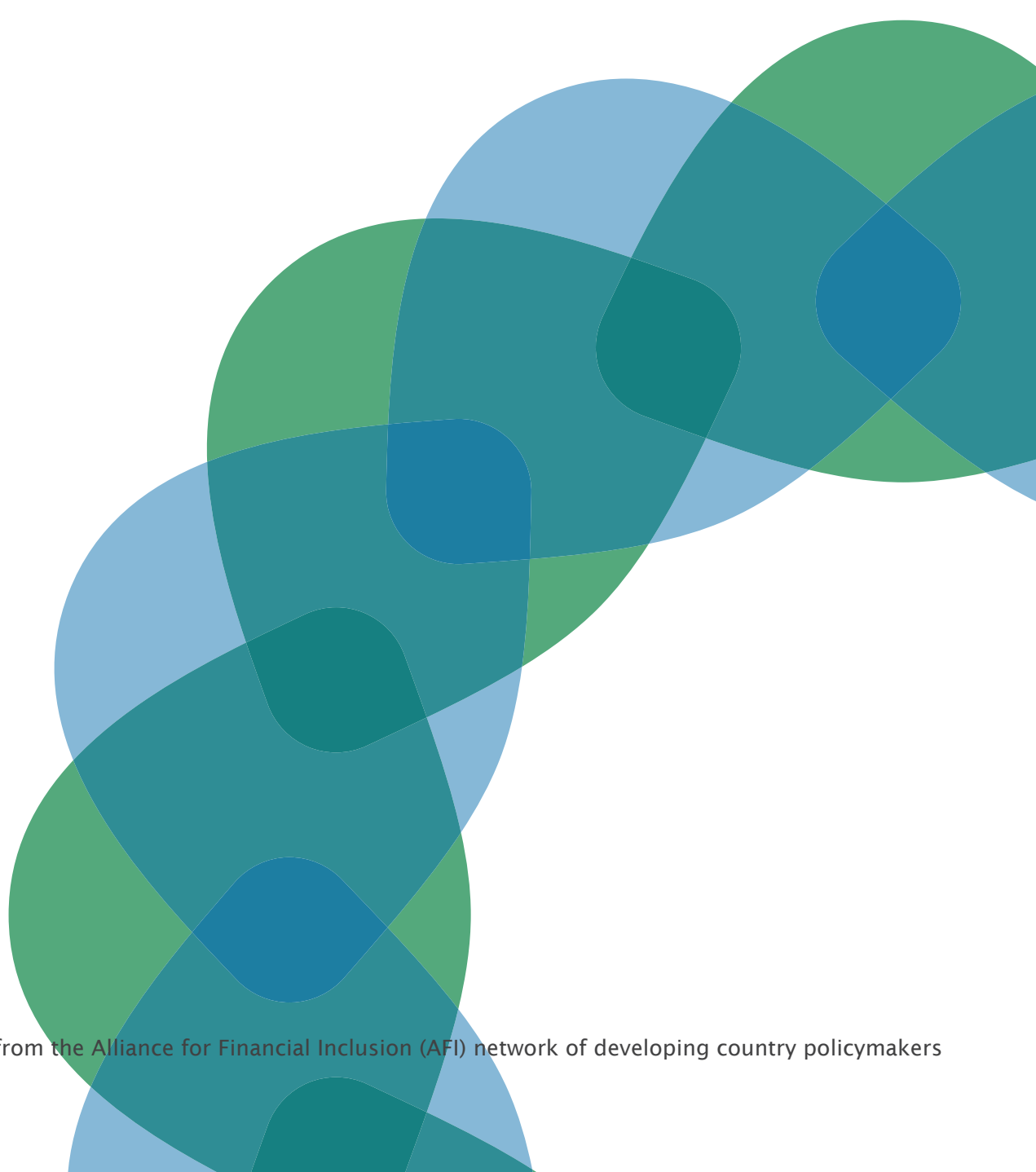
GPI

Global Partnership
for Financial Inclusion

The G20 Principles for Innovative Financial Inclusion

BRINGING THE PRINCIPLES TO LIFE

Eleven country case studies



A contribution from the Alliance for Financial Inclusion (AFI) network of developing country policymakers

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Disclaimer:

Suggestions made in this document do not represent the official views of any of the regulatory authorities consulted. All errors and omissions are those of the authors.



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OVERVIEW

The diversity of demographics, regulatory environments, and other factors preclude a simple, off-the-shelf solution for improving financial inclusion. Recognizing this, the G20's Financial Inclusion Experts Group, established in response to the global financial crisis, has not identified an overarching model for financial inclusion policy, but rather nine principles for success based on the experiences of countries that have promoted financial inclusion effectively.

The G20 Principles for Innovative Financial Inclusion are not rigid prescriptions but indications, based on country experiences, of the core characteristics needed to foster greater financial inclusion. The principles are deliberately broad in order to accommodate the diversity of these experiences. They also recognize that financial inclusion is not an exact science. It is necessary to test, learn, and apply the principles creatively, adapting them to each country's unique circumstances.

The nine principles are:

- Leadership
- Diversity
- Innovation
- Protection
- Empowerment
- Cooperation
- Knowledge
- Proportionality and Framework

These principles were endorsed by G20 Leaders at the Toronto Summit in May 2010 and underpinned the creation of the Global Partnership for Financial Inclusion (GPFI) at the Seoul Summit in November 2010. The GPFI serves as a platform for peer learning, knowledge sharing, policy advocacy, and coordination among G20 and non-G20 countries, together with partners in the private sector, civil society, international organizations, and others with a stake in increasing financial inclusion.

This report describes how 11 very different countries, from Brazil and Nigeria to the Philippines and Russia, have brought the G20 principles to life in different yet equally innovative ways. They are designed to inspire and educate, as well as illuminate the opportunities and challenges that lie ahead. These 11 case studies, which have been produced on behalf of the GPFI by the Alliance for Financial Inclusion, are by no

means exhaustive. There are many other examples of innovations for financial inclusion. However, it is hoped that these examples of challenges and policy solutions will serve as an inspiration to other countries seeking to promote financial inclusion.

Below we summarize some of the key themes that emerged from the case studies, and discuss the individual country studies in greater detail on the following pages.

Key themes from the case studies

- **Leadership**, often coupled with cooperation, is a recurring theme in all 11 case studies. In Nigeria, for example, the Central Bank of Nigeria (CBN) has taken a consistently strong leadership role in championing financial inclusion, setting regulations, and bringing parties together to forge a shared agenda. Similarly, Brazil's central bank has made financial inclusion one of its strategic objectives and a key part of its mission to ensure the soundness and effectiveness of its National Financial System (SNF). This has been supported by a Financial Inclusion Project, designed to leverage partnerships between the public and private sectors. As Brazil and other countries have demonstrated, leadership has to be more than rhetoric to succeed. It has to be underpinned by shared vision, tangible deliverables, and clear targets.
- **Diversity**, of both financial services providers and products, is evident in many countries, despite initial caution in allowing new service providers to enter the market. Indonesia, for example, embraces both institutional and product diversity, ranging from large universal banks to small-scale community institutions, and growing increasing numbers of Islamic banking outlets. Financial institutions with a local community presence may be better positioned to meet low-income households' product and service needs. Other examples of diversity include agent banking models in Brazil and Russia and the Philippines' branch liberalization program.

- **Innovation** mainly focuses on embracing technological or other opportunities to increase the access of consumers, and particularly the poor, to financial services and products, such as mobile phone banking, networks of correspondent banks, and other Kenya's mobile money transfer and channels. payment system, M-PESA, powerfully illustrates the potential of technological innovations, as well as strong leadership, among other principles.

Other countries have launched novel programs to stimulate the market. Korea's Sunshine Loan scheme, which incentivizes financial institutions to offer loans to specific customer segments, including low-income families and small businesses, is a case in point. Turkey's creation of a new capital market for SMEs is another example. The case studies reveal numerous other examples of innovations, from enabling clients to make informed decisions about personal and small business financing to protecting them against fraud and abuse.

- **Consumer protection** and **empowerment** are two separate principles, yet countries often view them as complementary and critical pillars of financial inclusion initiatives. Russia, for example, complements supply-side initiatives to enhance access to payment systems and bank accounts with a clear demand-side strategy, that encompasses a consumer protection framework and financial literacy programs developed through public-private partnerships. Mexico and Peru, on the other hand, see consumer protection as a way of ensuring transparency and providing mechanisms for redressing consumers' problems.

Many countries have recognized the importance of financial education in empowering consumers, but it is still too early to assess the impact of these initiatives. Different approaches may work with different target groups and in different country contexts. These programs will therefore need to be carefully observed and monitored to enable meaningful comparison in the years ahead.

- **Cooperation** not only involves working constructively with relevant public sector bodies, such as the regulator and the central banks, but also connecting with

private sector players. The interplay between public policy and commercial interests is a recurring theme in many of the case studies. Specifically, it appears that instructing banks and financial institutions what to do is not enough; carrots and sticks are often required, including a combination of constraining measures and incentives in regulation, supervision, and monitoring.

The general perception of the public sector is that it should act as a pioneer whenever necessary, but that it should take a backseat once it has successfully engaged private actors, as it has in Mexico. The ease with which this can happen varies from case to case, depending on the context and opportunity.

- **Knowledge**, notably data, is also key to effective financial inclusion policies. The general consensus is that there is a lack of high quality data and that obtaining it – whether by repeat household surveys, randomized control trials, or other methods – is challenging from both a resource and organizational perspective. Mexico, a leader in data collection, has shown a potential way forward by collecting a range of both supply- and demand-side evidence. The UK, under the leadership of a Financial Inclusion Taskforce, has also made significant strides in gathering evidence needed to make the case for innovations for financial inclusion. By providing precise evidence of the costs of financial exclusion for both the individual and society, the Taskforce has made an argument that is far more powerful than ethical considerations alone.
- **Proportionality** and **framework** are closely linked but less understood principles and seem to be areas that require further understanding in terms of balancing risk and rewards. Implementing these principles may therefore be difficult, but several countries have made significant progress. Nevertheless several countries have made significant progress. In terms of the principle of proportionality, changes to regulations in the Philippines have made it possible for microfinance institutions to establish a presence cost effectively, and reduced the barriers to customer access. Turkey, in turn, has successfully applied the framework principle in financial inclusion policies

targeted at SMEs. As well as a proportionate risk-based approach toward AML/CFT regulation, which provides appropriate flexibility for SMEs, the country has established a comprehensive legislative framework to support small businesses and reduce their administration burden as they formalize their activities for the first time.

The following pages describe the nine *G20 Principles for Innovative Financial Inclusion* in more detail and then discuss how 11 countries have brought these principles to life. The report concludes with some recommendations for moving forward so that all countries can learn from each other and capitalize on their collective insights to draft successful financial inclusion policies.

Bringing the principles to life: Eleven country case studies was published at the first forum of the GPFI in Riviera Maya, Mexico on 1 October 2011. A number of the countries showcased in this report were present to discuss their experiences and the challenges they have faced.

Alongside the forum, the GPFI launched its website – www.gpfi.org – which will serve as a focal point for the G20's financial inclusion initiatives. As more countries prepare to document their financial inclusion experiences, stories of how countries have implemented financial inclusion policies in line with the spirit of the G20 Principles will be maintained as a live document on this platform.

THE NINE G20 PRINCIPLES FOR INNOVATIVE FINANCIAL INCLUSION

1. Leadership: Cultivate a broad-based government commitment to financial inclusion to help alleviate poverty.

2. Diversity: Implement policy approaches that promote competition and provide market-based incentives for delivery of sustainable financial access and usage of a broad range of affordable services (savings, credit, payments and transfers, insurance), as well as a diversity of service providers.

3. Innovation: Promote technological and institutional innovation as a means to expand financial system access and usage, including addressing infrastructure weaknesses.

4. Protection: Encourage a comprehensive approach to consumer protection that recognizes the roles of government, providers, and consumers.

5. Empowerment: Develop financial literacy and financial capability.

6. Cooperation: Create an institutional environment with clear lines of accountability and coordination within government, and encourage partnerships and direct consultation across government, business, and other stakeholders.

7. Knowledge: Utilize improved data to make evidence-based policy, measure progress, and consider an incremental “test and learn” approach by both regulators and service providers.

8. Proportionality: Build a policy and regulatory framework that is proportionate with the risks involved in developing innovative products and services, and that is based on an understanding of the gaps and the barriers in existing regulation.

9. Framework: Consider the following in the regulatory framework, reflecting international standards, national circumstances, and support for a competitive landscape: an appropriate, flexible, risk-based AML/CFT regime; conditions for the use of agents as a customer interface; a clear regulatory regime for electronically stored value; and market-based incentives to achieve the long-term goal of broad interoperability and interconnection.

HOW 11 COUNTRIES HAVE APPLIED THE PRINCIPLES

- Brazil
- Indonesia
- Kenya
- Korea
- Mexico
- Nigeria
- Peru
- Philippines
- Russia
- Turkey
- United Kingdom

BRAZIL:

Optimizing the potential of agent banking

Summary

Between 2000 and 2008, the number of bank accounts in Brazil doubled, thanks to a dramatic expansion of Brazil's correspondent banking model, which is now the largest network of correspondents in the world.

Over this period, an integrated policy introduced changes in regulations that allowed correspondents to practice in more places and more ways, and to offer a wider range of services, increasing financial inclusion.

Principles in practice

Brazil's progress in financial inclusion illustrates the following principles.

- **Leadership and coordination** – Banco Central do Brasil (BCB), backed by a supportive government, has taken overall leadership for the strategy, creating an enabling environment for institutional arrangements, providing regulatory clarity, and setting reporting requirements. It has also worked closely with partners and stakeholders within the financial services sector and beyond.
- **Innovation** – Brazil's geography stood in the way of establishing bank branches in remote locations, so a new approach was introduced that allowed non-banks to act as correspondents.
- **Diversity** – regulatory changes enabled correspondents to diversify and provide a wider range of services.

Country context: a leader in correspondent banking

For the past decade, the Brazilian government has been successfully implementing an economic plan aimed at controlling inflation and providing economic stability. Alongside this initiative, originally driven by the Solidarity Community Council, there was significant high-level debate around legalizing microcredit. In 1997, this debate culminated in several microfinance policy measures, with the Central Bank of Brazil (BCB) at the center of the effort.

In Brazil, some 70 million people fall within the income range typically associated with microfinance. Assuming that half of these people are interested in obtaining credit, there is a potential market of 35 million microfinance customers. More precise research, such as the IBGE (Brazilian Institute of Geography and Statistics) report, “Urban Informal Economy” suggests that there is a latent demand for microfinance among more than 10 million urban, informal entrepreneurs.

In the mid-1990s, BCB launched a program of financial inclusion that aimed to increase the supply of financial services to low-income populations recognized as fundamentally important to the fight against social inequity in the country. They carried this work out in an integrated manner with representatives from both the private and public sectors, and actively helped to:

- build the regulatory framework;
- improve mechanisms for banking – including formalizing the role of correspondents (banking agents) and introducing simplified accounts;
- forge closer relations with the credit cooperatives, introduce a regulatory framework for microcredit and help set up two key organizations: the Society of Credit to Micro entrepreneurs and the Small Business Credit Company (SCMEPP).

To help expand the provision of microcredit, the government then obliged commercial banks to direct 2 percent of their demand deposits to microcredit, and introduced rules that enabled banks to make payroll-consigned loans that are largely channeled through agents or credit cooperatives.

These measures proved successful in increasing the volume of credit available, but they gave the banks little control, so the BCB decided to ban exclusive contracts on payroll-linked consigned loans between banks and employers.



Brazil has long been renowned for increasing access to banking through its ‘correspondent’ network – an agent banking model. Since 1991, there have been a number of significant regulatory changes that have helped expand the correspondent model. As a result, there is now some form of financial access in every municipality, and many now offer a larger range of services. Retail stores, post offices, and lottery outlets are also now used to overcome the need for physical bank branches.

During the 1980s and 1990s, there was significant growth in the number of cooperatives. This growth has slowed in the last decade, with several mergers creating economies of scale and streamlining processes. In turn, this has ensured a continued expansion of the number of access points of attendance – effectively expanding access to cooperatives. By 2011, there were approximately 1,450 cooperatives in operation.

Overall, the convergence of microfinance and the traditional financial system has expanded access to financial services tailored to the needs of different populations -- a step in the right direction toward a sustainable and inclusive financial system.

Understanding social mobility is key to financial inclusion in Brazil, particularly with respect to the country’s C and D demographic segments. (See table 1 below)¹. Between 2005 and 2009, the C segment in Brazil grew by 48 percent, while the D/E segments shrunk by 28 percent.

¹ Report “O Observador – Barômetro 2010”, developed by Ipsos Public Affairs, supported by Cetelem, BNP Paribas Personal Finance and Banco BGN.

Table 1: Population per social class, 2005-2009 (in millions)

	2005	2006	2007	2008	2009	Growth %
A/B	26.42	32.81	28.08	29.38	30.22	14.38
C	62.7	66.72	86.21	84.62	92.85	48.09
D/E	92.94	84.86	72.94	75.82	66.88	-28.04

Source: Report O observador – Barômetro 2010

Table 2: Monthly household income per social class, 2005-2009 (in US\$)

	2005	2006	2007	2008	2009	growth %
A/B	1.583	1.481	1.413	1.647	1.614	1.96
C	705	740	676	765	813	15.32
D/E	347	364	369	414	467	34.58

Source: Report O observador – Barômetro 2010

Alongside social mobility, there was also an increase in household income, as Table 2 indicates. Between 2005 and 2009, the average household income for the C segment grew by 15 percent and the D/E segment by 34 percent, respectively.

Unsurprisingly, this led to a reduction in poverty: in 2005, most households in the D/E segment had insufficient financial resources to cover their expenses, with an average deficit of US\$10. By 2009, the same households had an average disposable income of US\$39².

Despite these increases, some 66 million Brazilians are still classified as D/E, with an average income of US\$467 a month.

Leadership and coordination: unlocking the power of partnerships

Armed with the contention that financial inclusion is not an end in itself but rather ‘a way to improve the quality of life of a country’s citizens and strengthen economic agents’, BCB became the champion of financial inclusion policies in Brazil. It made the promotion of financial inclusion one of its strategic objectives, and saw its commitment to financial inclusion as one way it could fulfill its institutional mission to ensure the soundness and efficiency of the National Financial System (SFN). BCB further

understands financial inclusion to be a prerequisite for long-term financial stability, as those who join the formal financial system come to understand how new services and access channels serve their needs.

The BCB’s Financial Inclusion Project (PIF) aims to leverage partnerships between different organizations from the private and public sector. These partnerships will lead to concrete actions targeted at improving financial inclusion in Brazil. The project is divided into two main phases:

- diagnosis and coordination
- knowledge and project development

Phase 1: Diagnosis and coordination

The first stage sought to understand the barriers to inclusion and secure the commitment of a range of actors and stakeholders to cooperate on developing policies and projects. This step has been successfully concluded. Following extensive discussions with the many actors and stakeholders involved with microfinance, the Financial Inclusion Report (RIF) was launched, strengthening the diagnosis tools available in Brazil. The RIF presents data and indicators on the level of access and use of financial services—vital knowledge to support policy development.

BCB held a series of events geared toward the microfinance sector to disseminate the result of its actions. Between 2002 and 2008, it held two seminars on microcredit and seven on microfinance,

² Source: Central Bank of Brazil (Financial Inclusion Report, 2010).

as well as two international seminars. These events were highly successful, with some attracting more than 900 attendees. Other smaller events were also held, including meetings of operators who took the opportunity to bring their members together. Meetings were also held with the Central Bank itself, and some group work such as what was implemented under the strategic project Cooperative Governance – a new approach of the Central Bank to institutions under its jurisdiction.

Among the main activities of PIF is the Brazilian Central Bank Forum for Financial Inclusion. The Forum provides an environment for debate between various stakeholders, with the goal of discussing problems and identifying possible solutions. Through the Forum, cooperation agreements have been signed, involving both public and private institutions, and government officers have begun dialogue and joint works with international organizations. Since the late 1990s, BCB and the Ministry of Finance (MF) have maintained active dialogue with credit unions, with the aim of improving the regulatory framework. Another important partner is the Ministry of Social Development (MDS), which has responsibility for policies related to social benefits networks like ‘Bolsa Família’ (Family Allowance).

Since 2004, BCB has established several institutional partnerships, including those with government agencies such as:

- The Ministry of Agrarian Development (MDA);
- The Brazilian Micro and Small Business Support Service (SEBRAE), aimed at developing microfinance;
- The Brazilian Organization of Cooperatives (OCB), to develop, strengthen, and promote efficient and effective economic and social development in Brazil’s credit cooperative movement;
- The Ministry of Labor and Employment, to study ways of monitoring the development of social currency in Brazil;
- The Ministry of Justice, signing an agreement aimed at ‘improving the development of products and the supply of services to customers and consumers of financial institutions, managers of consortiums, and other institutions authorized to operate by BCB’; and
- The Ministry of the Environment (MMA), focused on strengthening the monitoring agenda around the social and environmental responsibilities of Brazilian financial institutions.

The BCB also actively participates in national committees aimed at technical cooperation, the impacts of which can be seen in Federal Public Administration policies and programs related to financial inclusion. For example, the Committee

for Regulation and Inspection of Financial, Capital, Insurance, Pension, and Capitalization Markets (COREMEC) promotes the coordination and improved performance of Federal Public Administration entities that regulate and supervise activities related to public holdings of personal savings.

Alongside this, the BCB plays a key role in consumer protection. Through its call center and ombudsman, the Central Bank is able to maintain a direct channel of communication with the consumer. It also undertakes nationwide public information campaigns around issues of public interest. Finally, the BCB is represented on the government working group, National Strategy for Financial Education (ENEF).

Phase 2: Knowledge and development of partnerships and projects

As part of the second phase of PIF, due to be implemented by November 2011, BCB will continue to coordinate efforts to pursue financial inclusion through the National Partnership for Financial Inclusion. This partnership sets a common agenda among many public and private actors to encourage synergy and avoid duplicating efforts.

The Brazilian government, and especially the BCB, works closely with the international community on issues of financial inclusion. It has taken part in international debates, such as those promoted by the G20 Financial Inclusion Experts Group (FIEG), which it has been involved with since 2009, and international working groups, such as the Alliance for Financial Inclusion (AFI), the Consultative Group to Assist the Poor (CGAP), and the World Bank. The objective is to develop efficient data collection technology that enables comparison with databases used by other countries, international organizations, and non-governmental entities.

Diversity and innovation: creating new opportunities through new regulations

The use of financial services in Brazil has expanded considerably in recent years, creating greater diversity of provision to meet the broad range of customer needs. This ‘in turn’ has created new business opportunities for banks and economic agents. However, gaps remain in the provision of services to those on a low income, as well as the relatively poor use of financial tools, highlighting the need to consider which type of service is most suitable for each target consumer and how government policy can influence these choices.

Although Brazil has used its correspondent model since the 1970s, the real boost came a little more than a decade ago when regulations broadened the range of services that correspondents could offer and eased several other restrictions.

The rationale behind the correspondent model is clear.

- The country is large (8.5 million sq km) with an unevenly distributed population. Roughly 25 percent of its 5,560 municipalities have less than 5,000 inhabitants each—an insufficient number to justify a physical bank branch.
- Income distribution in the country remains uneven, despite recent improvements. The richest 10 percent of the population hold almost 50 percent of Brazil's total disposable income.

As a result, financial institutions have tended to locate their offices in the larger cities, particularly in the south and southeast regions of the country, and to target richer clients. More than 50 percent of the financial industry's points of sale are located in the southeast. Within larger cities, branches are concentrated in the central and richer quarters, with few in the poorer neighborhoods and large outlying areas.

Correspondent arrangements refer to partnerships between banks and non-banks that are created to offer financial services. Retail stores, lottery outlets, pharmacies, and post offices can all act as correspondents and individual contracts determine the range of services they offer and fees they are paid. However, many of these services do not require customers to hold a bank account, which means that more than twice as many adults can now access financial services.

Over the last decade, the model has grown rapidly. Brazil's 150,000 correspondents account for about 62 percent of the total number of service points in the financial system, making it the world's largest network of this kind. The network has grown very rapidly since the new regulations were issued in 1999. At that time, only two-thirds of all municipalities were provided with some type of service by financial institutions. This left 4 to 5 million of Brazil's economically active population without basic financial services provided by bank branches.

However, despite the change in regulation, it became clear that a large portion of the economically active, living on the outskirts of large cities, were also underserved in terms of basic financial services. This segment of the population outnumbered those living in areas without any financial services ten to one. In light of this, all restrictions guiding where correspondents could operate were lifted.

By the end of 2002, all 5,560 municipalities had at least one point of sale for basic financial services—an extraordinary achievement considering the time it takes the banks to make the necessary arrangements (hiring and training correspondents, developing systems, and implementing internal procedures). *See map for detailed coverage.*

It is estimated that around 15 percent of all bank accounts in Brazil were opened in the last seven years since the regulations were relaxed. Today, between 80 and 90 percent of state benefits such as 'Bolsa Família' are paid via correspondents, serving close to 40 million people. The companies contracted as correspondents directly benefit from the increase in sales and contribute to the improvement in their local economy.

The success of the correspondent model can be attributed to:

- technologically advanced banks;
- the government's encouragement of state banks to serve those on a low income, including relaxed account opening standards and agent banking rules in line with risk-based regulation;
- high-priced credit that gives banks incentives to build a distribution infrastructure to reach more borrowers.

Another important innovation was the creation of simplified current and savings accounts. Today, there are approximately 10 million simplified current accounts. In February 2009, 5.5 million of these were active—a growth of approximately 193 percent since January 2004. More recently, the Caixa Econômica Federal has begun to convert recipients of the Bolsa Família to simplified accounts, some of which are linked to savings and loans.

Standards regarding microcredit were also issued, and the SCMEPP was regulated as a new segment.

In the past, BCB has been criticized for not having a diversity of service providers. However, in coming months, financial services via cellphones may take off. Network operators Vivo, Claro, TIM, and Oi are partnering with commercial banks to offer special low-value accounts where the customer's monthly maintenance fee is converted into airtime value. The telecom regulator has also recently passed regulation allowing MVNO licences, which means that more providers may join the cellphone market.

BCB is now evaluating the infrastructure required for such partnerships, as well as the competition framework, financial and operational management, and the supervision process.

This reflects BCB's long-term commitment to proportionate yet enabling regulation and supervision. It first sought to ensure the availability of a diversity of financial services by encouraging financial institutions to analyze wider macroeconomic scenarios and take a market-led approach, while putting in place prudential and proportionate regulation for new services. In doing so, it took a risk-based approach, focusing on issues such as information disclosure and best governance practices, among other issues.



Map: Correspondent coverage in Brazil

Number of correspondents by municipality

	(Total number of municipalities in this range)
 1	(33)
 2 to 5	(2,171)
 6 to 10	(1,491)
 More than 10	(1,836)

That said, one of the shortcomings that has emerged from the correspondent model is that correspondents typically target pensioners and informally employed workers, but are not equipped to offer microcredit to self-employed entrepreneurs. So far, the correspondent network has primarily been utilized for bill payments, while products such as savings and insurance remain unproven as successful products. Current legislation prohibits microfinance institutions from making loans for consumption and taking deposits from the public, which directly affects their financial management and strategy.

Moving forward: challenges and opportunities

Legal uncertainty further threatens the agent banking business: currently a number of banks are facing lawsuits from labor unions demanding equal pay between agent and bank employees. The unions have questioned the central bank’s right to regulate this service provision. This threatens to destabilize the correspondent business model and frustrate financial inclusion efforts. Of course, such legal issues are

multifaceted, and the lack of a firm legal definition of a correspondent leaves it open to challenges.

Agent exclusivity is another challenge, as no agent banking regulations currently exist. The three banks with the largest footprint are reputed to have exclusive arrangements with end agents, creating barriers to entry.

The BCB has drafted regulations to tackle this, but many policy issues still need to be ironed out as well as divergent views from different parties with different interests. Non-bank providers prefer regulation; for example, as things stand, there is considerable uncertainty about the legal status of e-money issuance, which is threatening to deter mobile operators from developing financial services. Concerns about the interoperability of the payment system are also inhibiting further investment.

The fact is that although the provision of financial services is enabled by different technologies, the products that emerge inevitably reflect market demand. Moreover, the driving motivation isn't social-supporting customers from a certain economic or demographic group is commercial.

Understanding this, BCB acknowledges that the main challenges to innovation come from legal uncertainty and a lack of knowledge about how new services might work. This, in turn, creates uncertainty around the supervision framework, as well as issues related to consumer protection and financial education. To manage some of these challenges, the BCB has created a new unit in the Central Bank to deal with financial inclusion issues. The aim of the new Financial Inclusion unit is to foster a common agenda and engagement in financial education programs. To better link product innovation with regulation, the unit is now formally part of the Regulation Department, which has increased efficiency and knowledge-sharing and promoted the concept that regulation is a relevant tool to foster national financial inclusion.

BCB firmly believes that financial inclusion is a component of financial system efficiency, and that actions and solutions therefore need to be coordinated across its own activities and with those of other stakeholders. The Financial Inclusion Forum has already proved its value in this coordination effort, providing valuable insights into innovative services, new portfolios, competition, and banking expansion.

BCB has also been instrumental in influencing changes to the general infrastructure of payment systems, which has allowed significant technological progress, especially in terms of accelerating the processing of financial transactions. Improvements in telecommunications and information technology now enable immediate connection with all regions of the country – even the most remote areas. This means that the cost of reliably transmitting detailed information on bank transactions is no longer dependent on the distance between the headquarters of the bank and where the transactions actually take place.

BCB reforms in 2001 and 2002 shifted the focus to risk management. The launch of the Sistema de Transferência de Reservas – STR (Reserves Transfer System) provided the country with a large value payment system that allows interbank funds transfers to be settled irrevocably and unconditionally. The focus is now on increasing the efficiency of the retail payment systems in Brazil, bringing more convenience to current users and tackling exclusion by enabling more people to make payments and transfers – the entry point for more complex financial services.

This coordinated approach, manifested in technical agreements between the BCB and other relevant public and private organizations, has been central to Brazil's progress. Further developments will reflect lessons learned and the National Partnership for Financial Inclusion will seek to set priorities within a common agenda: the national strategy.

While the BCB has persevered in many areas of leadership, coordination, and diversity, many challenges remain. Notwithstanding the increase in the use of financial products and services, a large part of the population is still excluded. Some of the next steps therefore include:

- improving the data around financial inclusion;
- expanding the availability of credit services (especially microfinance) and savings;
- tailoring supervision mechanisms;
- Strengthening the institutional structure of financial education; and
- increasing protection for consumers.

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INDONESIA:

Creating a national financial inclusion strategy

Summary

Despite its pioneering reputation in microfinance and a commitment to financial inclusion that dates back to the early 1980s, recent studies revealed that a large proportion of the Indonesian population were unbanked. In particular, the rural poor remained underserved, as did migrant workers, and there were considerable disparities in inclusion between those living in Java and other islands.

In response to this problem, the Government has taken several steps to reinvigorate its progress toward greater financial inclusion – recognizing its integral importance in facilitating wider economic growth and poverty alleviation. Specifically, the Indonesian government has introduced a new National Strategy for Financial Inclusion, new incentives to encourage diversity – particularly in terms of developing savings products – and reduced barriers to entry for suppliers. It has also re-examined the regulatory framework and introduced credit guarantees to banks for their loans, enabling them to serve MSMEs that would otherwise remain financially excluded.

The next key challenge for Indonesia is to make use of new technology in innovative ways to make branchless banking a reality – a vital step in extending further access to financial services, particularly to the more remote and rural areas.

Principles in practice

Indonesia's second wave of financial inclusion demonstrates the following principles:

- **Leadership** – The Vice President's Office has taken on the responsibility of co-ordinating national policy initiatives with other agencies, and works in close cooperation with Bank Indonesia (BI) to devise policy and ensure high-level backing.

- **Diversity** – Studies indicated that the reason for the continued exclusion of many Indonesians was not access to financial products: credit in particular had become widely available. Instead, people wanted different products, in particular savings, and products that complied with Sharia principles. Changes in the law and government-backed provision have helped encourage this diversity.
- **Protection and empowerment** – As well as investing in a new era of consumer protection and transparency around products and services, there has been a concerted effort to improve financial education to build financial literacy.

Country context: a pioneer of microfinance and the G20 principles

Indonesia is often seen as the country that laid the foundation for the global microfinance revolution, so it's no surprise that it has one of the longest histories of promoting broader access to financial services in the developing world. This history includes the story and evolution of Bank Rakyat Indonesia (BRI)¹, which continues to be at the forefront of providing access to financial services for low-income households. It also involves the creation of a wide range of community-based, small-scale financial institutions such as the Bank Perkreditan Rakyat (BPRs – which translates

as people's credit banks)², and Badan Kredit Desa (BKDs village credit organizations), which provide basic financial services to millions of poor people in rural areas.

Through innovative policy and institutional reforms during the early 1980s, Indonesian policymakers transformed the primarily credit disbursing state-owned BRI into a dynamic, robust rural financial intermediary. In November 2003, the policymakers took a bold initiative to partially privatize the bank. By the end of 2009, the share of private ownership in the bank was 43.3 percent³, and included both domestic and foreign shareholders. The BRI, with its microbanking system, is widely considered to be a pioneering example of the new paradigm of sustainable, large-scale commercial microfinance⁴.

¹ BRI was first established in 1895 and is the first state-owned bank in Indonesia.

² BPRs are also commonly called Rural Credit Banks. However, this is somewhat misleading given that a good number of BPRs also operate in urban and peri-urban areas.

³ Bank Rakyat Indonesia, 2010

⁴ Robinson, 2001

The story of financial inclusion in Indonesia is insightful. The country has persistently strived to adopt evidence-based policies to improve access to and use of financial services. What's more, these policies and approaches have consistently been broadly in line with the *G20 Principles for Innovative Financial Inclusion*, even before the Principles were published.

The most recent chapter in Indonesia's history of financial inclusion began around the turn of the millennium. With the financial landscape characterized by thousands of small-scale institutions and their emphasis on savings, the success story of BRI reforms, and the subsequent expansion of its unit desa system for microfinance, Indonesian policymakers presumed that the country was on a smooth track for greater financial inclusion. The reality, however, proved to be different.

A household survey carried out in 2000 jointly by BRI and the Center for Business and Government at Harvard University confirmed that banking services had successfully been extended to Indonesia's 'unbanked majority'. However, the research also revealed that some 67.7 percent of those surveyed still did not have credit from any formal or informal financial institution while 61.9 percent of the sample had no savings account in any formal or informal financial institution. Even among households with viable enterprises, the figures showed surprisingly high levels of exclusion: 58.2 percent did not have loans from financial institutions and 51.7 percent had no savings in a financial institution. For Indonesian policymakers, who firmly believe that savings are the fundamental building block of financial inclusion, these findings were particularly disturbing.

More disturbing still were the results of a 2009 nationally representative survey which highlighted continued major gaps in financial inclusion, despite the continued growth in the outreach of unit desas of BRI and many other small-scale rural financial institutions. According to this survey⁵, approximately half of Indonesia's population still had no access to formal financial services. Commercial banks, which, as in most other developing countries, dominate the Indonesian financial sector, served only a relatively small proportion of the households. An estimated 32 percent of Indonesians did not save at all and could be considered 'truly financially excluded'. Only 17 percent of Indonesians borrowed from banks and about 40 percent of the population was financially excluded from credit. The 'truly financially excluded', or those who have neither a savings account nor a loan, were predominantly poor, poorly educated, lived in rural areas outside the island of Java (home to the capital city and many other large conurbations), and

did not own non-farm enterprises. This group proved more than twice as likely to have neither a bank account nor a loan than Java residents.

Yet intriguingly, the survey also revealed that physical access to formal financial services was not generally regarded as a significant constraint, with some 95 percent rating the physical and geographical accessibility of banking facilities as 'convenient' or 'very convenient'. Contrary to the popular presumption that credit was the most important financial service for the majority of the population, the single most important financial service identified by households was a bank savings account, and the most important reason for having a bank account was security.

An extensive survey of migrant worker households in three provinces (East Java, Nusa Tenggara Barat and Nusa Tenggara Timur, from where large numbers of migrant workers originate⁶) also indicated relatively high levels of financial exclusion, with just 27 percent having savings and 59 percent having credit.⁷ The number of those truly financially excluded was 18 percent for this sample as a whole, with 13.4 percent for urban regions and a much higher figure of 19.3 percent for rural areas. However, a Bank Indonesia national survey indicated that some 82 percent of migrant workers do use banks to send remittances⁸. These survey findings revealed not only major gaps in financial inclusion, but also hinted at the challenges involved in extending access to financial services. It was clear that as well as taking further steps to secure the availability of a broad range of affordable services that reach a much larger proportion of the population, particularly low-income groups and those in rural areas, there was also a need to improve financial literacy.

The findings of these national surveys and greater understanding of the importance of financial inclusion for poverty reduction, coupled with growing global interest in financial inclusion, have driven policymakers in Indonesia to reinforce their emphasis on improving financial inclusion, focusing particularly on four of the G20 Principles of Financial Inclusion: leadership, diversity, protection, and empowerment.

Leadership: promoting pro-poor growth and equity

A high level of financial inclusion is now widely seen as a critical requirement for higher growth and poverty reduction and lower income inequalities. As Indonesia's President Susilo Bambang Yudhoyono

⁵ World Bank, 2010

⁶ In 2007, BI estimated the total number at 4.3 million (BI.2009, p.iv). No reliable data are available on the actual size of the Indonesian migrant worker population for a more recent year.

⁷ World Bank, 2010a, p.9

⁸ BI, 2009, p.ix

stated in his keynote address at the 2010 Alliance for Financial Inclusion (AFI) Global Policy Forum at Bali, the government of Indonesia recognizes that financial inclusion has far-reaching implications for both pro-poor growth and equity. Given the Government's commitment to reduce national poverty to 8-10 percent by 2014⁹ under the Medium-Term Development Plan (2010-2014), financial inclusion is high on the policy agenda.

The Government, however, recognizes that a pro-poor financial sector policy requires a broader focus of attention than just access to credit for the poor. Improving access to a broad range of financial services for the excluded non-poor micro, small and medium enterprises (MSMEs) can also have a strong impact on poverty reduction.¹⁰ Therefore, the Government has taken the lead in promoting inclusive financial systems.

The Government commitment to help reduce poverty through financial inclusion has been a major feature of the policies for financial sector development for many years. The efforts in the 1980s and 1990s were led largely by the Ministry of Finance (MOF) and Bank Indonesia (BI), the Indonesian central bank, and involved little collaboration with other agencies. Following the resurgence of interest in financial inclusion in recent years – and in recognition of the cross-cutting and multi-dimensional nature of financial inclusion – both MOF and BI have mobilized the support of other government agencies such as the Coordinating Ministry of Economic Affairs, the Ministry of Cooperatives and SMEs, and Bappenas to implement the financial inclusion agenda more effectively. The seriousness with which BI has embraced the concept of financial inclusion is also reflected in a lengthy new section on financial inclusion in the 2011 issue of BI's annual Indonesian Banking Booklet.¹¹

Assigning leadership to the Vice President's Office

Given the critical importance of financial inclusion for poverty reduction, the importance of non-bank financial institutions, and the need for effective coordination of the activities of different stakeholders, the Government assigned the leadership role for financial inclusion to the Vice President's (VP's) Office. It now coordinates major national policy initiatives with other line agencies in close consultation with BI, and has set up a National Team for Accelerated Poverty Alleviation¹² with a specific mandate for this.



A national strategy for financial inclusion

Led by the VP's office, the Government has formulated a National Strategy for Financial Inclusion, which takes into account the complexity of the financial exclusion problem and the need for high level inter sectoral coordination to achieve the desired results. The VP's Office works closely with BI and a number of major line ministries such as MOF, the Ministry of Cooperatives and SME, and the Coordinating Ministry of Economic Affairs. This has ensured a process of consultation and collaboration that has won strong commitment from a wide range of stakeholders. The strategy, which aims to integrate financial inclusion with poverty reduction efforts in a clear and systematic manner, focuses on five pillars of financial inclusion:

- financial education;
- financial eligibility;
- supporting policies and regulations;
- intermediation facilities; and
- channeling and distribution.

The strategy also includes a cross-cutting pillar of strengthening the supporting infrastructure, for example, through the establishment of a credit bureau to support inclusive financial policies.¹³

⁹ At the end of 2010, the national poverty rate was 13.33% with 31 million poor people, while the urban sector rate was 9.87% with 11.1 million poor people, and Asli et al.2008. the rural sector rate was 16.56% with 19.93 million poor. Bank Indonesia. 2011 a, p.30-31.

¹⁰ Asli et al.2008.

¹¹ BI, 2011, pp.19-24

¹² This team was established in February 2010 in accordance with the Presidential Regulation No.15 of 2010 concerning Acceleration of Poverty Alleviation.

¹³ BI,2011, pp.22-23

Today, Indonesia's financial institutional landscape is as diverse as the country itself.

The strategy is expected to provide a consistent framework and clear guidance on financial inclusion for policymakers and financial institutions in both public and private. In addition, it is expected to facilitate the adoption of a long-term perspective for government policies and support for financial inclusion.

Credit for People program

Another major Government initiative is the Kredit Usaha Rakyat (Credit for People or KUR) program. Launched in November 2007 following the President's Instruction No. 6 of June 2007 concerning policies to accelerate real sector development and revitalize MSMEs, the program provides a credit guarantee to banks for the loans they provide to MSMEs¹⁴. This effectively enables banks to serve MSMEs that would otherwise remain financially excluded. The banks charge an interest rate of 14 percent per year for the loans.

The program has brought together a number of agencies such as MOF, the Ministry of Agriculture, Ministry of Fisheries, and the State Ministry of Cooperatives and SMEs. The Government has provided capital of Rp 1,400 billion to strengthen the state-owned credit guarantee agencies PT Askrido and PT Jamkrida, and ensure they can pay the guarantee premium. These agencies now cover 70 percent of the credit risk for the loans provided under the program. BI both acts as a counterpart of the government in regulating the Credit Guarantee Policy, and as a facilitator between the banking industry and government in implementing the program. Nineteen banks are currently participating in the program, and implementation is monitored by the Financial and Development Supervisory Board¹⁵. At the end of 2010, the program scope was extended to cover Indonesian migrant workers working overseas¹⁶.

As highlighted by President Yudhoyono in his keynote address at the 2010 AFI Global Policy Forum, the program has produced encouraging results within a short period of time: by April 2011, banks had extended loans worth a total of Rp 1213.1 billion to some 4.43 million borrowers. BRI accounted for a large share of these loans. According to BI, the overall non-performing loan (NPL) rate for the loans extended under the program was only 2.04 percent at the end of April 2011, indicating the extent to which clients value the program. Indeed, without it, a majority of these borrowers would have remained financially excluded from formal sector credit.

Some 96 percent of the borrowers under KUR are microentrepreneurs with an average loan size of about Rp 4 million (US\$400). According to BRI, by the end of 2009, more than 300,000 of program borrowers had migrated to commercial micro and small loans¹⁷. While the Government admits that the program involves a significant element of subsidy, in view of its broader socioeconomic impact – particularly through creation of productive employment and the long-term nature of such benefits – it considers this to be 'smart subsidy'.

Financial Identity Numbers

The Financial Identity Number (FIN) program is another major initiative. Led by BI, its aim is to give every adult in Indonesia a unique identification number that allows banks and other financial service providers to access their credit history through a centralized credit bureau system. To help track the financial behavior of those on a low income, the system will also take information from the informal financial sector and feed this data into a formal database. This program is expected to enable many informal sector clients to have access to formal sources of finance.

Diversity: nurturing a robust, competitive financial sector

Indonesia has implemented a consistent policy to promote diversity in the financial sector with a view to improving competition and creating an enabling environment to meet the diverse demand for financial services more effectively. 'Creation of a strong, highly competitive banking industry resilient in the face of risks' is one of the six pillars of the recently redesigned Indonesian Banking Architecture (IBA).¹⁸ To support this, Indonesia has not only promoted institutional diversity but also provided incentives to make these institutions robust.

¹⁴ The main objectives of this credit program are: (i) to accelerate the development of real sector and MSMEs; (ii) to increase access to financing for MSMEs and co-operatives; and (iii) to alleviate poverty and expand employment (Retnadi, 2008).

¹⁵ Alliance for Financial Inclusion, 2011

¹⁶ Bank Indonesia, 2011a, p.31

¹⁷ BRI, 2010, p.21

¹⁸ BI launched IBA in January 2004 as a comprehensive policy framework for the future development of the Indonesian banking industry (BI, 2010). Thereafter, IBA has been redesigned based on stakeholder feedback.

Today, Indonesia's financial institutional landscape is as diverse as the country itself. Some 50,000 to 60,000 outlets of a wide range of formal and semi-formal financial institutions are involved in providing financial services throughout the country.

Institutional diversity has been promoted by allowing legal and regulatory space for different types of financial service providers to flourish. As a result of this policy, the banking industry landscape is characterized by both universal commercial banks and small-scale regulated financial institutions, such as BPRs, that are capable of providing basic financial services to low-income households.

With the banking sector reforms in recent years, the number of commercial banks decreased from 130 in 2007 to 121 by March 2011. However, the number of branches operated by the banks has increased substantially from 9,690 to 14,069 in the same period¹⁹, providing greater physical access to financial services. The ATM network has also expanded substantially in recent years, so that by 2010 there were 13.37 ATMs per 100,000 adults and 12.39 ATMs per 1,000 sq km. The regulations consistently support the expansion of BRI's unit desa system and the entry of other commercial banks into the field of microfinance. At the end of 2010, over 4,600 BRI Units were operating throughout the country, providing access to savings, credit, and money transfer facilities to over 12 million households mostly in rural and peri-urban areas. In addition, BRI had over 850 branches and sub-branches serving mostly urban areas.

The Government continues to recognize the critical importance of BPRs for institutional diversity and greater financial inclusion on a sustainable basis. Accordingly, a number of measures have been taken to strengthen the BPR system. Recent policies on BPRs have emphasized the future development of BPRs as 'community banks' and the strong links between BPRs and commercial banks. Today some 1,679 BPRs are operating in the country, with over 3,970 branches and cash offices²⁰ providing access to basic financial services to those on a low income and MSMEs in rural and peri-urban areas. The redesigned IBA sets out a concrete direction and strategy to strengthen BPRs with the aim of leveling the playing field with conventional banks.

Supervision and regulation of BPRs have been improved in accordance with the complexity of their business and a proportionate understanding of the risks faced by these institutions. In line with this policy, rural banks are divided into several groups, based on the amount of core capital they hold. To

reinforce their competitiveness and to enhance the range of services, all BPRs are required to comply with minimum capital requirements and increase their human resources. However, the tiered minimum capital system means that BPRs in rural locations have much lower minimum capital requirements than those in urban locations. BI is continuing its efforts to strengthen the BPR industry by encouraging mergers, consolidations, and acquisitions. As such, while the number of BPRs has decreased, they have emerged stronger, with a branch network that has increased approximately 22 percent between 2007 and March 2011. These policies have also increased their competitiveness.

Sharia banking

The development of BI's Sharia banking policies has further contributed to building diversity within the financial system. According to BI, the present development of the Sharia banking industry reflects the public demand for banking that is both financially sound and that complies with Sharia principles.²¹ The enactment of Law No. 21 of 2008 on Sharia banking provided much needed clarity on Islamic banking in the context of the broader financial system, and has contributed to a rapid growth in Sharia banking. While in 2007 only three commercial banks, with 398 branches, were operating entirely according to Sharia principles, by March 2011 this had grown to eleven commercial banks with 1,268 branches. A further 34 conventional banks had Sharia business units in 1,575 bank offices²².

BI has also stipulated minimum capital requirements for Sharia rural banks and supported their human resource development. By mid-2010, the country had 143 Sharia rural banks with over 2,800 service outlets.

As a result of these measures, many Indonesians who had not taken up financial services for religious reasons have been brought into the formal system.

The development of Sharia banks has helped to reduce both financial exclusion and poverty by mainly catering to the lower end of the market. Sharia rural banks, for example, offer services almost exclusively to lower income groups²³. At the end of 2010, the total assets managed by the Sharia banking system, which consists of Sharia commercial banks, Sharia business units within conventional banks, and Sharia rural banks, amounted to Rp 100.2 trillion or 3.2 percent of the total assets of the country's banking system²⁴.

¹⁹ BI, 2011b

²⁰ BI, 2011b

²¹ BI, 2011, p.37

²² BI, 2011b

²³ World Bank, 2010, p.36

²⁴ BI, 2011, p.38

Perum Pegadaian

The Government's focus on financial sector diversity is further reflected in the state-owned pawning company Perum Pegadaian (PP). In 2007, PP had only 902 branches. Today it operates with over 4,920 branches and 13 regional offices throughout the country. This unique institution provides small as well as large loans against movable assets. It has a large outreach that includes rural areas. PP's clients increased from 15.2 million in 2006 to 23.1 million in 2010, and included 1.6 million farmers and fisherfolk and 1.27 million MSMEs. In 2010, it provided Rp 62.27 trillion in loans.²⁵ Over 97 percent of these are repaid by clients voluntarily, who then get back their pawned items, suggesting that pawning does not necessarily indicate abject poverty, desperation, or excessive indebtedness.²⁶

PT Pos Indonesia

The Indonesian post office, PT Pos Indonesia, further increases institutional diversity by providing a number of financial services. PT Pos operates over 3,500 branches, 300 mobile service vehicles, and some 11,000 village agents, and government policies have encouraged partnerships between it and commercial banks. The PT Pos network now processes over 20 million money transfers a month on behalf of its 38 bank partners, in addition to 10 million transfers through its proprietary money transfer service²⁷.

Non-financial institutions

A range of semi-formal, small-scale, non-bank financial institutions also add to the institutional diversity. These include the Rural Savings and Credit Institution (Lembaga Dana Kredit Pedesaan or LDKP), Badan Kredit Desa (BKD), and village credit institutions such as Lembaga Perkreditan Desa (LPD) and Unit Simpan Pinjam (USP). The latter is a cooperative type organization operating in many rural areas.

In 2009, some 1,379 LPDs were operating in Bali province, providing over 1.3 million deposit accounts and 404,000 loan accounts. The total number of financial cooperatives operating in Indonesia at the end of 2010 was 177,482²⁸.

Despite being very small-scale village credit institutions, BKDs have attracted BI's support via a program to improve their capacity. A human resource development scheme for directors of BKD Boards aims to make BKDs 'more active in providing services to village communities, especially the people with limited access to the banking sector.'²⁹

Another way that Indonesia has followed the principle of diversity is through providing legal and regulatory space and incentives for financial institutions to offer a broad range of financial products and services. The National Strategy for Financial Inclusion, referred to earlier, emphasizes the need to provide a broad range of products and services such as savings, credit, payment services, insurance, and financial services for MSMEs. BI has encouraged financial institutions to provide a range of products and services with a view to meeting the diverse demand of households and enterprises, including MSMEs, while MOF has shown an increasing interest in the development of microinsurance services, still in its infancy in Indonesia.

The BRI's unit *desas* system provides credit, deposit, and money transfer services under the regulation and supervision of BI. At the end of 2008, BRI units had 4.5 million active borrowers and 19.6 million active depositors, and a total deposit portfolio of over US\$6.7 billion. BRI disbursed Rp 39.52 trillion or 84 percent of its total loan disbursements in 2009 to MSMEs^{30 31}.

An increasing number of other commercial banks also offer microfinance services, including small loans, deposit services, and money transfer facilities. Many commercial banks have partnerships with PT Pos Indonesia for money transfers. BPRs had Rp 32,032 billion in saving and time deposits in 11.47 million accounts at the end of 2010.

To accelerate access to and use of deposit services, in February 2010 BI launched a national microsavings movement called 'Tabunganku' (My Savings). The program intends to mitigate the challenges facing the unbanked population and in particular has been designed to overcome the two key barriers to accessing deposit services through waiving administration fees and keeping balance requirements at a minimum level. Underlying the program is the policymakers' strong belief that savings are the fundamental building block of financial inclusion.

Within a very short period of time, the Tabunganku program has become hugely popular among low-income households with over 1.45 million accounts opened by the end of April 2011, holding deposits worth in total over Rp 1213 billion. Some 70 commercial banks, including 66 private banks and more than 1,000 rural banks, have joined the program. Future plans for the program include harnessing the potential of mobile phone banking to enable account holders to carry out transactions more conveniently and with minimal transaction costs.³²

²⁵ Perum Pegadaian, 2011

²⁶ Although pawnshops are an important source of microcredit in most developing countries in Asia, there are many misconceptions about and prejudices against pawning. Some of these issues are discussed in Fernando (2003).

²⁷ CGAP, 2010

²⁸ Reliable, accurate, and up-to-date detailed data on most of these small-scale financial institutions are scanty.

²⁹ BI, 2011, p.51

³⁰ BRI, 2010, p. 21

³¹ It is important to note that BRI's return on equity in 2009 was 35.22%.

³² Nasution and Hannig, 2010

BI has also adopted a comprehensive policy to expand access to credit for MSMEs. This is critically important given that the majority of Indonesia's more than 50 million micro and small enterprises, which account for over 90 percent of the total labor force³³, do not have adequate access to formal sector financial services.

BI's policy on MSMEs is comprehensive. On the supply side, it supports banks to enhance credit disbursement on a sustainable basis, while on the demand side it seeks to reinforce MSMEs' eligibility and capability to meet requirements for bank credit. In 2007, BI launched a 'cluster program for SMEs'. Under this program, 34 SME clusters had been formed by the end of April 2011 and many SMEs have been linked with banks. In addition, BI is supporting the establishment of regional credit insurance companies in various areas to improve access to finance for MSMEs.

Although the level of financial inclusion has been improving in recent years, information on its impact at the household or enterprise level is scant. Studies dealing with the subject in general suggest that financial inclusion has placed poor and low-income households in a better position to smooth their consumption and cope with risk, and enabled many MSMEs to expand their operations. However, the need for rigorous studies on the impact of financial inclusion remains.

Consumer protection and empowerment: two sides of the same coin

From 2007, in line with the global trends, Indonesia began to develop a comprehensive approach to both consumer protection and empowerment. The country co-hosted with OECD two major international conferences on financial education in 2008 and June 2011. In view of the absence of adequate data for evidence-based policies in financial education, a pilot survey was carried out in 2008 in two provinces to assess the level of financial literacy among both urban and rural populations.

The Indonesian approach positions consumer protection and empowerment as two sides of the same coin. The recognition of the importance of consumer protection is reflected in its inclusion as one of the six pillars of the redesigned IBA. As articulated in the IBA,³⁴ consumer protection encompasses four aspects:

- A satisfactory and effective customer complaints mechanism;
- The establishment of an independent mediation institution;



- Transparency of product information;
- Customer education.

Steps have been taken to standardize customer complaint mechanisms across financial institutions. Until an agency is established, the tasks earmarked for an independent mediation agency are being carried out by a Directorate of BI. To ensure implementation of consumer protection measures more effectively, BI is also in the process of establishing a new Directorate of Consumer Protection.

To encourage saving in banks, enhance confidence in the banking system, and protect depositors, in late 2008, Indonesia also increased the Deposit Insurance Corporation's maximum limit for protection of customer deposits in banks from Rp100 million to Rp 2.0 billion.

As the key agency for financial consumer protection and empowerment, BI recognizes that government, financial service providers, and consumers all have an important role to play in these areas.

Banks are now required to provide complete, clearly written information in the Indonesian language on the characteristics of each product they offer. They are also required to have a dedicated unit established in each bank office to handle and resolve customer complaints. To resolve complaints, banks must establish a policy and have written procedures covering the receipt of complaints, handling and resolution of complaints, and monitoring of complaint handling and resolution. All complaints should be resolved by the bank in question within 20 working days from the date of receipt of a written complaint.

Indonesia considers effective consumer empowerment to be a core element of consumer protection. Consumer empowerment is mainly directed toward customer education, service excellence and optimization of mediation functions performed, by financial institution supervisory authorities. The

³³ Hadad, 2010

³⁴ BI, 2010, p.21

Government's declaration of 2008 as 'the year of financial education' provided a boost to the financial education activities of both government agencies and the private sector. The government also established a working group on financial education that brought together banks, non-bank financial institutions, associations of banks, and associations of credit card issuers under the leadership of BI. The group has produced a blueprint for banking customer education, developed educational materials, and launched many programs for consumer empowerment.

To help consumer empowerment on a large scale, in 2008 Indonesia launched a national campaign called 'Ayo ke Bank' (Let's go to the bank). A major purpose of the campaign is to introduce bank products and services and their characteristics: benefits, risks, charges, and rights and obligations. The program has been implemented in close collaboration with the nationwide network of banks. In 2009, Indonesia also launched a campaign to enhance the financial capabilities of consumers with the slogan, 'whatever the product ensure the benefits, understand the risks and consider the costs'.

BI's efforts in financial consumer education also focused on educating the public on Sharia banking. Effective consumer empowerment is one of the seven development areas included in the strategic initiatives for the period 2010–2015 for Sharia banking development.

Further steps have been taken by BI to improve financial education at schools: it has signed a memorandum of understanding with the Ministry of Education and has also implemented financial education programs for migrant workers, their families and members of religious communities. The programs for migrant workers focus on conveying key messages on the importance of using formal channels for remittances and the prudent use of remittances.

Moving forward: challenges and opportunities

While Indonesian policymakers have done a great deal to promote financial inclusion, they are not complacent and are well aware that a lot more needs to be done in order to achieve their goal. One of their main concerns is the uneven progress across geographical regions and intra-sectoral variations in rural areas—for example, the disparity in inclusion between Java residents and others. There are still a large number of local jurisdictions (kabupaten in rural areas and kotamadya in urban areas) in relatively remote, sparsely populated provinces of Papua, Kalimantan, Sulawesi, and Sumatra with no commercial bank branches. These areas together account for over 70 percent of the rural and urban jurisdictions with no commercial bank branches. The government is determined to address these issues, particularly through use of new technology and innovative modalities of branchless banking.

According to CGAP (2010), the current legal, regulatory, and policy framework for branchless banking requires significant improvements. The government is keen to address these issues in a systematic manner and BI is currently studying the branchless banking model in collaboration with the World Bank and IFC and reviewing the existing regulatory framework with a view to making it branchless-banking friendly. Policymakers are also keen to learn from other developing countries that have achieved positive results: with support from AFI, representatives of BI are planning to visit Brazil and Kenya to study their experiences of branchless banking.

Policymakers also admit that access must be improved for a broad range of financial services, not just for credit. Plans are in place to promote use of new technology and public-private partnerships in payment services, money transfers, and microinsurance, among other things. To facilitate the agent banking model, BI is currently reviewing regulation on agent banking.

Finally, the government is aware of the inadequacies in the legal and regulatory framework for insurance in general and microinsurance in particular, and is determined to address these issues. It plans to liberalize the insurance market in accordance with WTO requirements in 2012 and abolish the current 80 percent limit on foreign ownership initially imposed in 2007. It is expected that this will contribute to the development of a more competitive and diverse insurance market.

Indonesia has made remarkable progress in improving financial inclusion, and in recent years has taken a number of major initiatives that are in line with the G20 Principles for Innovative Financial Inclusion. Pushing the frontier of inclusive finance is a long-term, complex task, but policymakers are confident that, with the unwavering commitment from the leadership, peer learning, evidence-based policies and guidance from AFI, among others, they will be able to open the doors of the formal financial sector for many millions of poor and low-income unserved and under-served households.

To fully harness the relationship between financial inclusion and poverty reduction, policymakers need to further strengthen their focus on access to, and use of, a broader range of financial services rather than just credit. Evidence strongly suggests that the financially excluded particularly demand effective access to convenient and safe savings services at affordable prices. Therefore, the current emphasis on improving access to reliable and safe savings facilities should be reinforced as much as possible. Given that people in many remote areas still lack such access, the policies and programs need to pay more attention to unbanked areas. However, it is hoped that innovative use of new technology, particularly mobile phones, may help bring the financially excluded into the formal financial system in those areas at relatively low cost. Indonesia also hopes to learn a great deal from Brazil's banking correspondent model as well as the branchless banking experience of the Philippines and Kenya.

It is already clear that it will be necessary to improve policy, legal, and regulatory framework for different branchless banking models that make use of new technology in innovative ways. Hence, there is an urgent need for a comprehensive review of the existing policy, legal, and regulatory framework with a view to removing barriers to greater financial inclusion. The overall framework should create adequate space and provide incentives for private sector participation and innovative public-private partnerships. Market-friendly regulation on agent banking and risk-based regulation and supervision deserve a great deal of attention.

BI has intensified its focus on the development of the BPR system, which has considerable potential to push the frontier of inclusive finance. While this is commendable, the BPR development policy requires further improvements. Restrictions on foreign equity participation in BPRs may be relaxed gradually. Also, greater incentives may be provided to BPRs in remote locations, including lower minimum capital requirements and time-bound 'smart subsidies' to partially meet operational costs in the early stages of growth. Formulation of a legal and regulatory framework for microfinance and improvement of supervision and regulation of cooperatives will also help advance the development of financial services for the poor – particularly in remote rural areas.

Policy attention on the development of insurance markets for the poor and low-income households and MSMEs must also be substantially increased. This is particularly important given that a vast majority of low-income people do not have easy access to appropriate insurance products and services and therefore remain unprotected. It may also be useful to examine the feasibility of index-based insurance for the farming community. Along with these measures, consumer empowerment programs need to be broadened to improve insurance literacy and insurance capabilities among poor and low-income households.

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KENYA:

Forging a technology – driven vision of the future

Summary

As the home of M-PESA, perhaps the world's best-known mobile money transfer and payment scheme, Kenya has earned a reputation as being at the forefront of innovation in financial inclusion. But as this case study shows, the success of M-PESA and the many other mobile money programs and providers that have followed only exist because of the willingness of regulators to permit this potentially high-risk innovation. When the Central Bank of Kenya (CBK) first granted Safaricom authorization to trial M-PESA, there was little regulation in place, but CBK's visionary approach removed unnecessary obstacles and bureaucracy, allowing the scheme to flourish.

In doing so, CBK reflected the wider direction of the Kenya government, embodied in its Vision 2030, which seeks among other things to build Kenya's economy and raise financial inclusion levels. It has maintained its commitment by introducing new, enabling legislation that encourages microfinance and agent banking and builds cooperation within the formal financial sector. The results have already shown a significant increase in the numbers of financially included adults, from 26.3 percent in 2006 to 40.5 percent in 2009. Latest figures would undoubtedly show a higher percentage still.

Principles in practice

While all nine of the Principles for Financial Inclusion have been built into Kenya's overall strategy, their progress thus far illustrates the following principles in particular:

- **Leadership** – CBK has shown real leadership in its willingness to embrace and facilitate innovation – taking a 'test and learn' approach and building regulation around the lessons learned.
- **Cooperation** – from CBK to the commercial banks and regulators to the telecommunications industry, Kenya has benefited from a spirit of cooperation that reflects Vision 2030.
- **Innovation** – the mobile money programs have rightly been lauded for their ability to reach many millions of people otherwise excluded. They make it possible to deliver financial services cost-effectively to remote areas and low-income customers, first with payments and now a wide range of financial services.

Country context: pursuing high, broad-based economic growth

Relative to its neighboring states, Kenya has a fairly large and developed formal financial sector, under the supervision of Central Bank of Kenya (CBK). It includes 44 banking institutions (43 commercial banks and one mortgage finance company), 6 deposit-taking (MFIs) 122 foreign exchange bureaus, two Credit Reference Bureaus and two representative offices of foreign banks. Outside CBK's regulatory sphere, there are a number of other formal financial institutions, including Post Bank and over 12,000 co operative societies, approximately 5,900 of which are Savings and Credit Societies (SACCOs). Of the 5,900 SACCOs, 218 are now registered to take deposits under a recently introduced SACCO Society Regulatory Authority. In addition, there are many informal and unregulated financial institutions, which also play a role in providing access to financial services. These include non deposit-taking MFIs, rotating savings and credit associations, investment

clubs and financial services associations. The main challenge for policymakers and the CBK is that only 41 percent (FinAccess survey 2009) of Kenya's adult population has access to formal financial services, as shown in Figure 1 below. Kenya has a population of about 38.9 (2009) million people, 50 percent of whom are adults.

Two other long-term structural dynamics exacerbate this challenge, as shown in Table 2. First the adult population is getting younger at an accelerating rate. Younger adults not only outnumber their older counterparts, but the gap is growing. The second critical dynamic is that the majority of Kenyans (outside of those who work in smallholder agriculture) are now in informal or self-employment rather than formal jobs: this is also a growing trend, and the informal sector is the dominant provider of job opportunities for new entrants to the labor market. Traditionally, both younger people and the informal sector have been financially excluded.

Figure 1 Financial services market penetration, % of adult population, 2009

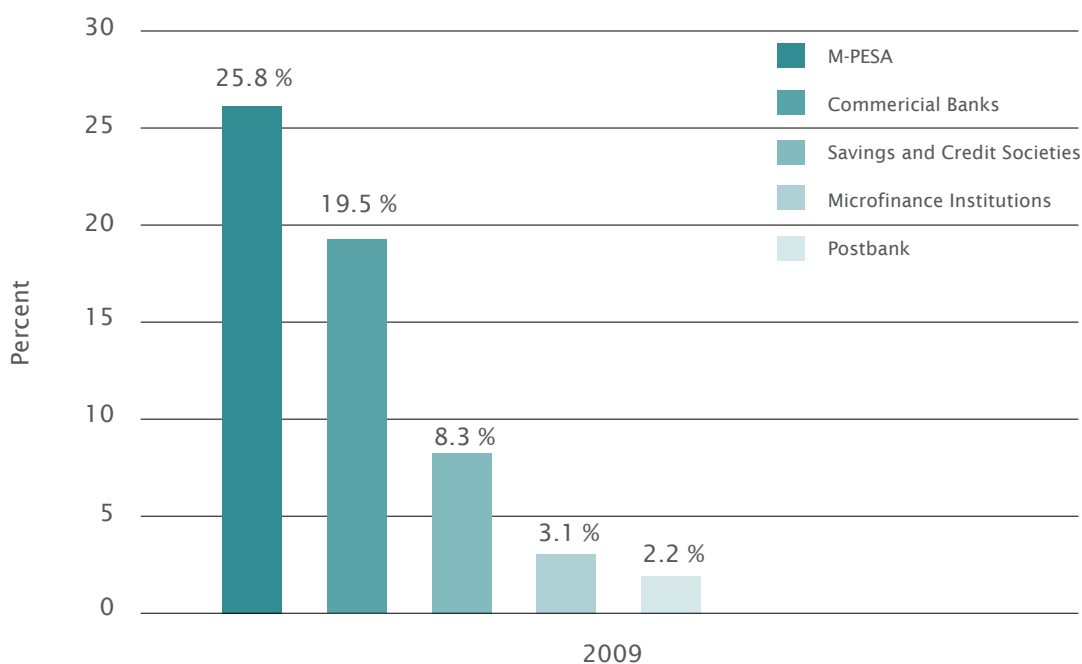


Figure 2 Population age structure

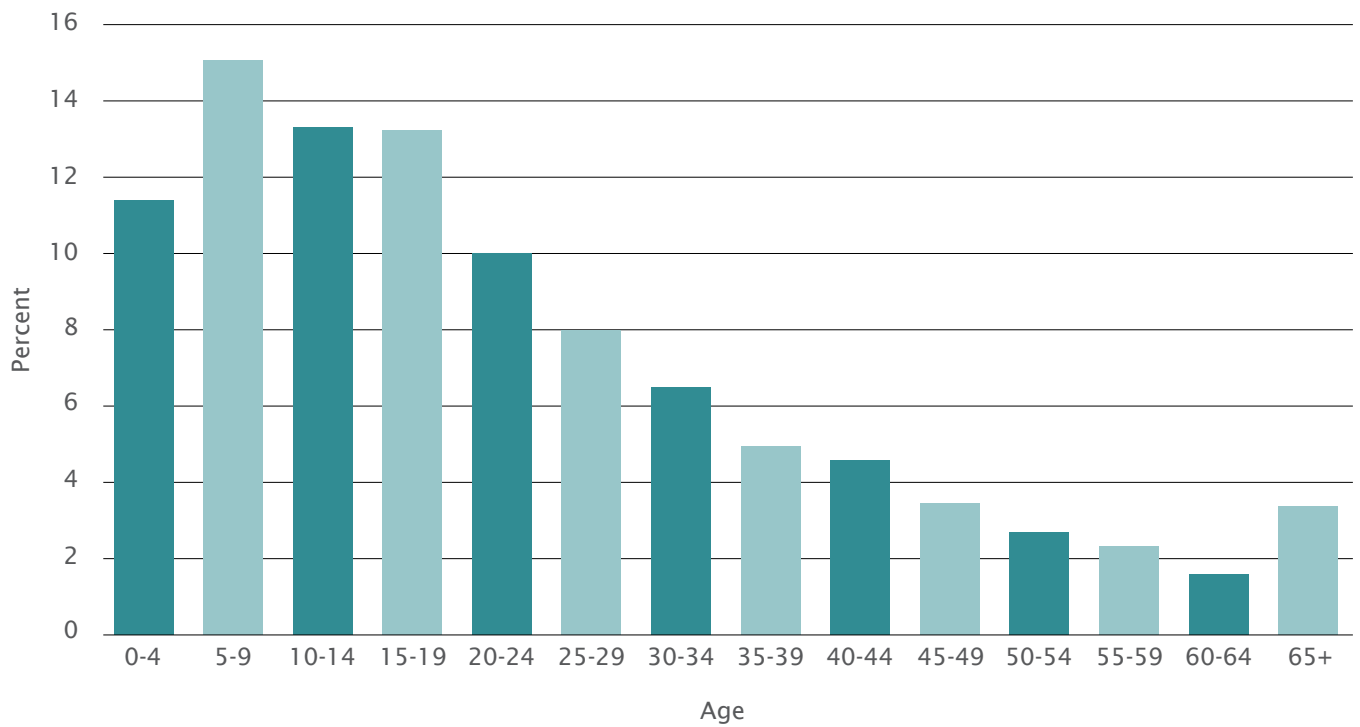
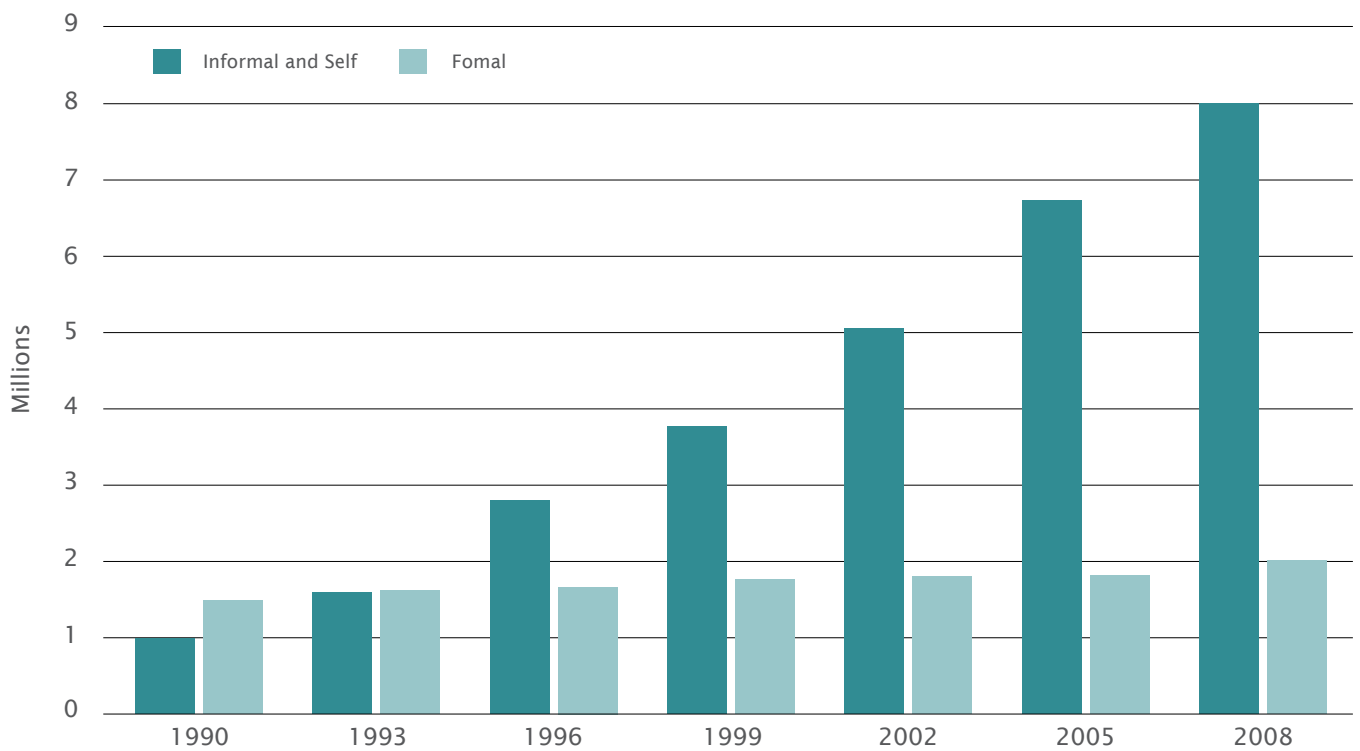


Figure 3 Structure of nonfarm employment, millions



To realize its financial inclusion goals, Kenya introduced Vision 2030 in 2009. This Vision states:

“Kenya strives to become a regional financial hub with a vibrant, efficient and globally competitive financial system to drive savings and investments. This, it is believed, will lead to a high and sustainable, but also broad-based economic growth. There is growing recognition in the current body of knowledge that increasing access to financial services has both private and social benefits. In addition to enhancing efficiency and stability therefore, Vision 2030 identifies the need to increase access to affordable financial services and products for a wider section of Kenyans, particularly poor, low-income households and micro-, small- and medium- scale enterprises (MSMEs). Poor and low-income households in informal urban settlements, small and micro-level businesses, rural areas, and women are therefore prioritized in the new vision for financial sector development.” (Ndung’u, 2009)

In pursuit of this vision, CBK initiated a number of policies and innovations to provide access to financial services for segments of society who have historically been financially excluded. This effort also aims to increase the usage of diverse financial services within the entire Kenyan populace, while embracing diversity in sector-wide developments. The ultimate objective is to create access to affordable financial services.

In the last 20 years, Kenya has been at the forefront of building an inclusive financial system that reaches the poor. Earlier initiatives were championed by microcredit institutions that operated as non-governmental organizations (NGOs). In the 1980s and 1990s many of the microcredit programs became very successful at delivering microcredit to micro level enterprises, on a scale that attracted the attention of policymakers and stakeholders. At the policy level, the Ministry of Planning, with the support of ILO and UNDP, took the lead in developing a policy framework for the development of the microfinance sector and raising awareness among policymakers. Although these early initiatives focused on the development of micro level and small-scale enterprises (MSMEs), they laid the foundation for the broad-based financial inclusion policies being pursued today.

Some of the important milestones that marked this era and influenced the financial sector in Kenya significantly include:

- The licensing of K-Rep Bank in 1999, which opened the door for transforming of microcredit organizations into regulated financial institutions;
- The enactment and operationalization of the Microfinance Act in 2006 and Regulations, which provided a window for licensing deposit-taking microfinance institutions;
- The evolution of Equity Bank from a microfinance building society to a commercial bank and the leading player in financial inclusion in Kenya;



- The conversion of Family Bank from a building society into a fully fledged bank in May 2007.

These developments influenced other commercial banks, notably Co-operative Bank of Kenya, to embrace financial inclusion innovations.

Leadership: establishing a clear strategy, supported by a positive central bank

With respect to the Leadership Principle, two important aspects stand out. First, the Comprehensive Financial Sector Reform and Development (CFSRD) strategy, provides clear direction and a reform agenda to CBK and other regulatory bodies. It is further supported by a board and secretariat that co ordinates and monitors progress to ensure accountability. This structure enlists the support of other relevant players and involves the Domestic Regulators Forum (CBK, Insurance Regulatory Authority, Retirement Benefit Authority, and Capital Markets Authority), commercial banks, microfinance institutions, the Ministry of Planning and National Development, and development partners.

The financial inclusion agenda is entrenched in Kenya’s current development blueprint, Vision 2030, which seeks to make Kenya a middle-income country, with a stable, efficient, and inclusive financial



system by the year 2030. The specific goal of the financial sector is to 'Create a vibrant and globally competitive financial sector, driving high levels of savings to finance Kenya's investment needs'. The target is to raise savings and investment ratios from 14 percent to 25-30 percent of GDP. To achieve this, the financial sector must become more efficient and increase penetration. CBK is playing a large part in spearheading banking and microfinance sub sector reforms toward this, as its strategy documents confirm, setting out reforms with the aim of:

- Deepening penetration of financial services, especially to rural areas, to help drive increased domestic savings;
- Strengthening the financial sector structure through reforms that facilitate the transformation toward stronger large-scale banks and microfinance institutions;
- Extending credit information-sharing mechanisms from negative information sharing to full file (positive and negative information sharing) for commercial banks, and microfinance institutions.

Over the last five years, the CBK has undertaken the following three key financial inclusion measures/policy interventions:

- **Microfinance Act:** The Microfinance Act (2006) was operationalized in May 2008, after developing supporting regulations around the licensing, regulation, and supervision of microfinance businesses in Kenya. This policy intervention addresses the principles of financial inclusion, including Diversity and Innovation. It promotes competition by introducing institutions that have the mission and capability to reach the vast number of unbanked Kenyans. Secondly, it encourages targeting low-income segments, especially small and micro enterprises and poor households. This move has spurred competition from conventional banks that have, in turn, sought to secure their share of the savings and deposits market in these segments.
- **Agency banking:** The Banking Act was amended in 2009 and the Microfinance Act in 2010, to allow licensed institutions to use agents to reach out to their customers and provide specific services. Addressing the Innovation Principle, this policy provides an environment for banks and deposit-taking microfinance institutions to spread their presence to populations in unbanked regions. It promotes technological and institutional innovation as a means of expanding both financial system access and usage, and

aims to overcome the challenges of limited infrastructure and the geographical distance between customers and the traditional locations of financial institutions. Historically, branches of licensed institutions have been located in cities, towns, and some market centers, depending on the infrastructure, security, and population density. By using agents, institutions are able to extend their reach to locations that do not fit the traditional criteria and are also able to lower costs. Presently, agents are allowed to undertake transactions including cash deposits and withdrawals, bill payments, balance inquiries, and collection of account opening forms. These services through agents, which are underpinned by technology, are expected to expand rapidly as more banks and MFIs acquire agents. Agency guidelines have been drafted for DTM to cover the engagement of third party outlets to provide specified services around deposit taking on their behalf. These are expected to be implemented before the end of 2011.

- **Credit Information Sharing:** Credit Information Sharing was made possible by the operationalization of the Banking (Credit Reference Bureaus) Regulations in February 2009. This policy intervention encourages cooperation, among institutions. The CBK is now mandated to license and supervise the operations of the Credit Reference Bureaus, which collect, collate, and disseminate credit information to lenders, to aid their credit decisions. The long-term objective of this initiative is to increase access to loans, especially for borrowers who do not have conventional collateral. This has been a major barrier for younger people, as well as small and micro enterprises. In the long run, the policy is expected to make the credit markets more competitive and affordable, while entrenching responsible lending on the part of banks and MFIs and responsible borrowing on the part of the borrowing public. The Microfinance Act has also been amended to allow information sharing for DTMs using CRBS and supporting guidelines have been drafted.

The most significant financial inclusion intervention outside these new policies is Mobile Money, which was introduced in 2006. Since then, many mobile money solutions have been introduced to compete with the legendary Safaricom M-Pesa, and together are poised to take this revolution to new levels. Virtually all banks, DTMs, and other financial services providers have now signed partnership arrangements with mobile service providers and expanded their products and services beyond money transfer. 'Banking on the move menus' are now a common feature in all financial services, allowing customers to access information and make payments/transfers directly from their bank accounts. Using technology to link mobile money, bank accounts, ATMs, POS devices and internet banking, institutions continue to develop highly innovative products, services and solutions, which have become the key driver in opening access to financial inclusion.

Overall, the introduction of mobile money has made significant contributions both to the financial sector and financial inclusion in Kenya. First, it has opened a new channel for delivering financial services and information – one that is now used by many other players, including all mobile phone service providers. Banks and MFIs have integrated their systems with these channels, enabling customers to perform a growing range of transactions, such as making deposits into their accounts, loan repayments, making payments to other parties, transferring funds from one account to another, obtaining mini statement, and making various inquiries. Secondly, it has reduced the barrier of proximity to bank branches, which previously limited inclusion. Those who did not operate bank accounts because they could not access the banks now find it easier to open accounts and transact via their mobile phone. Lastly, the innovation has introduced another medium or currency, which has empowered those who were limited to cash to settle payments. This is a major development considering that the vast majority of the population were limited to using cash, as cheques were used by only a very small segment of the population.

Other policy measures undertaken to expand outreach and delivery of financial services include:

- The introduction of Islamic banking products, in the formal banking, sector to serve the needs of those previously excluded from conventional banking products on the basis of their cultural and/or religious beliefs;
- Enacting the Proceeds of Crime and Anti-Money Laundering Act in December 2009, incorporating a risk-based approach to AML/CFT requirements where financial institutions dealing with low-income customers that present a lower risk are subject to reduced/simplified controls to facilitate financial inclusion. In other words, customers below a certain threshold may be exempt from certain due diligence requirements such as the need to provide verification of a physical address.

Cooperation: encouraging external involvement

The clear leadership structure has led to the formulation of financial sector policies, as well as medium- and long-term policy objectives for the financial sector. It has also provided a fertile environment for innovation and ensured cooperation, as illustrated by the introduction of new technology-based players, namely mobile phone companies and other service providers, into the financial sector.

This is clearly the most significant development in Kenya's financial inclusion story to date. Although the innovations have been driven largely by market-level



factors and market dynamism, they would not have seen the light of day without industry cooperation, particularly between CBK and the Communications Commission of Kenya (CCK), an independent regulatory authority for the communications industry.

Innovation: nurturing a positive environment for new service models

CBK also demonstrated its leadership in 2006 when it gave Safaricom a ‘No Objection’ letter to its plans to introduce M-Pesa – the mobile phone money transfer system. At that time, Kenya had no regulations or guidelines on mobile money transactions, which has proved a major hurdle for many regulators in other countries. CBK adopted a test and learn approach – essentially a benign stance toward the mobile money innovation. But it was a calculated risk rather than a blind leap of faith: a deliberate process of monitoring, learning, and evolving appropriate guidelines was put in place, which enabled CBK to formulate and implement policies to promote this initiative.

Safaricom’s service pioneered Kenya’s technology-driven revolution in financial inclusion. By adopting a responsive attitude to market-led proposals, CBK is encouraging institutions to embrace technological innovations. For example, in the National Payments System, CBK has encouraged the use of mobile phone financial services to reduce costs and enhance financial access. As a result, innovative institutional arrangements for promoting financial inclusion are now in place.

One example is the integration of mobile money systems with core banking systems, such as the Equity Bank and Safaricom product M-Kesho, which enables transfers between a mobile phone virtual account and traditional bank accounts. The innovation is not limited to Safaricom and Equity: virtually all banks have now entered into similar arrangements. All mobile phone companies have introduced mobile money services and other technology-based service providers have entered this space, spurring competition and introducing an array of new products and services, such as access to credit and micro insurance services via mobile phones. The newly introduced agent banking model is also using this innovation.

So far, financial inclusion innovations, which span policy, technology, institutional arrangements and products, have largely been driven by technological advancement. Market-level factors such as competition, innovative business models, increased market dynamism, entry of MFIs into formal financial sector, and mobile money have also been major drivers. None of the innovations, however, would have come to fruition without a supportive policy and regulatory framework – something that can be seen in countries where regulators have been slow to respond to market initiatives. The CBK has played the biggest role in enabling market-level innovations. It has taken leadership in facilitating policy formulation, as well as serving as a link between institutions, other regulatory bodies, and relevant government ministries. It has engaged service providers and institutions to discuss new innovations and formulated a regulatory framework. The identification of innovations for financial inclusion has therefore been a team effort, which is also supported the

broader country development strategy, Vision 2030.

Currently, CBK is formulating additional regulations to supervise electronic money and electronic retail transfer providers. The next step is to enact a National Payments System Bill to enhance oversight.

To nurture and encourage innovation, CBK has maintained its test and learn approach to formulating laws and regulations. CBK facilitates knowledge exchange forums to understand best practice and learn from experience. Study tours to other countries have also added value to this process. Lessons learned are used to draft and/or amend requisite regulations or laws, in consultation with key players. Finally, CBK has initiated and participated in a number of diagnostic studies and surveys, such as the FinAccess surveys of 2006 and 2009 and the upcoming one in 2011.

While these principles have been the driving forces behind Kenya's progress toward financial inclusion, work is still in progress with regard to the remaining six principles: diversity, protection, empowerment, knowledge, proportionality, and framework. The main challenge now is managing the implementation process to ensure that all the various initiatives are completed and meet their targets. This requires further coordination – taking account of different levels of maturity of both services and customers to facilitate prioritization and focus. Finally, there is also the challenge of getting explicit legal mandates for certain financial inclusion efforts, such as financial education.

Moving forward: challenges and opportunities

The new policy and operating environment is not mature enough to gauge the impact conclusively. Despite its infancy, the numbers of new customers that have joined the formal financial sector since these initiatives were implemented, is encouraging.

The broader impact of the financial inclusion initiatives undertaken by CBK is best illustrated by the results of a National Financial Access Survey, conducted by CBK and FSD in 2009. The survey is now two years old and many changes have taken place. The numbers have also changed significantly. Nonetheless, it demonstrates that over a two and a half year period (2006–2009), the overall proportion of the formally included (including users of mobile money) jumped from 26.3 percent to 40.5 percent. Excluding mobile users, the proportion of those financially excluded decreased from 38.4 percent to 31.7 percent, as shown in the table below. The third Financial Access survey is expected to be carried out in 2011.

On balance, Kenya has accomplished quite a lot over a relatively short period. Clearly, there is a long way to go to accomplish the ambitious goals of Vision 2030. It has embraced all the nine principles for innovative financial inclusion and recorded impressive progress in many others. There are however, a number of challenges.

Availability of data is a major challenge. Neither the CBK nor the Kenya National Bureau of Statistics (KNBS) has accurate financial inclusion data on both the supply and demand sides to support formulation of an enabling policy. Most of the data collected by the two institutions are not geared toward financial access, forcing the CBK to rely on surveys which are conducted at long intervals. This makes it difficult to formulate and/or amend regulations in line with new information and risks assessed from innovations. It is advisable that CBK restructures its routine reporting requirements to enable the collection of appropriate and adequate data on financial inclusion. To this end, the Bank will be carrying out a holistic diagnostic study to garner accurate data on both supply and demand.

Technical and human resource capacity constraints are also a major challenge. Most of the innovations are new concepts that are conceived at the market level. Often, CBK staff have limited technical expertise to assess risks associated with the new products or services. This has forced the CBK to shift responsibility to the boards and management of banks and DTMs. To accomplish Kenya's noble financial inclusion goals, capacity must be enhanced, and to this end, the Bank has engaged with a number of development partners to provide extensive staff training in these areas. It is recommended that AFI focuses its attention on enhancing technical and human resource capacity.

Although CBK recognizes that financial illiteracy hampers efforts toward financial inclusion, not much has been accomplished with respect to customers' protection. Currently, there is no specific legislation addressing consumer protection in the financial sector. A draft Bill is in place and the Banking Act and Microfinance Act both contain a number of clauses on consumer protection, covering interest on savings accounts, publication and display of financial statements, limits on interest charged (in duplum rule), and approval for increases in bank charges, among other things. But this may not be enough, considering the pace at which innovations are being introduced. Innovations come with risks that are best mitigated through financial literacy and appropriate regulations to curb excesses or unscrupulous behaviors by service providers. It is crucial that the consumer protection initiatives, such as the pending legislation and the financial education and consumer protection partnership initiatives be fast tracked.

KOREA:

Rising to the challenges of the global financial crisis

Summary

With an average of 4.5 deposit accounts per adult, Korea may seem at first glance to have solved the most pressing challenges of financial inclusion. However, recent events have proved that the availability of a wide range of financial services alone is not an answer; in fact, the global economic downturn proved that there was still considerable inequity in terms of access to affordable credit and that many Koreans required greater financial education to avoid over-indebtedness.

In response, the Korean Government – and in particular, the Financial Supervisory Commission (FSC), Korea’s lead agency for financial inclusion – have introduced new business models to extend access to credit for low-income families and small businesses, reinforced consumer protection legislation, and put in place new financial education programs, that target adults.

Principles in practice

Korea’s recent steps to improve financial inclusion are focused on the following principles:

- **Innovation** – Korea has introduced a new KW 10 trillion Sunshine Loan scheme that incentivizes financial institutions to offer loans to specific customer segments, including low-income families and small businesses.
- **Protection** – a new Financial Consumer Protection Act is set to be introduced that makes existing legislation more consistent and comprehensive, both to protect consumers and bolster industry competitiveness.
- **Empowerment** – Korea’s Financial Education Council, established in 2010, is seeking to reform financial education, based on a comprehensive study of financial literacy it is currently undertaking.

Country context: turning the financial crisis into an opportunity

With a large and diversified financial sector, Korea has achieved a high level of financial inclusion compared to most other emerging economies. Korea has 78 commercial bank branches per 1,000 sq km and an average of 4.5 deposit accounts per adult. The outstanding loans from commercial banks are estimated at 84 percent of GDP, while outstanding deposits with commercial banks are 74.5 percent.¹ A considerable majority of the population has access to, and makes use of, formal financial services, in particular deposit and savings accounts, and therefore has the ability to make bill payments, remittances, cash checks, or put aside savings. Bank accounts can be opened free of charge and account opening is generally straightforward due to a universal national ID system. The financial sector includes banks and insurance companies various non-bank financial institutions (NBFs) that offer a similar range of financial products and services. Government-owned Korea Post also offers financial services.

However, despite widespread access to basic financial services, the financial crisis of 2008-09 has provided Korea with an opportunity to address a number of consumer protection issues around financial services. Although the Korean economy as a whole was relatively less affected by the financial crisis than Europe and the United States, it showed policymakers that there was a need – and an opportunity – to reform the institutional framework for the financial sector, in particular to align it with the financial regulatory measures under discussion at the international level. The Korean Government has stated its intention to proactively adopt the G20 global financial regulatory reform measures as part of its strategy to prevent and/or reduce the impact of any future crisis. An important element of this strategy is identifying and taking necessary steps to continuously reduce risks in the financial system. In short, Korea's approach to the issue of financial inclusion can be seen as both an important complement to financial stability and a means of building a sound and effectively regulated financial sector.

The global financial crisis brought to the fore three particular issues around financial inclusion in Korea:

An important element of this strategy is identifying and taking necessary steps to continuously reduce risks in the financial system.

- It raised serious concerns regarding equality of opportunity to access affordable credit – with low-income individuals and SMEs both disadvantaged.
- It highlighted alarming levels of over-indebtedness. Household debt increased from 74.8 percent of GDP in 2005 to 85 percent of GDP in 2010. Together with inadequate financial education, this reliance on credit is seen as a significant cause of over-spending and as one of the reasons behind the financial crisis, leading Korea to identify the need for a comprehensive credit counseling service.
- The financial crisis renewed focus on the consumer protection framework and the need for new legislation in the form of a Financial Consumer Act.

Korean policymakers have sought to address these elements of financial inclusion in their response to the financial crisis, spearheaded by the FSC. The FSC is the lead agency for financial inclusion in Korea, with overall oversight and coordination responsibility, working closely with the Small & Medium Business Administration. In addition, a cross-government Money Lending Policy Council oversees money-lending policy and regulations. Outside government, key partners include the Smile Microcredit Bank and the Credit Counseling & Recovery Service.

¹ Source: International Monetary Fund (IMF)

Financial inclusion is framed as an important element of social policy in Korea. The OECD has highlighted that Korea has the lowest level of social spending in the OECD (7.5 percent of GDP relative to an OECD average of 20 percent), among the weakest systems of tax and transfer to address income distribution and poverty, and a sharp distinction in the labor market between regular and non-regular workers, leading to wide inequality in wage incomes. Income inequality has grown substantially over the last decade. As part of the policy response, the OECD has made recommendations for higher social spending and sustained growth to reduce inequality and poverty.² Financial inclusion – in particular equity in access to credit and greater financial awareness among consumers – is seen as an important element in addressing social inequality.

Innovation: launching new funds for low-income individuals and SMEs

Access to finance for low-income individuals is seen as a particular challenge, especially given the fact that many in this group are facing a credit crunch in the wake of the global financial crisis. The available evidence suggests that the demand for small-sized credit significantly exceeds supply. Increasing the supply of small-sized credit is an important element of the response to the financial crisis in Korea; it can facilitate opportunities for those on low incomes (i.e. to set up their own businesses) and prevent further deterioration in living standards as real incomes have been squeezed.

Government is seen as having a role to play, due to financial services providers' reluctance to lend to those with high credit risk or without collateral. The withdrawal of these providers from lending to these segments is viewed as a market failure with negative consequences for economic vitality and financial stability – not least because of the increased government spending that will be required to provide greater welfare support to those falling into a cycle of credit exclusion and poverty.

In response, the FSC has introduced the Sunshine Loans program, through which approximately KW 10 trillion will be extended over the next five years to low-income individuals, including individuals with low credit scores or income less than KW 20 million. Importantly, this program is delivered through non-bank financial institutions that are allowed to set their interest rates up to a capped level of 10.6 percent for financial cooperatives and 13.1 percent



for mutual savings banks. The ceiling is adjusted over time based on changes in funding costs. Ceilings are allocated for assisting low-income individuals starting up businesses (up to KW 50 million), small business owners (up to KW 20 million), and workers (up to KW 10 million). In total, 1 million people and small businesses are expected to access the program over the next five years.

To bolster the supply of small-sized credit to low-income individuals, the Government has also sought to promote the microcredit project with additional private sector funding. In December 2009 it created the Smile Microcredit Bank with KW 2.2 trillion set aside for microfinance over a 10-year period – 1 trillion from chaebols, 500 billion from the banks, and 700 billion reclaimed from dormant deposit accounts.³ As of July 2011, the bank had made 47,000 basic livelihood assistance loans.⁴

Access to finance for SMEs is also an important policy priority. SMEs account for 99.9 percent of industrial firms in Korea and 87.7 percent of industrial employment. There are several schemes intended to provide SMEs with favorable access to credit. Since the 1970s the Korean Government has been very active in easing the access of SMEs and entrepreneurs to finance.

The Korea Technology Finance Corporation (KOTEC) provides SMEs with credit guarantees based on technology value appraisal and certification, which facilitates their access to loans and guarantees by

¹ OECD, 'why is achieving social cohesion such as urgent priority for Korea?' in *A framework for growth and social cohesion in Korea*, 2011, p.5

² *Community finance in Korea: policy directions*, Chan Woo Jeong, February 2011

³ *Ibid.*, p.16

other institutions. The Small Business Corporation (SBC) supplies loans to SMEs at concessional rates. A SME credit guarantee scheme previously covered 85 percent of a loan made by a financial institution. During the financial crisis, the level of guarantees became more generous, increasing to 95 percent and in some sectors 100 percent. These were coupled with the provision of direct government loans to essentially bail out financially distressed SMEs.

There is widespread acceptance within Korea that some government intervention is required in the short-term to address this issue. However, analysts such as the Korea Institute of Finance have recommended that the Government look to reorient policy toward more market-based approaches and that Sunshine Loans should be an interim tool to allow non-bank financial institutions to develop a wider range of financial products at a variety of interest rate levels.

This reflects the view among some analysts that extensive and sustained state subsidy has had a damaging effect on industry competitiveness, with a decline in SME profitability coinciding with an increase in credit guarantees for SMEs from 2 percent of GDP in 1995 to 7 percent in 2009.⁵ Whereas government support for SMEs has certainly prevented bankruptcies and sustained employment in the wake of the global financial crisis, there are concerns that a significant problem of moral hazard has developed. The argument is that guarantees have encouraged both banks and SMEs to rely on public assistance: banks have loaned money to SMEs with less control and SMEs have had less incentive to strive for profitability. There will be a significant challenge ahead, therefore, to rationalize support for SMEs while continuing to ensure that adequate financing is available to them.

The OECD has recommended that the Government should:

- look to reduce the level of public guarantees for lending to SMEs;
- address the distortions created in the financial markets and in the SME financial structure; and
- phase out the public support for SMEs introduced during the financial crisis and instead promote restructuring based on market incentives.

The risks of dependency on government interventions are as real through financial inclusion policies as any other policy responses to the global financial crisis. As the chairman of the US Federal Reserve, Ben Bernanke, noted in his speech in Seoul in May 2010, 'like the Federal Reserve and many other central

banks, the Bank of Korea will have to manage its exit from accommodative policies' and 'weigh the risks of a premature exit against those of leaving expansionary policies in place for too long'.⁶

Protection: providing comprehensive and consistent legislation

There is now a focus in Korea on ensuring that prudential regulations to enhance financial stability are supplemented by effective protection for consumers of financial services. However, under the current laws and regulations for financial services, it is difficult to effectively meet the demand for stronger consumer protection. Accordingly, the FSC plans to enact the Financial Consumer Protection Act to provide a stronger and more comprehensive overall framework.

By establishing a single and comprehensive Act that incorporates various components of relevant laws of consumer protection, such as sales restriction, dispute resolution and financial education, the FSC aims to create stronger institutions and to enhance consistency in the consumer protection framework across financial products and services. Under the Act, a "same function – same regulation" system will be introduced by classifying each financial product according to its features rather than by sector. This will ensure that similar types of products are subject to common sales regulations, such as an obligation to explain the product to the consumer, a suitability principle, and a restriction on marketing activities.

To supplement the provisions in the Act, the FSC has stated that it will enforce stronger sanctions and penalties where financial institutions violate sales regulations. It will also develop an improved dispute resolution mechanism to ensure that consumers can be compensated where the principles in the Act are violated.

Empowerment: creating a Financial Education Council

Recognition of the need to ensure adequate financial education of consumers led to the establishment, in 2010, of the Financial Education Council to coordinate and oversee initiatives. The Council will assist with development of a coordinated national strategy, supported by Government funding specifically for this purpose. The Council

⁵ OECD, *A framework for growth and social cohesion in Korea*, 2011, p.42

⁶ B. Bernanke, 'The policy response to the crisis in Korea and other emerging market economies', speech in Seoul 31 May 2010

is leading the first comprehensive evaluation of the current state of financial education in Korea, and embarking on a national survey of financial literacy and capabilities. Based on the survey results, FSC will develop a national strategy identifying how financial education can be adapted to the various circumstances that consumers can face.

Financial education programs are currently geared towards elementary and middle-school students, but there are plans in store to provide additional programs to post-secondary school students and adults. Korea's central bank is currently running education programs on both consumer finance and the economy in general. Other organizations such as the Korea Federation of Small and Medium businesses, the Credit Counseling and Recovery Service, and the Korea Council for Investor Education run a combination of courses and online video classes. An impact analysis of the financial education programs will be published later in 2011.

Moving forward: challenges and opportunities

The Korean experience shows how even where the problem of extending access to transactional banking facilities and a range of other financial services has been largely resolved, many challenges remain. These include ensuring access to affordable credit for low-income individuals and SMEs and dealing with the consequences of over-indebtedness, low levels of financial education, and inadequate consumer financial protection. The shock of the global financial crisis has renewed focus on consumer usage of financial services as an important area of policy and highlighted in particular how having a clear policy framework for financial consumer issues, backed by appropriate legislation and coordination within and outside of government, can contribute to overall financial stability.

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MEXICO:

Implementing a national plan

Summary

The Mexican government has long promoted transparency of financial institutions, strong consumer protection, and widespread financial literacy as ways of alleviating poverty. To bring these issues together into a coherent strategy, the government established a National Development Plan for 2007-2012, which led to reforms of the banking laws. These reforms have enabled non-financial entities, such as banking agents, to provide financial services in rural areas. They also permitted the creation of specialized niche banks that can offer different services and are subject to different regulations, and provided assistance to small savings and credit institutions to help them develop into regulated deposit-taking entities.

The continuing challenge is to make sure that future policies are aligned with incentives and laws in order to achieve common goals.

Principles in practice

Recent progress in Mexico demonstrates the following principles:

- **Knowledge** – gathering data is the backbone of the regulator’s strategy on financial inclusion in order to inform public policy and private sector decision making. Initial results are promising.
- **Innovation** – implementing new initiatives and drawing on new technologies has expanded access to and usage of a growing range of financial services – even to Mexican migrants in the US.
- **Protection** – the Government has appointed supervisory bodies to oversee institutions and implemented other measures to prevent predatory practices and safeguard consumers.
- **Empowerment** – a significant emphasis on new strategies, guidelines, and events to increase financial literacy has helped customers to make informed decisions about financial services.

Country context: a long-standing commitment

In Mexico, financial inclusion is understood to be ‘the access and use of a portfolio of financial products and services for the majority of the adult population with clear and concise information attending the growing demand under an appropriate regulatory framework’.

Since 2005, long before the global financial crisis, the Mexican Government has been promoting policies and legal reforms to increase the transparency of financial institutions, strengthen consumer protection, and enhance financial literacy. Led by the Ministry of Finance and Public Credit, the coordinator of the financial sector, acting in close collaboration with the National Banking and Securities Commission (CNBV), in 2005 the Government published its 2007-2012 Development National Plan and the 2008-2012 Financing for Development National Program.

Both featured a number of measures to advance financial inclusion in Mexico, built around the application of some of the G20 Principles for Innovative Financial Inclusion.

Knowledge: obtaining better data for financial sector decision makers

In 2007, the CNBV’s mission was expanded to include the promotion of a sound and inclusive banking system. This led to the creation of an Access to Finance Unit within the policy and regulation branch of the CNBV, dedicated solely to addressing issues of access to finance in the country. The Unit has pursued a comprehensive data collection strategy to understand the dimensions of the access to finance challenge, inform policy decisions, influence the business models of providers, and monitor progress. The CNBV began by crafting a definition of financial inclusion for Mexico and conducting a gap analysis to determine its data needs and gaps in available surveys and reports.

The immediate priority was to focus on analyzing existing supply side data from financial service providers. CNBV defined supply side indicators, built awareness and consensus among a wide range of stakeholders, and improved the accuracy of the data collected. Indicators such as the percentage of municipalities without bank branches drew immediate



public attention to the issue of financial inclusion. To make the data collected more useful for policymakers and financial service providers, the CNBV added more details, improved granularity, and made the data widely available through the creation of a public database and publishing regular Financial Inclusion Reports,¹ which present relevant indicators for assessing the current situation and help identify ways to evolve the system in terms of increasing access to financial products and designing better public policies.

The data collected is beginning to feed into public policy and private sector decision making. For example, Bansefi, the major national savings development bank, used the CNBV’s database to plan the installation of a large number of point-of-sale devices in Diconsa stores to manage payouts of government cash transfers. Furthermore, the CNBV’s pursuit of data has created a clear focal point for the national debate on financial inclusion and has supported the creation of partnerships with other agencies, for example, a partnership with CONDUSEF ‘the consumer protection agency’, to carry out focus groups of financial literacy.

The number of banking agents has increased from 9,429 in 2009 to an estimated 20,000 by 2011.

¹ First Financial Inclusion Report: [http://www.cnbv.gob.mx/Prensa/Tabla Lista Estudios/Primer Reporte de Inclusi3n Financiera.pdf](http://www.cnbv.gob.mx/Prensa/Tabla%20Lista%20Estudios/Primer%20Reporte%20de%20Inclusi3n%20Financiera.pdf)
Second Financial Inclusion Report: [http://www.cnbv.gob.mx/Prensa/Tabla Lista Estudios/Segundo Reporte de Inclusi3n Financiera.pdf](http://www.cnbv.gob.mx/Prensa/Tabla%20Lista%20Estudios/Segundo%20Reporte%20de%20Inclusi3n%20Financiera.pdf)
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Innovation: introducing new technologies and new regulatory initiatives

To improve access to financial services and products, a number of new activities were implemented across the country:

- Between 2000 and the first quarter of 2011, the number of bank branches increased by 63 percent, the number of points of sale (POS) by 403 percent and the number of ATMs by 127 percent – reward ATMs per 100,000 inhabitants by 2010. Moreover, from 2005 to the first quarter of 2011, the use of debit and credit cards has soared: debit card transactions have risen by 69.7 percent and credit card transactions by 131.5 percent.
- In 2004, the Banco de Mexico developed the SPEI (system for electronic interbank payments), which makes it possible for any authorized financial institution to make electronic payments, of any value, directly into any banking account.
- To facilitate remittances by the large number of Mexican migrants in the US, the central banks of both countries decided to align their payment systems.
- New regulations were put in place to encourage the emergence of niche banks, as a way of increasing competition in the financial services sector. These banks benefit from reduced capital requirements and lower levels of regulation. As a result, savings and loans companies like Sofipos and Cajas and ‘non-banks’ such as Sofoles and Sofomes have all been established.
- Banking agents have increased from 9,429 in 2009 to an estimated 20,000 by 2011. By taking advantage of the infrastructure of commercial establishments, banking agents can provide access to deposits, money transfers, and cash withdrawals at locations close to the client’s home, at a lower operating cost for the business. However, there are limitations: in order to make transactions, customers have to go to the nearest point in the municipality or region. The Government is also aware of the need to regulate mobile banking, which is being increasingly tested by commercial banks in a market of more than 90 million of registered mobile phone users.

The Government has also expanded the use of financial services by:

- Introducing the Cetes Directo Program as a means to allow more people to invest in Treasury Bonds as a savings option. Under the program, there

is no fee to purchase bonds and the minimum purchase is far lower;

- Using electronic channels to pay welfare benefits, like the food aid ‘Programa de Apoyo Alimentario, which has 360,000 users, Procampo’ which has 2.4 million users, and ‘Programa Oportunidades’ which allows 2.3 million individuals in extreme poverty to draw their benefits with a debit card issued by the development bank Banco del Ahorro Nacional y Servicios Financieros (Bansefi);
- Modifying commercial bank regulations to include a specific classification for microcredit, thereby encouraging better conditions and interest rates and lowering entry barriers for some segments of the population;
- Introducing a zero fee basic account for savings and payroll transactions;
- Simplifying and adapting AML/CFT regulation to facilitate small-scale transactions. Based on an assessment of product characteristics, household vulnerabilities, household income levels, and official welfare payments, authorities defined thresholds for caps on deposits for low-risk accounts.

Protection: preventing predatory practices

Mexico has established arrangements for the supervision of financial institutions by specialized oversight bodies, along with redress mechanisms, to prevent predatory practices and give customers the necessary tools to make informed decisions. As well as a general consumer protection framework, the country has an additional consumer protection framework covering the financial sector. Although it covers the entire financial sector, the framework puts special emphasis on particular retail products and services such as savings, consumer credit, mortgage loans, insurances, retirement savings, and on particularly vulnerable groups. It also considers the protection of consumer data and privacy.

The measures and mechanisms in place for consumer protection are:

- Oversight via CONDUSEF (National Commission for the Protection and Defense of Users of Financial Services);
- Transparency requirements around pricing and terms and conditions for products and services;
- Disclosure of information on periodic statements, contracts and promotions;

- Supervision of periodic statements, contracts and advertising, commissions, interest rates, and other relevant information;
- Standards and norms regarding the protection of consumer data and privacy;
- Regulation of certain fees or commissions;
- Limits on certain offerings;
- Grievance redress mechanisms;
- Deposit insurance;
- Sanctions and fines; and
- Transparency and disclosure standards on fees charged by financial institutions (“New Transparency Law”).

Empowerment: building a financially literate country

The government has placed considerable emphasis on the importance of developing both financial literacy and financial capability in Mexico.

- On May 30, 2011, the national financial education strategy was launched through a multi-stakeholder Financial Education Committee, under the auspices of the Ministry of Finance, to promote programs, workshops, and other initiatives related to financial education.
- Since 2008, CONDUSEF has held an Annual National Financial Literacy Week that focuses on family’s budgets, savings, investments, credit, and insurance. There are over 1,000 events across the country supported by government agencies, financial institutions, schools, and universities.
- CONDUSEF also issued Guidelines for Financial Education for Elementary School. There are now six teachers’ guides that provide simple and clear tools explaining basic economic and financial concepts for children. Since January 2011, with the help of the Ministry of Education, these Guidelines have been distributed to Mexico’s 98,575 elementary schools – reaching a total of 14.6 million students.

Other institutions engaged in financial literacy campaigns are:

- CONSAR, the pensions supervisory agency, which promotes a culture of pensions and savings for retirement;

- Bansefi, which has developed materials to train trainers (Financial Education: Your Money and Your Future, Financial Protection for your family: Insurance and Risk Prevention). Bansefi has also launched www.finanzasparatodos.org.mx, a website that provides tools for financial planning, savings, credit, remittances, risk prevention and insurance, and the Sociedad Hipotecaria Federal (SHF), which promotes tools that help people choose the most suitable housing solution for them or their family.

Moving forward: challenges and opportunities

Despite the advances made in the past few years, there remain numerous population groups without access to formal financial services. As a result, the immediate challenge is to develop specific strategies to support those who remain financially excluded or underserved.

One recurrent issue experienced in Mexico has been the need to strike a balance between the size of financial transactions and prudential requirements in other words, identifying how best to balance an effective and efficient financial inclusion process, and the soundness and solvency of the financial system. While the principle of proportionality makes sense in the abstract, it has proved difficult to gain agreement from the various stakeholders on setting specific and concrete thresholds in prudential regulation.

A second challenge is the sustainability of expanding points of sale and physical bank networks. While broadened systems are desirable from a public point of view, they may not always make business sense to banks and financial institutions. Hence, it is important to develop and continue to facilitate innovative business models and strategies (banking agents, mobile financial services, and joint ventures between the private sector and public institutions).

Nevertheless, the Mexican government has a clear vision and sense of direction, which focuses on enhancing the well-being of households, based on a balance between financial innovation and financial integrity (which includes consumer protection and financial literacy principles).

Data will continue to guide the initiatives of the Mexican government. In 2011, the National Institute of Statistics and Geography, INEGI, joins hands with the CNBV to carry out a national demand-side survey to construct a complete view of financial inclusion in Mexico that includes household motivations for using financial services as well as barriers to greater usage. The survey is expected every three years and will complement other CNBV initiatives to deepen and broaden its financial inclusion data efforts.

NIGERIA:

Fostering cooperation through strong leadership

Summary

Despite the strength of its banking sector, and a relatively long history of financial inclusion initiatives, around 60 percent of Nigeria's adult population remains unbanked. In the last five years, the Government has reaffirmed its commitment to tackling this exclusion and the Central Bank of Nigeria has taken on the responsibility for driving increases in financial inclusion across the country. It has introduced a new, stronger regulatory framework and actively increased cooperation and collaboration between the many different organizations engaged in financial inclusion – from regional government to international donors and NGOs.

Evidence suggests this has had some impact in terms of reducing the numbers excluded, but in the coming years the challenge will be to build on these foundations with innovative banking models to extend the availability of financial services far more widely.

Principles in practice

The key principles demonstrated in Nigeria are:

- **Leadership** – the Central Bank of Nigeria (CBN) has taken on a strong and consistent leadership role – particularly important in setting regulations and bringing the different parties involved together.
- **Diversity** – Nigeria has actively encouraged the development of a wide range of different financial institutions, products, and services to meet the many different demands of consumers.
- **Cooperation** – a key element of CBN's work in recent years has been bringing different organizations and partners – from local government to central government to donors and NGOs – together to eliminate duplication and encourage alignment with each others' programs.
- **Framework** – considerable work has been undertaken to introduce proportionate regulation while at the same time meeting international standards.

Country context: a large and complex environment

Nigeria is an African giant in many respects, banking and finance included, as demonstrated by its conventional commercial banks, that have branches across many African nations. Nigeria was also quite an early entrant to the microfinance sector, and has for some years been home to numerous microfinance institutions and the famous 'People's Bank'. However, recent research shows that over 60 percent of its adult population remain unbanked, indicating that much remains to be done.

In its 2010 survey, *Access to Financial Services in Nigeria: Enhancing Financial Innovation and Access (EFINA)*, showed that 63.5 percent of adult males 76.8 percent of adult females, and 78.8 percent of the rural population are unbanked. The report further stated: 'Only 30 percent of the adult population currently has a bank account, which is equivalent to 25.4 million people. 67.2% of the adult population have never been banked, which is equivalent to 56.9 million people while 2.4 million adults were previously banked.'

With over 59 million unbanked adults, reaching out to this market is a major challenge for service providers. New ways of thinking and innovation in bank product and service offerings are needed to capture this market, and the EFINA survey suggested approaches such as 'extending banking beyond branches by the use of technology such as mobile phones and POS devices.'

The Central Bank of Nigeria (CBN) recognizes this challenge and is promoting innovative solutions and driving a number of measures and policy interventions. It is committed to strengthening the institutional and regulatory frameworks that will encourage financial inclusion of the unbanked over the next few years. In particular, CBN has acknowledged that innovations in payment systems require institutional support; hence it has already issued relevant rules and regulations to provide a level playing field for all stakeholders in the retail payment industry.

Barriers to financial inclusion

Despite its size, economic status, and early commitment to financial inclusion (it first launched a rural banking scheme in the late 1970s), Nigeria continues to experience high levels of financial exclusion. Some of the key barriers include:

- *Rapid population growth:* Following many years of rapid population growth and demographic shifts such as urbanization, there are now many more adults in the population overall, and financial services provision has not kept pace with these changes.

With over 59 million unbanked adults, reaching out to this market is a major challenge for service providers.

- *Inconsistent policy:* After the early investment in financial inclusion, government commitment and policy fluctuated. This meant that there were often inadequate funds available to support microfinance initiatives, and good ideas were not backed up by regulations to ensure they became common practice. This has also led to a lack of investment in new service models and technology.
- *Lack of participation from commercial banks:* Nigeria has a strong commercial banking sector, with many of its banks now expanding across Africa. However, as in many other countries, they have been less interested in supporting low-income customers and small businesses – deemed higher risk. Only in recent years, at government request, have they increased their involvement in financial inclusion programs.
- *Insufficient cooperation between existing programs:* Many programs have been introduced in Nigeria by central and local government, NGOs, and development partners. However, these have rarely been aligned.

In recent years, however, there has been a substantial change in political momentum toward financial inclusion.

Goals

Financial inclusion is now recognized as an integral element of the National Financial Sector Strategy of Nigeria and has become a priority consideration in the CBN's Financial Sector Strategy.

The primary goal is to increase the number of Nigerians with access to financial services, as a means of promoting economic activities and generating employment. The specific microfinance policy targets include:

- To ensure that by 2020 the majority (65 percent) of the economically active population are also financially included;
- To increase the share of microcredit as a percentage of total credit within the economy from 0.9 percent in 2005 to at least 20 percent in 2020, and the share of microcredit as a percentage of GDP from 0.2 percent in 2005 to at least 5 percent in 2020;
- To promote the participation of at least two-thirds of state and local governments in microcredit financing by 2015;
- To eliminate gender disparity by improving women's access to financial services by 5 percent annually;
- To increase the number of linkages among UBS, development banks, specialized finance institutions, and microfinance banks by 10 percent annually.

Conventional banks in Nigeria are very mature and perhaps some of the strongest in Africa, underlined by the fact that many of them have ventured into other African countries. Recently the CBN spearheaded far-reaching reforms, which have resulted in major restructuring and strengthening of these banks. Financial inclusion initiatives involving commercial banks, however, are quite new, having started in 2005 with the launch of the Microfinance Policy, Regulatory and Supervisory. The commercial banks have ventured into the sector through the establishment of dedicated departments, subsidiaries, and wholesale lending activities. Alongside these, non-governmental organizations (NGOs) involved in financial inclusion are supposed to register with the CBN and provide comprehensive details of their activities and returns.

More recently, CBN embarked on a number of ambitious policy measures in the area of Mobile Banking and Agency Banking. It is, however, too early to gauge the success of these initiatives.

The underlying approach to financial inclusion in Nigeria has been based on three essential perspectives:

- The demand perspective recognizes that all sectors – from agriculture to industry, building and construction, wholesale and retail trade, and services, are eligible for and require financial services provision.
- The supply perspective uses information on the dynamics, preferences, types, and volume of financial services from the demand perspective and seeks to employ diverse institutional structures and arrangements to meet them.
- The developmental perspective pertains to the creation of an appropriate environment for the demand and supply of financial services.

Each of these perspectives, together with inputs from various stakeholder forums and support from various partners such as AFI, have helped in planning and identifying financial inclusion initiatives in Nigeria.

Leadership: championing financial inclusion in formal and informal forums

Nigeria is a large and complex country where implementation of any large-scale initiatives requires strong leadership. CBN has taken the leadership role in championing financial inclusion in Nigeria and, despite challenges such as low awareness and inadequate understanding of the ramifications of financial inclusion, CBN is making progress by adopting this principle effectively.

As well as developing policy, it has effectively used formal and informal forums to enlist the support of relevant stakeholders from both the private and public sectors. These include:

- Microfinance Advisory Board;
- National Microfinance Policy Consultative Committee;
- Bankers' Committee; and
- Apex Association of Microfinance Institutions.

The results of their input have been evident to all. For example, the microfinance regulation benefited both the Microfinance Advisory Board and the National Microfinance Policy Consultative Committee. Similarly, the Bankers' Committee has been effective in giving feedback to CBN's financial inclusion initiatives. Through these leadership forums, which are discussed in more detail below (see 'Cooperation' section), CBN and other stakeholders are working toward designing a new national strategy on financial inclusion, which will build on and complement existing microfinance policy, regulatory and supervisory guidelines, as well as other financial inclusion programs.

More specifically, the CBN has undertaken three key financial inclusion measures and policy interventions over the last five years:

- *Microfinance banks:* The CBN has encouraged the creation of microfinance banks mainly to cater to the financial needs of small and medium entrepreneurs/producers. These customers typically require small amounts to fund their businesses, but cannot provide collateral to secure the loan. The microfinance banking in Nigeria is supported by the microfinance policy, regulatory, and supervisory framework.

Latest research conducted in May 2011 shows that there are now around 860 microfinance banks and a further 660 microfinance institutions. These have total savings of N7,460,000,000.00 (US\$49,078,947) and a loan portfolio of N7,760,000,000.00 (US\$51,052,632).

- *Poverty Alleviation Program:* The government of Nigeria operates a poverty alleviation program through its national poverty eradication programme (NAPEP). Specific activities are taking place in each of the 36 states of the federation and the federal capital territory, but figures on their activities are not readily available.
- *Specialized Schemes:* CBN operates a number of specialized schemes such as:
 - The agricultural credit guarantee scheme and related programs such as the commercial agricultural credit scheme. Since it was launched in 1978, the agricultural credit guarantee scheme has supported 709,610 projects, valued at N44,342,124,880 (US\$291,724,505.79). The commercial agricultural credit scheme launched in 2009 has now supported 148 projects, valued at N131,492,536,626 (US\$865,082,477.80).
 - Refinancing and restructuring facilities for SMEs and an SME credit guarantee scheme. 539 SMEs have benefited from the former since March 2010, amounting to total support valued at N197,595,202,502.14 (US\$1,299,968,437.51). A further 24 projects have been supported by the credit guarantee scheme, valued at N1,356,500,000.00 (US\$8,924,342.11)
 - A newly launched incentive-based risk sharing system for agricultural lending.

Diversity: supporting a wide range of financial institutions

Diversity of financial institutions is a key element in Nigeria's current financial inclusion strategy, reflecting the commitment to consider the demand perspective. Through diversity, all types of customer needs can be reached. To this end, CBN promotes and supports different categories of financial institutions, for example:

- organizations offering 'big-ticket' financial services;
- institutions focusing on micro, small and medium clients;
- mortgage houses;



- Agriculture finance institutions; and
- Development finance institutions.

In addition, CBN encourages unlicensed service providers, facilitated by a new regulatory window. The policy also extends to diversity in financial products and services. For example, CBN encourages and supports products and services such as microleasing, microinsurance, mobile money, and agent banking. The capacity to adopt some of these products and services is limited for a number of institutions, however. As a result, they are not yet widespread in Nigeria.

Diversity is facilitated through capacity building activities such as training, seminars and workshops, some of which are supported by donor programs. One challenge in this process is that Nigeria has a large number of institutions, which means it will take a long time to reach all of them. There is also a need to change some cultural aspects to facilitate implementation of the new products and services.

Protection: empowering consumers with information

CBN sees consumer protection as a system for empowering consumers with information, to enable them to make better financial decisions. A consumer protection unit was established to oversee this area. To ensure consumer protection, rules regarding transparent disclosure of interest and forbidding hidden charges are enforced. The general public is informed through campaigns.

Cooperation: establishing a multi-stakeholder steering committee

Within Nigeria, there are large number of institutions concerned with financial inclusion, and a wealth of state government programs exist alongside those run by development partners and local government. Clearly, the best results can be achieved through cooperation, but it is quite a challenge to ensure effective coordination with all stakeholders. Issues identified as a result of non-cooperation include duplication and at times conflicts in financial inclusion initiatives, and an unwillingness among stakeholders to explore or key into existing programs.

On one level, there is a need to convince Government of the value of sustainable, commercially viable approaches, as opposed to subsidized programs; on another, the challenge focuses on ensuring that stakeholders, and development partners in particular – undertake sufficient consultation before implementing their microfinance programs.

CBN has taken on the responsibility of ensuring the necessary coordination, and has set up a number of forums to foster cooperation. These include:

- *Financial system strategy (FSS 2020) and related matters:* The FSS 2020 initiative was designed as a collaborative venture encompassing all stakeholders in the financial system. Its implementation steering committee is made up of CBN, Federal Ministry of Finance, Nigeria Deposit Insurance Corporation, National Insurance Commission, National Pension Commission, Nigeria Securities and Exchange Commission, and the Nigerian Stock Exchange. The financial services regulatory coordination committee discusses issues affecting the financial system, creates uniform reporting formats, and develops to ensure effectiveness and efficiency in the system.
- *National microfinance policy consultative committee:* The national microfinance policy consultative committee, which is chaired by CBN, is the coordination body for microfinance initiatives. It comprises the Federal Ministries of Finance and Agriculture, National Planning Commission, National Poverty Eradication Program, Small and Medium Enterprises Development Agency of Nigeria, Bankers' Committee, National Association of Microfinance Banks, Nigeria Association of Small and Medium Enterprises, and Nigeria Deposit Insurance Corporation. This committee provides a platform for interaction and coordination of various stakeholders in the microfinance sub-sector. It is a forum for sharing thoughts on challenges in the sub-sector and offers solutions to them. Technical issues recommended

by the committee are handled by an Inter-Agency Technical Committee, comprising CBN and the Nigeria Deposit Insurance Corporation. Issues concluded at the level of the national microfinance policy consultative committee are channeled to appropriate organizations for adoption and compliance.

Considering the large number of organizations licensed by CBN to operate as microfinance banks, the national microfinance policy consultative committee has been very effective in resolving many growing pains expected from such an initiative. What is also impressive in this arrangement is that issues concerning different regulatory bodies can be competently dealt with in this committee.

- *Microfinance advisory board:* CBN hosts and serves as the secretariat to the microfinance advisory board (MAB). MAB consists mainly of donor partners, such as GTZ, DFID, UNDP, USAID, Ford Foundation, European Union, AFDB, the World Bank, National Association of Microfinance Banks (NAMBs), plus various other government agencies and non-governmental organizations. Its main objective is to create a forum for sharing experiences about donor partner program and policies and establishing coordination. It also creates room for identifying perceived gaps in the sector. Other agencies with similar aspirations and development goals are invited to its meetings as observers.

Framework: meeting international standards of proportional regulation

With respect to regulation, Nigeria now has a distinct framework for conventional banks and a separate one for microfinance banks. Supervision is also separated and provided by Banking Supervision and Other Financial Institutions Supervision Departments. Other institutions such as NGOs and financial cooperatives are suitably overseen.

Proportionality principles are applied through a risk-based supervision approach: the level of regulation and supervision is dependent on the size and risk of the institution, service, or product. For example, there are different prudential requirements for conventional banks, microfinance banks, primary mortgage institutions, and finance companies.

CBN has taken a number of measures to meet international standards and national objectives, as the following paragraphs from the CBN/AML/CFT Regulation 2009, developed to encourage financial inclusion, illustrate:

- Access to basic banking facilities and other

financial services is a necessary requirement for most adults. It is important therefore that the socially and financially disadvantaged should not be precluded from opening accounts or obtaining other financial services merely because they do not possess a valid piece of identification. In circumstances where identification can not reasonably be produced financial institutions must make allowances by providing appropriate advice to staff on other ways identities can be confirmed under exceptional circumstances.

- Where a financial institution has reasonable grounds to conclude that a client is not able to produce evidence of identity and cannot reasonably be expected to do so, the institution may accept as identification a letter or statement from a person in a position of responsibility, such as solicitors, doctors, ministers of religion, or teachers who know the client, confirming the client's and permanent address.
- When a financial institution has decided to serve a client they consider to be "financially excluded", it is required to record the reasons for doing so along with the account opening documents. Information on this category of customers should be provided to the CBN and NFIU on a quarterly basis.
- The financial institution should satisfy itself that customers are who they claim to be. Therefore, when a letter or statement is accepted from a person in position of responsibility, it should include a telephone number where the person can be contacted for verification. The financial institution should verify the information from an independent source.
- In order to guard against financial exclusion and to minimize the use of the exception procedure, financial institutions must include in their internal procedures acceptable "alternative documentary evidence of personal identity and address".
- Financial institutions are required to put in place additional monitoring for accounts opened under the financial exclusion exception procedures to ensure that such accounts are not misused."

In addition, CBN has introduced regulatory measures relating to:

- *Anti-money laundering and counter terrorism.* Measures include: laws against money laundering and terrorism financing; the establishment of an AML/CFT office in the central bank of Nigeria, promulgation of an AML/CFT regulation; and examination of financial institutions to ensure compliance, and cooperation with other agencies that fight money laundering and financing of terrorism. There have also been a number of seminars organized on the subject.

Latest research conducted in May 2011 shows there are now about 860 microfinance banks and another 660 microfinance institutions.

- *The use of agents as the customer interface.* Arrangements are being worked out with the Nigerian postal system to use post offices as agents.
- *Electronically stored value and mobile banking.* There has been considerable progress towards increased interoperability and interconnection via a central switch at the Nigerian interbank settlement system to which all Nigerian banks are connected. Clearing now takes place centrally on a daily basis.

Other policy initiatives include promoting the activities of cooperative societies, self-help groups, the state government microcredit program, and entrepreneurship development.

Moving forward: challenges and opportunities

Despite the considerable interest and participation in microfinance initiatives, a large percentage of Nigerians are still excluded from financial services. The 2010 EFINA study revealed a marginal increase of those served by formal financial market five years after launching of the microfinance policy, from 35 percent in 2005 to 36.3 percent in 2010.

If those using informal financial services such as savings clubs, pools, esusu, ajo, and money lenders are included, the percentage of those with access to financial services in 2010 was 53.7 percent. However, this still means that 46.3 percent of the adult population – or 39.2 million adults – are financially excluded.

There remain a number of challenges affecting the speed of impact, including:

- Lack of skills to serve poor and low income groups;
- Inadequate funds for lending as well as inadequate efforts on the part of financial institutions to mobilize deposits and savings for intermediation;
- Inadequate adoption of appropriate technology such as mobile and agent banking in Nigeria.

More generally, CBN actively encourages the development of computer applications to enhance effective service delivery. It is also poised to promote mobile banking, non-interest banking and agent banking, the latter through collaboration with the Nigerian postal system and other stakeholders. These efforts are complemented by capacity building

activities aimed at educating financial institutions about some of the innovative service models used in other countries. CBN also collaborates with agencies such as IFAD to create links with various stakeholders.

In terms of knowledge, CBN does not yet collect data on financial inclusion. However, efforts are being made to develop a database of information from unlicensed institutions, in collaboration with a UNDP program. Surveys conducted by Enhancing Financial Innovation Access (EFINA) provide valuable information and are used to help formulate policy.

PERU:

Empowering and protecting consumers

Summary

A strong emphasis on financial education and consumer protection, by Peru's regulatory and supervisory authority, the Superintendency of Banking, Insurance and Private Pension Funds (SBS), has paved the way for a significant increase in financial inclusion across Peru.

Many financial institutions in Peru have undertaken initiatives to educate and protect the consumer. SBS's could therefore concentrate on encouraging and reinforcing these activities. To date, SBS has emphasized compliance and greater transparency of information. This is helping to overcome a deep-seated mistrust of banks and the financial system as a whole. Consumers, particularly those on low incomes, are now in a better position to make informed choices and use financial products and services more effectively.

Principles in practice

Peru's successes to date illustrate the two principles of financial inclusion:

- **Empowerment** – a significant emphasis on financial education has helped to reach those on a low income, allowing them to make informed decisions about products.
- **Protection** – there have been a number of changes on regulations on information disclosure and contracts that provide safety and security for consumers. In addition, there is consistent supervision from SBS and a well-enforced complaints procedure.

Country context: four pillars of financial inclusion

The Superintendency of Banking, Insurance and Private Pension Funds (SBS), Peru's financial services regulatory and supervisory authority, defines financial inclusion as 'the population's sustained access to and use of a set of financial products and services, including credits, deposit accounts, investment opportunities, insurance, pensions and payments system'. In 2009 the SBS created the Committee on Financial Inclusion with the specific remit to design policies that promote financial inclusion, based on good practices employed in other institutions, both nationally and internationally.

Two of the most effective initiatives to come from this relate to financial education and consumer protection. These form two of Peru's four pillars of financial inclusion, together with regulation and supervision and transparency of information.

Empowerment: training teachers to provide financial education

As is the case in many countries, limited knowledge about financial market operations, a lack of transparency among banks and other financial institutions, and high-profile banking failures meant the general public did not have much faith in their national financial system. SBS sought to put in place a series of programs to raise the level of knowledge about financial contracts and financial institutions, and to enable low income households to make informed use of financial products, insurance, and pensions.

In 2007, SBS signed an agreement with the Ministry of Education to train public high school teachers to educate students about the financial system, including how insurance works, what private pension funds are, and asset laundering. The resulting 'Programa de Asesoría a Docentes' (PAD) has been offered since 2007. By 2011, the program had trained 3,267 teachers from 1,611 schools, reaching a total of 558,657 high school students.

In addition, SBS organizes free financial education talks aimed at those on a low income. Held in both public places and the workplace, these have covered topics such as savings, household budgeting, debt and planning for retirement. To date, 12,000 people have attended these talks.

SBS organizes free financial education talks aimed at those on a low income.

These initiatives have been backed up by Virtual Classroom, a website created by SBS that provides information on the financial system, the insurance system, private pension funds, and asset laundering. The website contains presentations, electronic versions of educational comics, videos, and other helpful tools.

Finally, SBS has produced a number of videos to inform consumers about their rights and how to make a complaint. These are shown to clients while they wait in financial institutions.

Protection: reducing consumer risk

SBS sees consumer protection as a preventive, non-interventionist way to redress the imbalance of knowledge between clients and their financial service provider. It should also lower the moral and financial risks for the client. Consumer protection in Peru is embodied in regulations on minimum disclosure, helping clients to make informed decisions when acquiring or using a financial product or service. These regulations are contained in the following laws and dispositions:

- Law N° 26702: General Law of the Financial System and the Insurance System and Organic Law of the Superintendency of Banking and Insurance (SBS);
- Law N° 28587, Complementary Law to the Consumer Protection Law in Financial Services issues;
- SBS Resolution N° 1765-2005, Regulation for Information Transparency and Applicable Rules for Contracting with Users in the Financial System, and its modifications (Regulation of Transparency).



These rules place a number of obligations on financial institutions:

- *Information disclosure* – Banks and other financial institutions must publish ‘price lists’ of interest rates, fees, and expenses in each of their branches. The list should be in a place that the public can easily access, and should be printed in characters at least 3mm high. Information, including contract clauses, financial formulas, loan simulators and price lists, should also be available on financial institutions’ websites and in any information brochures that they distribute. Interest rates must be expressed in annual effective rates, based on a 360-day year (Annual Effective Cost Rate (TCEA) for credits and the Annual Effective Yield Rate (TREA) for deposits). Financial institutions must also disclose the formulas used to calculate interest rates, fees and expenses, and give examples of their use, to help clients understand the charges applied.
- *Contract formalities* – Contracts signed by the financial institution and its clients must include a Summary Sheet (for credits) and an Informative Note (for deposits) in an annex. These documents must detail the full list of interest rates, fees and expenses for the product or service and the TCEA or TREA, and should be signed by customers to show that they accept the charges. It is the duty of the financial institution to file these documents. Additionally, every loan that is to be paid back in periodic installments should have a schedule of

reimbursements. Prior to signing the contract, the financial institution must provide clients with all required information about the product or service, including a hard copy of the contract and a full price list of the product or service. It must also be ready to respond to any questions about the contract.

Two copies of these documents should be signed and one given to the client. The other must be retained by the financial institution.

- *Contract modification* – Financial institutions are required to tell clients about any changes to interest rates, fees, and expenses that affect a product or service that they have already contracted at least 15 days before the change takes place. Changes can only be made in line with overall contractual terms.

Clients should be notified about changes to any other aspects of their contract 30 days before the change takes place.

These notifications should expressly state that the client has the right to refuse the change and can end the contract if desired. In such a case, no penalties or fees for early termination of contract may be applied.

- *Approval of contract clauses* – There is now a procedure in place for the SBS to approve the contract clauses used between financial institutions

and their clients, and which identifies all points that require prior approval, and any that would be considered 'abusive clauses' because of the potential damage they pose to users.

- *Overseeing compliance* – Every financial institution must appoint an 'Officer of Client Services', who is in charge of overseeing its compliance with the Information Transparency and Client Services Regulations.

The SBS ensures implementation of these rules through:

- On-site examinations to check the compliance of a financial institution with the regulations, especially regarding information disclosure. On-site examinations take between 2 and 4 weeks.
- Off-site supervision of the websites of financial institutions, advertising, updated price lists, and complaint reports. This guarantees permanent supervision of the User Services System and the disclosure of relevant information to clients. A central part of the off-site supervision is the Consumer Risk Model, a ratings-based tool that combines quantitative information about complaints, institution size, and regional influence, and qualitative information about compliance with the Regulation of Transparency and other client-related rules. This helps the SBS to assign more resources to institutions that have weak User Services Systems and/or show low compliance levels.

To accompany these measures, the SBS also provides softer Consumer Guidance aimed at the users of financial services. Central to the guidance is the Platform of Attention to the User (PAU), a unit within the SBS created to reduce the imbalance of knowledge between clients and banks. The PAU responds to client queries, launches investigations following complaints, and initiates 'Sanctioning Administrative Procedures' (SAP) in case of administrative infraction. It also compiles statistics on claims and has the authority to propose new or modified regulations on consumer protection.

However, the SBS does not resolve consumer complaints. In the majority of cases, complaints are dealt with by the financial institution involved. If a complaint is not adequately dealt with by the institution, the Financial Ombudsman may become involved. The Financial Ombudsman's Office was created in Peru in April 2003 to prevent and resolve conflicts that may arise between clients and providers of financial services. Alternative channels to resolve complaints are ASPEC, a nonprofit organization created in 1994 to defend consumer rights, the Office of the Ombudsman for Insurance Consumers, an independent body to safeguard the rights of insurance clients, and the National Institute of Defense of the Competition and Protection of Intellectual Property (INDECOPI).



Moving forward: challenges and opportunities

Peru launched a variety of measures and initiatives, many innovative, that amount to a fairly complete and consistent response to the information asymmetry between banks and their clients. Underlying those initiatives is a strong consensus between policy makers, regulators, and large parts of the banking community that it is in the long-term interest of providers and users of financial services to be fair and transparent in financial contracts. The only challenge is the passage of time. To really make a difference to a significant number of users, these consumer protection and empowerment initiatives need to be sustainable over years. This calls for personal, institutional, and political commitment, as well as adequate structures to keep up the momentum. Time will tell whether the financial inclusion agenda continues to muster interest and support across this unusual private-public partnership.

PHILIPPINES:

Stimulating innovation through a spirit of openness

Summary

Extending banking services out of the branch and into ‘unbankable’ markets and underserved areas of the country has been a focal point of the Bangko Sentral ng Pilipinas (BSP), the Philippines’ Central Bank, for the past decade. An open and integrated policy has helped to overcome the geographical barriers presented by an archipelagic country of more than 7,000 islands.

By maintaining open dialogue with industry and civil society players, an environment conducive to innovation has flourished. New regulations address the risks arising from new mobile channels and allow a variety of models to develop while maintaining the safety and soundness of the system. The results are faster movements of cash and a higher volume of transactions in previously unserved or underserved areas.

Principles in practice

Through branch liberalization, e-money and mobile banking, the Philippines has taken a significant step toward financial inclusion, consistently applying the following principles:

- **Innovation** – overcoming the geographical barrier presented by an archipelagic country required a new approach: two mobile phone financial services were introduced, enabling the previously underserved to be reached.
- **Diversity** – a liberal approach to branching and a reduction in regulations have promoted competition and increased the diversity of providers.
- **Proportionality** – changes to regulations have made it possible for microfinance institutions to establish a presence cost effectively, and reduced the barriers to customers using them.
- **Leadership** – the strategy has been led by the Bangko Sentral ng Pilipinas (BSP), the central bank of the Philippines, with full support from the Government.

Country context: a population spread across thousands of islands

Since 2000, the Bangko Sentral ng Pilipinas has been pushing to extend banking services to 'unbankable' markets and underserved areas—a daunting challenge in an archipelagic country composed of more than 7,000 islands. Through its policy initiatives in microfinance, electronic money, and mobile banking, the BSP has made headway in pushing financial inclusion forward and has consistently applied the financial inclusion principles of innovation, proportionality, diversity, and leadership.

With the introduction of ATMs to the Philippines in the 1980s, allowing the public to make deposits and withdrawals off-branch and at any time, formal retail banking services were no longer confined to bank branches. However, despite the number of bank branches and ATMs reaching 8,877 and 9,370 respectively as of July 2011, a large part of the population remains unbanked.

Today, although 610 of the 1,635 municipalities are still without a single banking office,¹ retail banking services in the Philippines have been made more accessible to the population. With less stringent requirements in bank branching, marketing and account opening, as well as the integration of mobile telephone technology, branchless banking is making rapid headway in the underserved areas of the country. The results are faster cash movements and a higher volume of transactions in previously unserved or underserved areas. Indeed, through the national government's conditional cash transfer program, consumers have gained several important advantages:

- The public now enjoys fast and on-time distribution of financial support through electronic money (e-money), even in remote areas;
- Microentrepreneurs in rural areas can access loans and other financial services for their personal and business transactions;

- Those living in rural areas can receive remittances from abroad through community cash-in/cash-out centers so it is no longer necessary to spend time and money traveling to the nearest bank branch in the city.

These developments were made possible through the policy initiatives of the Bangko Sentral ng Pilipinas (BSP), the country's central bank. As of June 2011, the bank had already issued 20 circulars related to microfinance, eight to inclusive bank branching, and two to e-money and mobile banking (see Annex for details).

While BSP was established primarily to serve as regulator, it has taken on the roles of promoter, enabler, and policy innovator to push financial inclusion forward. Since 2000, the BSP has been introducing policy innovations to reach the unbanked and underserved. Although financial inclusion is not explicitly stated in the bank's vision, mission, or mandate, it does believe that its role is only relevant if the financial system and its benefits are made available to all.

Innovation: unlocking the power of mobile banking

In September 1999, BSP issued a moratorium on establishing new banking offices or branches, except in cities and municipalities where there were no existing banking offices. The moratorium was in line with BSP's aim to consolidate the banking industry.²

In 2000, however, under the General Banking Law, BSP was mandated to recognize the peculiar characteristics of microfinance and establish rules and regulations for its practice within the banking sector. Aware of its potential impact on rural communities, BSP declared microfinance its flagship program for poverty alleviation, and focused on developing it using a three-pronged approach:

- To provide the enabling policy and regulatory environment;

¹ Estioko, 2011

² Circular Letter dated 10 September 1999 – Guidelines in the Suspension of the grant of new bank licenses

- To increase the capacity of the BSP and banking sector on microfinance operations;
- To promote and advocate for the development of sound and sustainable microfinance operations.³

With microfinance becoming BSP's main program, the 1999 moratorium was partially lifted in 2001, allowing the establishment of microfinance-oriented banks,⁴ as well as microfinance bank branches on a very select basis – for example, in areas not serviced by existing rural banks or microfinance-oriented banks, and on the condition that at least fifty percent of the gross loan portfolio of these banks must consist of microfinance loans.⁵

BSP's policy to make the banking industry more inclusive while also consolidating it led to institutional innovations that allowed new participants and new types of banks and bank branches to operate.

In addition, an integral part of BSP's financial inclusion strategy is to expand financial system outreach by building on technology and innovative business models, to improve efficiency, lower costs, and reach new markets. The improved access to banking services via liberalized branching and less stringent documentary requirements was further complemented by improved access to money transfers and cash-in/cash-out through e-money and mobile banking. Recognizing that product innovations were likely to come from the private sector, but that private institutions were unlikely to view those on a low income as a key market opportunity, BSP had to make this market attractive to business through policy innovations. At the same time, it had to keep the number of participants in hand.

As such, BSP sees its role as an enabler, balancing promotion of access and prudential concerns, risk taking and proportionality. 'Its approach to regulation is flexible yet cautious: encouraging financial institutions to expand scale and scope of operations for as long as risks are prudently managed, and allowing them to offer diverse products/services as they can appropriately handle, and instituting appropriate regulations within the limitations of applicable laws.'⁶

Discussions between BSP and the two biggest telecommunications companies, Smart and Globe, began in 2003. Acknowledging the opportunities that would come through technological advancement, BSP worked with these companies, which wished to be recognized as financial service providers, and consulted with them extensively to understand their business models, strategic plans, and proposed product offerings. This meant that BSP could be wholly confident that these companies were committed to developing e-money services – regardless of whether

they eventually became electronic money issuers (EMI) or Electronic Money Network Service Providers (EMNSP) – and weren't simply engaging for public relations purposes.

BSP also engaged the Bank Supervision Policy Committee to supervise financial institutions and involved its technology group in the consultation. This process, combined with the advocacy staff's study of other countries' e-money experience, allowed the BSP to understand the model and therefore apply proportionality. The mobile providers' openness to scrutiny and willingness to change their infrastructure to meet BSP's requirements (e.g. PIN blocking) were also vital in securing approval to proceed.

BSP granted its approval for transactions using the mobile technologies Globe and Smart in 2005 – initially for text payments, then for text deposits, and later on for text withdrawals. This signaled the beginning of a whole new era of non-traditional products and non-bank participants in the financial industry. Globe's G-cash and Smart's Smart Money were first used by the Rural Bankers Association of the Philippines, specifically by the Microenterprise Access to Banking Services (MABS), as well as by participating banks for their microfinance operations.

'Smart's bank partners hold the Smart Money accounts, making it a bank-based model, and Smart's bank partners are responsible for securing approval from and reporting to BSP. [On the other hand] G-Cash presents a nonbank-based model of branchless banking. G-Cash clients load cash onto electronic 'wallets' from which they then make payments via text to other G-Cash clients using their Globe mobile phone. Value in G-Cash accounts, and information about transactions, is held by GXI, a wholly-owned subsidiary of Globe that is registered with BSP as a remittance agent. Customer funds are pooled and deposited by GXI in several commercial bank accounts held in GXI's name.'⁷

With BSP Circulars 649 and 704 already in place by the late 2000s, the enabling environment for innovation had been set. These innovations eventually led to diversity, by encouraging the convergence of banks, non-banks, and technology service providers, and expanding non-traditional financial access points like storefront cash-in/cash-out points, through which clients can make remittances, fund transfers, payments, and other e-money transactions. These access points complement banks' brick and mortar offices and help increase client outreach. Government agencies have also benefited from the new financial technologies channel. It is now used for tax payments not exceeding US\$233 (or Php10,000), business registrations and renewals, and payment for various licensure application fees.

³ Bangko Sentral ng Pilipinas, 2010

⁴ Circular No. 273, 27 February, 2001

⁵ Manual of Regulation for Banks, 2008

⁶ Bangko Sentral ng Pilipinas, 2011

⁷ Consultative Group to Assist the Poor (CGAP), 2010

Recently, the national government has started using e-money facilities in distributing fuel subsidies amounting to US\$10.4 million (or Php450 million) from its Pantawid Pasada Program for jeepney and tricycle drivers, and its Pantawid Pamilyang Pilipino Program, a conditional cash transfer for promoting health and education among poor households.⁸ The total budget for the conditional cash transfer, which is a five year program, is US\$488 million (or Php21 billion) for 2011 alone.

A by product of the conditional cash transfer program is the stimulation of the local economy, as recipients can access their entitlement via the cash-in/cash-out centers within their municipality. In the past, they would have to go the nearest government-owned bank that was not always in the recipients' locality. Now, they are more likely to spend that cash within their municipality. The program, through e-money, is already serving 400 municipalities and 500,000 beneficiaries as of July 2011, despite the fact that the channels are new.

By the end of 2010, there were already 20 licensed EMI banks and three EMI non-banks.

With this innovation, Filipinos have started using e-money for various transactions, including banking (loans and deposits), bill payment, purchase of goods, money transfers, and remittances. The average inbound remittance to the Philippines is US\$300, and historically this would typically cost the sender US\$7 -US\$33 to send-equivalent to 2.5-10 percent of the remittance value. If routed via G-cash or Smart Money, the cost to the sender is less than 1 percent of the remittance value. As Ricardo Alair, Financial and Operations Head, Globe Commerce, stated in an interview, 'In 2009, the monthly turnover of Smart Money amounted to US\$174 million (or Php8 billion). A large portion is likely to be comprised of Smart airtime dealers paying for airtime, which they then resell. In the same year, G-cash turnover was US\$100 million (or Php4.6 billion) per month.'⁹

By the end of 2010, there were already 20 licensed EMI banks and three EMI non-banks. The total outstanding e-money was US\$155 million (or Php6.665 billion), with the number of e-money transactions exceeding 100 million.¹⁰

Diversity: liberalizing set-up rules for microfinance branches

The BSP further advanced financial inclusion in the country by liberalizing the set-up rules for branches of microfinance-oriented banks and for microfinance-oriented branches of regular banks, allowing them to establish branches anywhere in the country, as well as licensing them to set up extension offices, other banking offices (OBOs), and microbanking office (MBOs).

The BSP pushed for branch liberalization in recognition of the fact that microfinance clients are different from traditional banking clients: quite simply, they have very little access to conventional banks. The policy promoted competition, and hence diversity, among microfinance institutions and regular banks as well, encouraging them to expand their branch operations more aggressively and improving microfinance clients' access to banking services in the process.

The creation of the new legal entities of OBOs and MBOs reduced the requirements for new branch set-up, but also importantly reduced the cost of regulation for BSP. In turn, this cut the banks' operation costs, making expansion a sound business strategy.

OBOs, which have been allowed in the market since 2008, are generally permanent offices or places of business of a bank and have fewer requirements to set up as compared to a head office, branch, or extension office. They are allowed to undertake purely non-transactional banking related activities that include marketing, customer care services, and acceptance of loan applications.

MBOs, on the other hand, are authorized to provide services that are appropriately designed for the target market, such as microloans and collections and servicing of remittance transactions. The MBOs can also act as cash-in/cash-out centers for e-money, receive utility payments, collect premiums, pay benefits from social security institutions and other benefit systems, including the government conditional cash transfer programs, and purchase a limited level of foreign currency. As was the case with branch liberalization, setting up of OBOs and MBOs promoted both competition and diversity.

⁸ Estioko, 2011

⁹ Consultative Group to Assist the Poor (CGAP), 2010

¹⁰ Estioko, 2011

In 2010, BSP also broadened the scope and definition of microfinance to include microdeposits, which would require a minimum balance not exceeding Php100 and an average daily savings account balance not exceeding Php15,000; charges for dormant accounts would not apply. Microfinance products now also include housing and agricultural loans as well as microinsurance. This move was an example of how BSP promoted diversity in terms of microfinance products.

Proportionality: lowering costs, reducing red tape

As different channels were developed to promote financial inclusion, BSP applied the principle of proportionality in supervising them. The requirements for establishing MBOs, for example, were made proportionate to the type and volume of activity that these offices were authorized to undertake. This enabled the banks to establish a physical presence with minimal costs in areas where it may not be immediately economically feasible to set up a full bank branch. It also allowed the banks to capture savings of previously untapped markets and to provide much needed financial services in hard-to-reach areas. Through the MBOs, people who have been deprived of a face-to-face banking presence in their areas need not travel far to be able to save, pay their loans or make simple financial transactions. To date, over 300 MBOs have been approved to operate.

To further improve access to financial services, a circular (no. 608) was also issued that year which reduced the number of proofs of identification required to open an account from two to one, while broadening the range of acceptable IDs to include cheaper and more readily available ones such as barangay (village) certification and police clearance.¹¹ The policy aimed to promote access to services offered by formal financial institutions, particularly to those residing in remote areas and/or who have difficulty securing photos and IDs, as well as to encourage and facilitate remittances of overseas Filipino workers through the banking system. To safeguard against potential abuse (for example, fake identities) and to address anti-money laundering concerns, Circular 706 allows financial institutions and their authorized agents to take photos of their customers using their own facilities and resources and in general, allows them to have their own assessment of their clients' risk profile.

By reducing requirements to levels that are proportionate to the different level of risks, BSP reduced both barriers to entry and costs in a calibrated manner, specific to the type of financial service offered. This thereby allowed banks to make changes in their business models, particularly for

The challenge is identifying barriers that hinder institutional and product diversity.

the market for small loan, small savings, and small insurance.

Critically, BSP did not make hasty decisions: it moved cautiously, testing the water as it went. As BPS noted in one circular: "The challenge... is identifying the regulatory barriers that hinder institutional/product diversity, understanding the attendant risks of allowing institutional/product diversification and addressing such barriers/risks without infringing on existing legal provisions which otherwise would take a while to amend."¹²

As a result, the governing policies and framework for e-money transactions did not come out until 2009, ensuring that the regulatory measures applied were proportional to the risk entailed. The delay in implementation was deliberate: It not only allowed time for the companies to carry out pilot tests with a number of clients, it also meant BSP had the opportunity to coincide the approval of e-money transactions with its anti-money laundering resolutions from 2003 to 2005, which aimed to govern suspicious transaction, including dubious outward and inward remittances. Finally, it ensured that the policies would be encompassing and fair to all parties.

For example, while Globe intended to be an EMI, whose customers used virtual stored-value accounts for payments and money transfers, Smart opted to be an EMNSP, offering its Smart Money in partnership with Banco de Oro, a universal bank. Therefore, in 2009 BSP issued a circular that provided guidelines governing the issue of e-money and the operations of EMIs in Philippines. Subsequent circulars provided the guidelines for the outsourcing of services by EMIs to EMNSPs, addressing the complex technology and

¹¹ Circular No. 608

¹² Bangko Sentral ng Pilipinas, 2011

substantial investment required by e-money providers that served as a barrier to entry for aspiring EMIs. This provided the opportunity for even small banks to become competitive in the business.

To facilitate the expansion of EMIs and their access points, BSP also allowed the EMIs to accredit their own network of cash-in/cash-out agents (as opposed to BSP's accrediting every agent of the EMIs) 'provided that it conducts adequate due diligence; ensures that these agents comply with relevant regulations and AML requirements; and is ultimately accountable to the BSP for each of its agents, while the BSP retains the right to inspect any of these agents when deemed necessary.' In this way, the EMIs and EMNSP were given flexibility while at the same time were subjected to appropriate supervision. As Table 1 below illustrates, it was clear to BSP where it should draw the line in

its regulatory activities. In e-money for example, the BSP's basic approach to its regulation is to define its characteristics, its place in the regulatory space, and consequently, the extent of regulation that would be necessary for e-money issuers. The BSP defined e-money as: a surrogate for cash that is non-interest bearing, not insured by depository insurance, and is prepaid and fully re-convertible to cash. The BSP was firm about deposits remaining regulated and, since e-money transactions are classified as fund transfer activities and not as deposit-taking activities, e-money providers are therefore not subjected to prudential (safety and soundness) regulation required of deposit taking institutions. This opened the door to proportionate regulation as e-money providers are not unduly burdened and stifled.

Table 1. BSP Regulatory Guidelines

Issue	Point of Balance	Possible Policy Initiatives
Safety and Soundness	<ul style="list-style-type: none"> ● Deposits should be well protected ● Innovative financial services for low-income customers potentially expose deposit-taking institutions to new risks ● Prudential regulation can impose undue regulatory burden 	<ul style="list-style-type: none"> ● Limit safety and soundness supervision to entities with deposit taking activities ● Distinguish deposit taking activities from fund transfer activities ● Risk-based supervision ● Ensure adequate supervisor capacity through training ● Close coordination with other financial regulators
Consumer Protection	Financial inclusion brings in new consumers who are potentially vulnerable. They need appropriate information and increased capacity to use financial access in their best interest.	<ul style="list-style-type: none"> ● Financial education ● Price transparency and fair treatment regulation ● Contestable markets to drive competition in a multi-player environment (banks and non-banks) ● Consumer redress mechanisms
Anti-Money Laundering/ Combating Financing of Terrorism	Need to manage the risks of easy access to financial system to financial system integrity.	<ul style="list-style-type: none"> ● All simplified KYC (know your customer) requirements for small volume transactions only ● Leverage on KYC of other authorized institutions ● Recognize the use of technology in e-money systems in identifying and suppressing illegal activities

Source: Presentation by Deputy Governor N. Espenilla, Jr., 2011

Leadership: ensuring growth through sensible regulation

BSP showed leadership primarily by addressing policy and regulatory issues to facilitate new approaches and consumer protection, and ensuring that excessive regulation does not stifle growth. First and foremost, BSP's Governor has been a staunch advocate of microfinance, which was launched with the General Banking Law, a national policy that created opportunities for innovations that promoted financial inclusion.

Leadership played an integral part in managing the risk involved in unsecured loans and encouraging the banks to get involved in microfinance. Because microfinance loans are not covered by traditional collateral and are exempted from rules and regulations issued with regard to unsecured loans, the microfinance-oriented banks are advised to consider the projected cash flow of the borrowers in their schedule of loan amortization, and to adopt this approach in their terms and conditions to safeguard the quality of the loan. In addition, the microfinance-oriented banks are required to have, as a minimum, an adequate loan tracking system that allows daily monitoring of loan releases, collection and arrearages, and any restructuring and refinancing as a risk management mechanism.¹³

With the promotion of microfinance among banks, and because microfinance loans are unsecured (unlike traditional loan products) BSP adjusted the criteria for assessing risk assets. In this way, BSP facilitated new approaches in banks while also providing alternative risk management criteria in order to promote growth. Alongside this, BSP adopted a collaborative approach to financial inclusion that engaged all participants, including the private sector and auditing authorities, as well as BSP's own supervision division in dealing with the peculiarities of microfinance.

Another example of BSP's leadership can be seen in the way it addressed policy issues around the deposit- or savings-taking functions of non-regulated, non-bank, non-governmental organization (NGO) microfinance institutions. Because the compulsory savings of these non-banks are merely compensating balances against loan exposure, they were excluded from BSP's regulation – a policy that both contributed to the microfinance sector's growth and encouraged participation of non-bank institutions.

BSP also showed leadership in managing technological innovations. Although BSP had nothing to do with communications technology, much less with telecommunications, it took over the issue at hand as part of its financial services mandate. It understood that by using technology to facilitate transfer of remittances from abroad, it could benefit the low-income group the most. The telecommunications regulator, the National Telecommunications Commission, authorized Globe and Smart to do business with BSP while retaining its functions to collect fees and to ensure client protection. The strong and sustained leadership of BSP as the lead agency in this arena is evident in the reach, use, and impact of e-money and mobile banking.

Banks have adopted better risk-management practices as a result of microfinance.

Moving forward: challenges and opportunities

As of 31 March 2011, there were 202 banks providing microfinance services to 980,260 clients, with outstanding loans amounting to Php7.4 billion. Many of these clients were net savers with deposits amounting to Php3.6 billion. Of these banks, 14 have been authorized to offer micro-agri loans, 17 to offer housing microfinance loans, and three have been given 'no objection notices' to proceed with their applications to the Insurance Commission to become microinsurance agents.

Banks have also adopted better risk-management practices as a result of microfinance. Whereas in the past these banks received money from the government, which they loaned to the low-income market, now they use their own capital and impose

¹³ Manual of Regulation for Banks 2008

credit discipline as applied in microfinance to make their operations sustainable.

However, increasing the reach of the financial system remains a challenge, despite the liberal banking policies and innovative mobile banking and e-money business. At present, the EMIs are exploring possible linkages with institutions authorized to take deposits using e-money as the channel. This issue could be on the agenda in the next series of discussion between the BSP and the EMIs.

'A related challenge is increasing the level of consumer awareness of innovative products such as e-money and mobile banking. For example, increasing the scale and scope of mobile financial services uptake requires appropriate consumer awareness to use such facilities and be comfortable handling electronic cash instead of physical cash. Smaller providers of these services may be constrained by their limited resources to provide adequate information dissemination and marketing materials about such products, which negatively affects the readiness of potential users of these services.'¹⁴

As more people move into the mainstream financial system, there is a risk that vulnerable people will become victims of fraudulent activities. The promotion of financial literacy, therefore, is a pressing challenge. The BSP has introduced Advocacy for Consumer Protection and Financial Education, which promotes more transparent disclosure of costs and all relevant information (for example, interest rate, penalties, and fees) in a standard, more understandable format in all marketing materials, contracts, and billing statements. It also mandates the use of a uniform method of calculating interest rates and a standard loan disclosure statement.

Looking forward, BSP has a clear, publicly stated vision for the next five years:

"In line with the national government's goal to establish 'an inclusive financial system which provides for the evolving needs of the diverse public' within the medium term (from 2011 to 2016), BSP's key reforms are focused on the following:

- (a) promoting a regionally responsive and inclusive financial system through effective savings generation and institutionalized resource mobilization;
- (b) developing an enabling environment for long-term savings;
- (c) strengthening the governance framework of the financial system in line with international standards and best practices; and
- (d) establishing a strong legal framework for financial sector development."¹⁵



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¹⁴ Bangko Sentral ng Pilipinas, 2011

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Annex: List of BSP Circulars related to microfinance

A. Microfinance Loan Regulation

- Circular 272 (January 2001) provides the operating guidelines of the General Banking Law Provisions. Specifically, it recognizes cash flow-based lending as a peculiar feature of microfinance, defines microfinance loans and provides for the exemption of microfinance loans, from rules and regulations issued with regard to unsecured loans
- Circular 364 (19 January 2003) reduces to 75 percent the risk weight applicable to small and medium enterprises (SMEs) and microfinance loan portfolios that meet prudential standards
- Circular 409 (14 October 2003) provides the rules and regulations for the portfolio-at-risk (PAR) and the corresponding allowance for probable losses, which depend on the number of days of missed payment

B. Liberalized Branching for MF Banks

- Circular 273 (27 February 2001) partially lifts the moratorium on the establishment of new banks as long as the new banks are microfinance-oriented

- Circular 340 (30 July 2002) provides the rules and regulations concerning the establishment of branches or loan collection and disbursement points (LCDPs)
- Circular 365 (16 January 2003) liberalizes select provisions of Circular 340
- Circular 369 (17 February 2003) liberalizes select provisions of Circular 340
- Circular 505 (22 December 2005) revises branching guidelines by allowing qualified microfinance oriented banks and microfinance-oriented branches of regular banks to establish branches anywhere in the Philippines
- Circular 624 (13 October 2008) amends branching policy and guidelines that govern the establishment of branches, extension offices, and other banking offices (OBOs).
- Circular 669 (22 October 2009) allows the servicing of limited withdrawals by microfinance/ BMBE clients in LCDPs and OBOs of microfinance-oriented banks/branches
- Circular 694 (14 October 2010) allows for the establishment of microbanking offices and defines microfinance products

C. Rediscounting for Microfinance Loans

- Circular 282 (19 April 2001) opens a rediscounting facility for rural banks/cooperative rural banks engaged in microfinance
- Circular 324 (2 March 2002) opens a rediscounting facility for thrift banks engaged in microfinance

D. Reporting Requirements for Microfinance Loans

- Circular Letter (2 October 2002) requires reporting of banks with microfinance operations
- Circular 607 (30 April 2008) amends Circular Letter dated 2 October 2002 on the reporting requirements of banks' microfinance loans

E. Documentary Requirements for Microfinance Loan Clients

- Circular 549 (09 October 2006) exempts microfinance from the required submission of additional documents for the granting of loans
- Circular 608 (20 May 2008) revises the rules on acceptable identification cards which reduced the requirement to 1 valid identification card (from two IDs previously) and expands the range of acceptable IDs

F. Microfinance Products

- Circular 678 (6 January 2010) provides rules and regulations that govern the approval of banks' housing microfinance products
- Circular 680 (03 February 2010) provides rules and regulations on the approval of banks' micro-agri loans
- Circular 683 (23 February 2010) provides rules and regulations for the marketing, sale and servicing of microinsurance products by banks

G. Microfinance Ratings

- Circular 685 (7 April 2010) provides rules and regulations for the recognition of Microfinance Institution Rating Agencies

H. Mandatory Credit to Marginalized Sectors

- Circular 374 (11 March 2003) provides guidelines for the implementation of the Barangay Micro-Business Enterprise Law
- Circular 570 (24 May 2007) allows wholesale loans of universal, commercial and branches of foreign banks to non-bank microfinance institutions as compliance with the 6 percent mandatory credit allocation to small enterprises.
- Circular 625 (14 October 2008) provides rules and regulations that govern the mandatory allocation of credit resources to micro, small and medium enterprises

I. E-money Issuance Regulation

- Circular 649 (09 March 2009) provides the guidelines governing the issuance of electronic money (e-money) and the operations of electronic money issuers (EMI) in the Philippines
- Circular 704 (22 December 2010) provides the guidelines on Outsourcing of Services by Electronic Money Issuers (EMIs) to Electronic Money Network Service Providers (EMNSP)

J. AML/CFT

- Circular 706 (05 January 2011) provides updated anti money laundering rules that recognizes the importance of financial inclusion

RUSSIA:

Integrating agents, education and e-money

Summary

Over the last decade, high-level government commitment has led to a significant increase in financial inclusion across Russia. An integrated policy has helped overcome geographical and historical barriers, with a well regulated agent banking model that has made it cost-effective to provide financial services to both individuals and small businesses in rural or underserved areas. Alongside this, significant emphasis has been placed on financial education to overcome the widespread mistrust of financial institutions – that has persisted despite the country’s rapid economic growth in recent years.

The next key challenge for Russia is to address an over-reliance on cash. To this end, as well as enabling e-money transactions via mobile phones, plans are being developed for a universal payment card, to be launched by 2014.

Principles in practice

Russia’s success to date in addressing financial exclusion demonstrates the following principles:

- **Leadership** – the strategy has been led by the Ministry for Economic Development working collaboratively with other ministries, agencies and partners, and with the unequivocal backing of the President
- **Innovation** – Russia’s geographically dispersed population makes traditional branch banking unprofitable so a creative approach involving agent banking has helped to extend financial services to even the remotest areas
- **Proportionality and Framework** – changes to the regulatory regime have made it feasible for agents, cooperatives and microfinance institutions to operate cost-effectively – without undue administrative burdens
- **Empowerment and Protection** – the government has placed significant emphasis on financial education to build trust in and understanding of the services available, and backed this up with consumer protection laws

Country context: three major obstacles to financial inclusion

Russia has experienced dramatic change in its financial services industry over the last two decades. Prior to the 1990s the provision of financial services was largely limited to several state owned entities. During the early part of the 21st century the availability and diversity of financial services in the Russian Federation increased significantly in line with economic growth.

Geographic obstacles

The first barrier is the unique challenge posed by Russian geography, which, despite fast economic growth, creates considerable problems in extending a traditional bank branch infrastructure.

Quite simply a traditional bank branch model is not economically viable throughout much of Russia. The rural population totals 38.2 million, or 27 percent of the Russian population. Rural areas lack adequate financial infrastructure, and only two banks have a significant rural presence.

Consequently, although Moscow has an extremely high penetration of financial services outlets, overall Russia has one of the lowest penetration rates of financial services institutions per capita of any country, particularly relative to overall economic development. Average access to financial services in the regions is only 4 percent of the level in Moscow, and in total, Russia has only 27 bank offices per 100,000 population, approximately one-fifth of the EU average; in small settlements this figure is as low as seven bank offices per 100,000.¹ The number of bank branches also declined somewhat in the aftermath of the financial crisis of 2009.

Unequal access

Secondly, there is marked inequity in the availability of financial services, with small businesses and low-income consumers particularly restricted in their access to financial services that are essential for growth, entrepreneurship, and day-to-day financial management.

Russia has one of the lowest penetration rates of financial services.

Low levels of financial literacy

Another problem has been low levels of financial education and financial literacy, and a cultural mistrust of financial institutions, leading many Russians to operate on a cash basis. Only 4 percent of the population regularly uses bank cards for payments and even in Moscow, where the provision of financial services is plentiful, use is constrained by lack of trust of financial institutions and low levels of financial literacy. However, managing in cash is less secure, and may also be more costly, resulting in difficulties in making payments.

As a result of these challenges, it is estimated that despite the pace of economic growth in Russia, as many as 60 million consumers-or 45 percent of the population-lack access to basic financial services such as a transactional bank account, with those on low incomes disproportionately likely to be affected.²

Leadership: setting high, aspirational goals

Concerted leadership from government has been necessary to tackle these issues, with the President and Prime Minister personally engaged. Financial inclusion forms an important element of a long-term social economic development strategy toward 2020. Specifically, this includes goals to:

¹ Source: central bank of Russia. Statistics report of 2010

² Banking services for SME: credits are indispensable. Press release No.40. National Agency for Financial Research (NAFI), 2008.

- stimulate savings by improving financial literacy;
- create new services to enhance access to loans and mortgages; and
- overcome the access challenges of Russia's geography.

As part of this strategy, Russia has set goals of reaching Eastern European levels of financial inclusion by 2012, and Western European levels by 2020.

Financial inclusion serves a number of government objectives, including the expansion of the financial services sector, and is an important element of economic growth (especially in the SME sector) and social policy. Financial inclusion addresses a basic need, given the extent to which those on low incomes are disproportionately likely to be affected.

Within these frameworks, the key elements of Russia's strategy for promoting financial inclusion are:

- Expanding and diversifying bank branch networks, and reducing the costs of expansion;
- Facilitating microlending by banks (lending to low-income households; start-ups and MFIs);
- Encouraging new technology that makes it possible to provide financial services outside bank offices – branchless banking;
- Promoting an enabling environment for financial inclusion through ensuring access to capital for MFIs, adequate and comprehensive regulatory policies, and the establishment of support infrastructure for microfinance.

The Ministry of Economic Development of the Russian Federation has policy responsibility for the promotion of financial inclusion, though the strategy is cross-ministerial. The Ministry works closely with the Central Bank of the Russian Federation, and Ministry of Finance of the Russian Federation, as well as other stakeholders outside government, such as the Russian Microfinance Centre (RMC), e-money associations, and banking associations. Collaborations between these stakeholders over a sustained period and technical level has been critical to ensuring the development of an enabling and proportionate regulatory framework.

The roles and responsibilities of the ministries and partner organizations are divided as follows:

- The Ministry for Economic Development of the Russian Federation is the federal authority with responsibility for the promotion of financial inclusion within the Russian Federation. It is also

responsible for eliminating barriers to stable economic development. It coordinates all projects aiming to improve the financial and credit system in Russia, often forming working groups with the representatives of the private sector to develop and implement new legislation and procedures.

- The Ministry of Finance of the Russian Federation is the regulator of banking and the insurance sector and participates in governmental working groups aimed at developing enabling financial services legislation, and is responsible for developing Russia as a world financial center.
- The Central Bank of the Russian Federation is responsible for the supervision of credit institutions, ensuring stability of the banking system, and protecting depositors and lenders concerns.
- The RMC was founded in 2002 with a mission to promote a vibrant and inclusive financial system in Russia in order to enhance financial inclusion.
- Three priority groups are identified by Russia as critical for engagement: SMEs, those living in rural areas, and those on low incomes. As of 2007, there were 1.13 million registered SMEs in Russia, employing a total of 9.1 million people.⁴ Facilitating access to retail finance for SME and individual entrepreneurs is seen as important for maintaining competition in the marketplace, driving innovation, and as a force for political and social stability.
- 27 percent of the Russian population (38.2 million) live in rural areas, and this proportion has remained consistent over the last decade (unlike many developing countries). Only two banks – Sberbank and Rosselkhozbank – have a significant presence in the rural areas. The high demand for finance is evidenced by escalating rates of borrowing: the annual growth of debt financing in agriculture, hunting, and forestry sectors exceeds 50 percent. One important priority is to correct the misperception-not backed up by facts-that rural borrowers are high-risk and unprofitable.
- By official data, 13.4 million (9.5 percent) of the population have incomes below subsistence levels. Conventional banks do not perceive this group as attractive borrowers. This is exacerbated by the relatively low penetration of microfinance in Russia: the microfinance coverage ratio is just 9 percent, low even relative to Africa and the Middle East.⁵ Extending provision of financial services to this group is seen as important to enabling people to start a business or engage in commercial or household farming, and thus escape a cycle of poverty.

³ President Medvedev informed the Presidium of the State Council that "in order to advance the objectives of Russia's social and economic development, it is imperative to ensure access to diverse forms of finance for entrepreneurial activities."

⁴ Source: Federal Statistics Service

There are two main types of exclusion in Russia recognized– territorial exclusion due to inadequate financial infrastructure and technological exclusion due to a mismatch between technologies and the needs of specific target groups.⁶ Five basic types of financial services are considered within the strategy: credits, saving, payments and remittances, insurance and leasing. This focus is derived from evidence on demand for financial services, which shows that:

- 97 percent of the economically active population require access to retail payments and remittances (Russia is in fact the third largest market in the world for remittances after the US and Saudi Arabia, with the majority sent to neighboring CIS countries);
- 70 percent require a safe place for savings;
- 50 percent require access to affordable credit.⁷

Innovation: embracing and implementing a model for agent banking

Due to Russia's geographical challenges, it has been necessary for policymakers and partners to embrace innovation and diversity in the delivery of financial services. Russian policymakers have had to accept that it is simply not profitable to operate a bank branch network across many parts of the country. In response, several avenues have been considered by policymakers. These include utilizing the substantial network of credit cooperatives in Russia and introducing a new regulatory framework for these cooperatives; developing a model of agent banking in which various intermediaries become the front office for a range of financial services; a concerted drive and clear strategy for financial literacy and education to ensure consumers are aware of the financial services available to them; and pursuit of innovation in e-money and technology.

To date, the most advanced of these areas is the strategy for agent banking. The cost of opening a payment terminal with a retail agent is estimated at less than 0.5 percent of the cost of setting up a bank office.⁸ There are many categories of these agents and each has a role to play.

One effective agent is Russian Post, where people can pay for their housing and community amenities at payment terminals. There are 42,000 branches of the federal post services (27 per 100,000 population), 29,500 in rural areas and 12,000 in villages of 500 people. By law, they are required to provide postal remittance service to individuals and legal entities, and they must accept, process, transmit, and deliver funds using postal and electronic communication networks. Russian Post is not permitted to act as an agent for banks, but does perform a type of money transfer service for individuals for the repayment of bank loans. In total, Russian Post derives 46 percent of its revenue from financial services.⁹

There are also a wide range of other non-bank institutions active as payment service providers. These include municipal authority bodies, credit cooperatives, and MFIs. Credit cooperatives have a particularly important role in extending financial services within villages, with a total of 600,000 clients, many of whom are in rural areas.¹⁰ The role of such actors had until recently been proscribed by an inadequate regulatory framework. Transforming the role of these agents has therefore been a central pillar of the Russian government's strategy for financial inclusion. Working across the government and with stakeholders made it possible to establish an agent banking program that aims to create approximately 50,000 agents and, through these agents, bringing an additional 5 million people into the financial system.

Proportionality and Framework: facilitating innovation through regulatory changes

Facilitating the role of non-bank agents in the promotion of financial inclusion has required significant improvements to the financial services infrastructure and legal framework.

The existing legislative framework for banking presumed that only licensed credit institutions (banks) and Russian Post were allowed to perform remittance/settlement by transfer. This system seriously limited access to finance by providing the banks with a monopoly for remittance services.

⁵ Microfinance coverage ratio is a ratio of active borrowers of microfinance providers to number of people below the poverty line.

⁶ Greater Access to Retail Finance: Measures to promote microfinance in the Russian federation, 2008-2012, 2008, p.3.

⁷ Source: National Agency of Financial Research

⁸ Greater Access to Retail Finance, p.28

⁹ 'Update on regulation of branchless banking in Russia', CGAP, January 2010

¹⁰ Concept note, p.6

A major breakthrough was the passage in July 2009 of the federal law on credit cooperatives, which allowed credit cooperatives to act as bank agents in accepting payments.

To further improve financial access, and taking into account the negative impact of the financial crisis that led to the closure of a number of bank branches, the Federal Law On Payment Agents was adopted on 1 April 2010, together with amendments to both the Banking Law and the AML/CFT law, relaxing customer identification requirements for transactions below \$500 USD per transaction, and allowing banking agents to collect documentation from customers in order to open bank accounts.

As a result of adopting the Federal Law On Payment Agents, the provision of payment services is no longer the exclusive domain of banks and Russian Post. (Although non-bank payment terminals have been a significant player since 1998; prior to the 2010 legislation they had operated in an ambiguous legal space). The law defines categories of both non-banking and banking agents. Non-banking agents are allowed to accept cash funds from individuals as payment for goods, works, or services as well as taxes and other government fees (P2B, P2G), whereas banking agents are allowed to undertake more operations, including opening saving accounts, loan repayment and money transfers (P2P).

The Federal Law On Microfinance Activity and Microfinance Institutions was adopted on 2 July 2010, and will now establish a legal framework for microfinance activities in the Russian Federation.

One important challenge that remaining is that it is not yet possible for agents to open bank accounts on behalf of banks. The agents can collect the documentation and submit it for banks to carry out Know Your Customer (KYC) procedures. It remains to be seen whether this will be addressed in future legislative amendments.

An important element of Russia's approach to facilitating agent banking is the sharing of international experience. The agent banking model in Russia was partly informed through studies of Brazil, Mexico, South Africa and Kenya, assisted by an AFI grant. Russia is also taking a lead in promoting the issue of financial inclusion in the wider region. In most countries of the CIS, the legal and regulatory frameworks for banking agents have lagged behind the needs of the market, due to the complexities in accommodating bank and non-bank services while meeting all AML/CFT requirements. The Ministry for Economic Development has therefore organized a roundtable discussion with representatives of regulatory authorities of these countries to disseminate learning.

Empowerment and protection: devising a strategy to boost financial literacy

The measures taken to promote financial inclusion in Russia have been founded on utilizing a network of non-bank actors to extend reach. As efforts to extend the supply of financial services have increased, so new challenges have emerged – particularly in terms of having appropriate regulation that can keep pace with diversity and innovation in financial services provision. At the same time, it is now being recognized that, given Russia's low levels of financial literacy, efforts on the supply-side must be complemented by a clear and coherent demand-side strategy and, particularly in the wake of the 2008 financial crisis, a consumer protection framework.

The program for improvement of financial literacy goes hand-in-hand with the development of the agent-banking model. Early evaluation of the agent banking model in Russia suggests lack of trust and low levels of financial literacy are major barriers to greater use.

Several household surveys were conducted in order to understand the impact of financial literacy. These showed that:

- only 45 percent of the adult population use a cost planning approach;
- 28 percent (and 40 percent of low-income households) spend more than they earn;
- 43 percent could not answer basic questions concerning inflation and interest rates; and

- 40 percent of the population believed the Government would compensate for financial losses associated with personal investments¹¹

In 2006, Russia made financial education a central component of the global agenda in its G8 Presidency. The promotion of financial literacy is seen as important in enabling families to manage their incomes and expenses better, preventing social crisis, and encouraging financial planning.

In December 2010, the World Bank (IBRD) approved a \$25 million loan for a Financial Education and Financial Literacy project in Russia, with the Russian Government providing a further \$88 million.¹² The project aims to strengthen financial literacy and consumer protection. Work is underway to establish a system for independent monitoring of financial consumer protection practices and introducing a financial ombudsman system. The financial literacy program also includes a dedicated campaign on safe channels for saving, trying to make it clear that e-money is not safe until regulations are in place, and informing people about sources of help and advice if they face severe debt.

The financial literacy program is focused on engaging children and young people who may be receptive to new innovations and information, and can in turn share their financial knowledge with the older generation (i.e. education through school or university curricula). In addition, it seeks to address those on low incomes or with below college-level education-for whom financial literacy courses may be provided by NGOs or consumer protection organizations.

The program is being implemented via several public-private partnerships, such as regional authorities, educational establishments, professional intermediaries, and NGOs. A public body-the Steering Committee for Financial Literacy-has been established with the participation of the Ministry of Finance, while some organizations and institutions, including the RMC, are offering training courses and workshops addressing the problem of poor financial literacy.

The project will be implemented simultaneously at a local and federal level, measuring changes in financial literacy levels by assessing knowledge (e.g. of the pension system), skills (e.g. calculating compound interest), attitudes (e.g. attitude to managing personal finances), and behavior (e.g. saving behavior).

In April 2011, the World Bank hosted a workshop to raise awareness of, and discuss goals for, the Financial Education and Financial Literacy Project. The World Bank made six recommendations on consumer protection for the Russian Federation to take forward:

1. Strengthen regulatory and supervisory structures for financial consumer protection
2. Make consumer disclosure clearer, simpler and more complete
3. Prohibit deceptive and unfair business practices
4. Have an inexpensive, efficient recourse mechanism to handle consumers' disputes with their banks and other financial institutions
5. Improve financial education programs
6. Conduct regular financial literacy surveys¹³

The government will now seek to address these issues hand-in-hand with its efforts to modernize the regulatory frameworks for non-bank agents and improve consumer financial literacy.

Moving forward: challenges and opportunities

There is clear political momentum behind Russia's drive to extend and deepen financial inclusion. E-money is seen as offering an opportunity to achieve a dramatic cultural shift from cash to electronic payment. However, a certain degree of caution is required until satisfactory regulation is in place.

Until recently e-money was not defined in Russian legislation and consumer protection in the area of remote service provision was weak. The Federal Law on national payment systems, adopted in June 2011, contains basic regulations for e-money, and defines the status of e-money operators. These organizations will be subject to a light touch regulatory regime compared to banks-for instance, by allowing mobile phone network operators to perform certain banking agent functions. Consideration is also being given to providing e-money licenses, for example, allowing mobile operators to offer payment and transfer services directly rather than being agents of a bank.

Of immediate importance is the Russian government's intention to introduce a universal ID and payment card for all citizens, which would mark a major shift for a country where non-cash payments are still the exception. The card would look similar to a regular bank card, contain an electronic chip with the holder's personal information, including a photograph, and could be used to pay utilities, transportation, and medical bills. It could potentially be combined with drivers' licenses, medical insurance and school and university ID cards.

¹¹ Financial literacy survey, June 2008

¹² "The World Bank Supports Russia's Government efforts to improve financial literacy, education and consumer protection of citizens", press release 7 December 2010

¹³ Eric Haythorne, "Russian Federation: consumer protection in financial services", Moscow 4 April 2011



The mandatory cards are to be issued by January 2014, and are likely to be used initially for social benefits and to serve as personal IDs. However, Presidential economic adviser Arkady Dvorkovitch has said that he expects the card could lead to perhaps 50 percent of payments becoming non-cash in the future, a dramatic rise from the current 4 percent of Russians making regular purchases with bank cards.

The ID project will be funded through a combination of state and private investment. To date, three commercial banks with large retail operations are partnering with the project, and discussions with other potential commercial partners are ongoing. The President's office has, however, made it clear that profit margins

on the card will be carefully regulated, stating that 'everyone that services the cards, all the major bank structures, must understand that this in fact a social mission and not a source for big earnings'.

What is clear is that the project has the full backing of President Medvedev, who has stated that, "we are ready to begin implementation of this massive socially important project. Its results will have a pivotal effect on people's lives, on the interaction between the citizen and the state. I am certain that as soon as we introduce this system, it will simplify life for tens of millions of citizens."¹⁴

If successful, the universal payment card would embody many of the features that have characterized Russia's financial inclusion policies to date: clear and prominent commitment from the highest levels in government and a willingness to embrace innovative solutions to substantial cultural and geographical challenges. But such is the scale of the project that a great deal of work will be needed to ensure that the final product meets the aspirations of government, commercial providers, and not least the end-users.

As the case of Russia shows, every country faces distinct financial inclusion challenges and economic growth alone does not guarantee financial inclusion. Russia has faced severe barriers to full financial inclusion, from geographical constraints to cultural factors limiting effective use of financial services even where they are available. Russia's story demonstrates that even where there are a range of potential intermediaries ready to extend the reach of financial services through their networks, they must be enabled to do so through an effective regulatory framework that encompasses diversity, innovation, proportionality, and consumer protection.

Embarking on an overhaul of financial services legislation to facilitate enhanced access has required concerted government leadership, both from the Ministry responsible and the office of the President, and cooperation with stakeholders on with stakeholders outside the government to harness expertise both on regulation and financial literacy. Given the extent of financial exclusion and low levels of financial capability in Russia, very significant challenges remain. But the signs are that the commitment to greater financial inclusion at the highest political levels in Russia remain strong, and significant breakthroughs can be expected in the coming months and years.

¹⁴ 'One card to rule them all', *the Moscow News*, 5 March 2011; 'Russia plans universal ID-payment card to cut red tape', *RIA Novosti*, 28 February 2011; 'Medvedev sees universal e-card as payment instrument in Russia and abroad', *Interfax*, 28 February 2011

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TURKEY:

Revolutionizing SMEs' access to capital

Summary

Turkey's economy features vast numbers of micro-, small- and medium-sized enterprises (MSMEs), many of whom operate partly or largely in an informal way. This not only hampers their productivity and profitability but also restricts the country's productivity as a whole. What's more, it has been a contributing factor in small- and medium-sized enterprises' (SMEs') inability to access capital to finance their growth.

To tackle this, Turkey took a radical step, led by the Istanbul Stock Exchange (ISE) to set up a new capital market through which shares in small business could be traded. Opened in 2011, the Emerging Companies Market promises to transform the way small businesses operate, giving them unprecedented access to investor capital. Crucially, to enter the market, businesses are required to formalize their operations.

The next challenge is to raise awareness of these reforms and their potential benefits to individual SMEs.

Principles in practice

Turkey's program to enhance the financial inclusion of SMEs is based on the following principles:

- **Diversity** – from low interest loans to new sources of capital, Turkey is seeking to increase the diversity of support available to SMEs.
- **Innovation** – the new capital market solely for SMEs is a highly innovative approach to solving financing challenges, while at the same time helping to bring these businesses and their activities into the 'formal' economy.
- **Framework** – as well as a proportionate risk-based approach toward AML/CFT regulation, which provides appropriate flexibility for SMEs, Turkey has put in place a comprehensive legislative framework to support small businesses and reduce their administration burden as they formalize their activities for the first time.

Country context: a large and growing informal economy

Turkey has grown at a rapid pace in the last two years. GDP growth in 2010 was 8.2 percent, a considerable jump from the 4.7 percent growth in 2009, and industry and services sectors comprised almost 90 percent of the total value added. Within these sectors, about 99 percent of the enterprises are categorized as micro, small and medium enterprises (SMEs) with less than 250 workers. About 78 percent are micro firms (employing less than 10 workers) and about 17 percent are small (employing more than 10 but less than 50 workers).

Most individuals in Turkey—6 out of every 10—work in firms with less than 10 employees. Workers in these firms display the highest informality rates (roughly 70 percent). Over time, informality rates have been increasing in manufacturing, transport, communications, and services—the sectors that have the majority of MSMEs. Informality is widespread among micro firms¹.

This high level of informality and the large share of the MSMEs in the country's economy pose a major challenge to Turkey's financial inclusion agenda. Aside from experiencing lower productivity growth, informal firms are also typically unable to access finance, which further limits their ability to grow and increase production.

This case study explains how Turkey has deliberately introduced reforms to its capital market to increase the range of financing options available to MSMEs. By creating an alternative capital market for firms that have growth and development potential, Turkey has enabled MSMEs to access additional sources of financing while at the same time encouraging them to formalize their operations.

MSMEs play a particularly important role in the Turkish economy. They account for:

- 99 percent of the total number of Turkish enterprises;
- 78 percent of total employment;

SMEs receive a small share of the funds mobilized by the banking sector

- half of total investments (about 38 percent are capital investments);
- 55 percent of value added;
- two-thirds of total retail sales; and
- 59 percent of total exports.

While 56.77 percent of firms have lines of credit or loans from financial institutions (WB Enterprise Survey, 2008), loans to SMEs account for just 25 percent of total bank credit (KOSGEB, 2011). In other words, despite their large contribution to employment and the national economy, MSMEs operate with comparatively little capital equipment and receive a small share of the funds mobilized by the banking sector. 'This implies that the development of a more productive and more outward-oriented SME sector is a crucial development challenge for Turkey. A healthy SME sector would not only significantly contribute to capital accumulation, provide increased employment opportunities for a rapidly increasing workforce, and promote regional development, but is also crucial to increase the resilience of the economy to external shocks, like the one represented by the recent global crisis.' (Nova Capital Markets, 2010).

¹ Informal transactions occur in many contexts: business is concluded based on a handshake; payments are routinely deferred; employees receive cash payments; receipts are often provided only upon explicit request. These phenomena interact with more traditional definitions of informality, such as unregistered workers, self-employment, and tax evasion. Formality and informality exist side by side, often in the same enterprise, such as when firms record only a certain fraction of their production. (WB Country Economic Memorandum, March, 2010)

Compared to MSMEs in other countries within the European Union, the average MSME in Turkey is smaller in terms of workforce. About 78 percent of the MSMEs employ less than 10 people (categorized as a microenterprise) and about 17 percent of the enterprises employ less than 50 people. They also lag well behind in terms of know-how, skill levels, capital investment to support their activities, and access and ability to take advantage of modern technologies, especially in the information and communications fields. As in most other countries, MSMEs in Turkey also find it difficult to obtain financing (OECD, 2004).

Opportunities for external financing for MSMEs in Turkey are limited. Due to the recent bank crisis, most banks are reluctant to offer MSMEs financing, and those who do typically offer it at relatively high interest rates. Moreover, severe interest rate fluctuations experienced in previous economic bank crises have made many entrepreneurs wary of seeking bank loans—a further self-imposed limit.

Yet finance and capital are crucial for the growth of MSMEs. Increased productivity is highly dependent on their ability to invest in new markets, activities and innovations. But investing in these requires capital and therefore access to finance. CGAP financial inclusion data for 2010 shows that MSME finance in Turkey has an aggregate loan value of only about 7.38 percent of GDP.

Diversity: increasing financial access for SMEs

Recognizing that MSMEs needed improved access to finance, the Small and Medium Industry Organization (KOSGEB)² developed a credit support system specifically for SMEs. This system provides credit support to SMEs through low or zero interest rate loans provided by intermediary banks.³ From 2003 to May 2011, some 196,788 enterprises have benefited from the KOSGEB interest support programs.

Yet despite the large amount of resources earmarked, the number of enterprises that benefited from the program is still small compared to the huge number of Turkish businesses (about 3.2 million SMEs according to the 2009 Census of Manufacturing and Business). This highlights the need for government to take action, and partner with the private sector to provide better access to financial services for SMEs.

To address this, the Istanbul Stock Exchange (ISE), in close cooperation with the Capital Market Board (CMB) of Turkey, set up a new market to allow SME shares to be traded. The market, under the governance of ISE, focuses on SMEs with growth and development potential. The main objective of the new structure, named the ‘Emerging Companies Market’ (ECM), is to facilitate SME access to the capital market and gather equity capital from there.

Innovation: introducing the Emerging Companies Market (ECM)

The ECM was formally established in 2009 as one of the markets for trading stocks in the ISE. It creates a transparent and organized platform where SMEs can raise funds from the capital markets through issuance and trading of securities. SMEs that are registered by the Capital Markets Board of Turkey (CMB), but fail to meet the ISE listing requirements and criteria, can apply for listing and admission into the ECM. Unlike in the stock market, the ISE does not require qualitative or quantitative criteria for ECM admission. Quantitative criteria such as profitability, operational age, and capital or market capitalization size are not required for admission of shares to the ECM Directory, provided the SME is a joint stock company.⁴

Admission to the ECM is facilitated through the market advisor system. The system is established to help companies under the ECM (SMEs in particular) get acquainted with and better comply with the regulations of the CMB and the ISE. The Market Advisor helps the SME during ECM application and cosigns the application. They then submit a report to the ISE including an affirmative opinion regarding the company. The ISE Executive Council bases its admission decision on the market advisor’s report and opinion of the SME.

With the establishment of the ECM, several legislative amendments were made to existing communiqués. These are aimed at decreasing the costs of issuers and making the capital markets more accessible as a viable alternative for fundraising, especially for SMEs. Companies whose shares are traded in the ECM market list under ISE ECM regulations are provided the following advantages:

² KOSGEB Small Business Administration of Turkey (KOSGEB), which was established in 1990, is the main public agency in Turkey responsible for the development of SMEs. The Administration operates under the Ministry of Industry and Trade with its headquarters located in Ankara. It extends its services through 55 local offices located in 44 provinces. Among other things, KOSGEB provides support mechanisms for increasing competitiveness of SMEs, encouraging entrepreneurship, and innovative start-ups.

³ ‘KOSGEB signed protocols with banks so as to provide financial credit at an agreed interest rate to eligible SMEs where eligibility rules are pre-determined by KOSGEB and the bank together. The interest cost of the credit is paid to the bank by KOSGEB, where only the principal amount of the credit is paid back to the bank by the benefiting SME at a determined pay back period’ www.yoikk.gov.tr

⁴ A Joint Stock Company is a limited company that can issue stock certificates, which is set up with at least five shareholders who can be real persons or a legal entities. Joint Stock Company’s stock capital is divided into shares, and the liability of the shareholders is limited with the share capital.

- Their semi-annual financial statements are not subject to independent auditing. They are only required to have their annual financial statements independently audited. They do not have to prepare quarterly periodical financial statements and interim period reports. They are exempt from the obligation to distribute a first dividend for a maximum of three accounting periods after their registration by the CMB.
- They do not have to publish a prospectus for security issues under TL 3 million.
- They are not required to establish an investor relations department or recruit personnel for the coordination of corporate governance applications.

Other incentives provided to firms traded in the ECM are:

- Fees: In order to provide cost advantage for ECM companies, the CMB, the ISE, and the CRA cut their fees to one-tenth of the fees applied in the other ISE markets.
- Sales method: The ECM offers lower cost alternative sales methods such as private placements for companies to access the capital markets. Also, the minimum number of investors criterion (250 investors in a public offering) is not sought for companies listed in the ECM.
- Independent audit requirements at the IPO stage: For trading on the ECM, only an independent audit report for the latest year and, if 9 months has passed since the date of such report as of the issue date, a 6-month interim audit report is required.

Added to this, the SME Support and Development Agency of the Ministry of Industry (KOSGEB) is also cooperating with the ISE at the ECM project. During the initial public offer of the SME's shares in the ECM, KOSGEB provides the business non-repayable support to cover the cost of the market advisor's consultancy services and the independent audit, CMB registration, ISE-ECM and intermediary institution fees. These various incentives give SMEs a considerable cost advantage in joining the ECM.

The ECM: progress to date

Having been formally established in 2009, the ECM really launched in January 2011 with an initial public offering from an SME. At present, there are two companies traded at the ECM and one application being evaluated.

To further promote participation in the ECM, the ISE is conducting a series of seminars to introduce the ECM to prospective participants, particularly SMEs. For instance, seminars were conducted in major technology industrial areas in Istanbul, Ankara and Kocaeli, where a number of technology start-up SMEs with high growth potential are located.

In cooperation with the private sector, seminars are also organized with local industrial unions, banks, and brokerage houses to give detailed information about the ECM to their member or client groups. In these seminars, SMEs are informed about the ECM. A series of seminars and meetings have already been held in various major cities including İstanbul, İzmir, Kocaeli, Ankara, Kayseri, Denizli, Uşak, and Bursa.

Under the cooperation agreement between the ISE and KOSGEB, information on the ECM is made available through KOSGEB's website, which is very popular among SMEs.

The ECM: benefits for SMEs

Aside from providing an additional source of financing for the SMEs, the ECM also increases financial inclusion, by providing access to the capital markets for smaller companies. This benefits investors too as it creates a greater diversity of companies that are eligible for investment. The ECM guide issued in December 2010 identifies the following benefits for companies (SMEs in particular) whose shares are traded in the ECM:

- *Alternative Source of Financing* – Previously, only larger companies could utilize the capital market to finance their investments. With the establishment of the ECM, SMEs are able to access financing from the capital market. This benefits the SMEs because unlike credit, funds from the equity market do not have principal and interest payments that put pressure on the cash flow of the enterprise. Capital funds also help SMEs to strengthen their financial position, thereby enabling them to access the credit market more easily and at better terms. Since companies whose shares are traded in the exchange market are required to disclose financial and other information on a regular basis, creditors are more inclined to provide funds to such firms.
- *Liquidity* – Since the ECM provides a reliable trading platform, it offers liquidity for company shares. Enterprises listed under the ECM can therefore use these shares as collateral for credit transactions, thereby further increasing the financing options of an SME.
- *Price Discovery* – SMEs are able to measure their market value through the prices of their shares. This will provide the basis for establishing a suitable price for any future mergers and consolidations.
- *Visibility* – The ISE provides a valuable transparency and disclosure function. Information about companies trading is disclosed and distributed to local and international investors through various means. This gives companies and enterprises traded at the ECM greater recognition and increased opportunities to raise funds from investors, consumers, banks and financial institutions, potential business partners,

and human resources. With greater visibility and exposure, companies are able to find credit more easily along with equity. This also opens opportunities for them to market and sell their products and services more effectively, to establish business partnerships, and to find better-qualified staff.

Framework: complying with AML/CFT standards while providing access to finance

Money laundering offenses were first introduced into the Turkish legal system under Article 2/b of Law No. 4208, enacted on 19 November 1996. A few months later, MASAK (Financial Crimes Investigation Board) was founded specifically to fight money laundering. MASAK is an administrative unit attached to the Ministry of Finance, and its duties and powers were initially defined as:

- developing and regulating policies;
- coordination;
- collecting, analyzing and evaluating data;
- supervision of AML/CFT obligations; and
- examination.

In 2008, Turkey's anti-money laundering regime was significantly enhanced to ensure that the country's banks, stockbrokers, insurance, and pension companies comply with international standards. The proportionate approach used in implementing the Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT) standards supports the ECM, which brings smaller companies into the capital market

Preventive measures are defined in detail in 'Regulation on Measures Regarding Prevention of Laundering Proceeds of Crime and Financing of Terrorism' (Official Gazette No 26751, January 9, 2008). It means that banks and financial institutions are now not only required to obtain customer identification as a due diligence process, but that they are also expected to detect any customers, business relationships, or transactions that are considered risky in terms of money laundering and financing terrorism. Likewise, suspicious transactions should be reported. Special attention is given to complex and unusually high amount transactions (MASAK Activity Report, 2010).

Accordingly, banks (except the Central Bank of Republic of Turkey, development, and investment banks), capital markets brokerage houses, insurance and pension companies, and PTT (pertaining only to banking activities) are required to establish and maintain internal procedures, policies, and controls to prevent money laundering and the financing of terrorism.

The regulation also includes a requirement for regulated institutions to put in place a risk-based compliance program that covers:

- Developing institutional policy and procedures;
- Carrying out risk management;
- Monitoring and controlling activities;
- Assigning compliance officer;
- Establishing the compliance unit that will carry out both training and internal control activities.

This risk-based approach provides appropriate flexibility to the firms to develop institutional policies and procedures, carry out risk management activities, and monitor and control activities. In this way, they are able to tailor their monitoring and control mechanisms according to the risks associated with the customer and the related financial transaction and service. Hence, small and simple financial transactions should not have tedious documentation requirements, thus facilitating access to financial services. The legislation forces financial institutions to introduce compliance programs that are designed to combat the threat of money laundering. The goal of this regulation is to make the Turkish AML/CFT system more efficient in its compliance with the international standards in this area. This also gives some flexibility to any firm to tailor its compliance program to the risks associated with their type of clientele and the kind and volume of financial transactions.

Moving forward: challenges and opportunities

One major challenge facing the ECM is to educate SMEs about the benefits and potential importance of the ECM to their growth, productivity and long-term viability. Given their long historical exclusion from the capital market, SMEs' appetite for and understanding of the stock exchange for financing has unsurprisingly diminished. The series of seminars being conducted among SMEs is expected to help overcome this obstacle. Introductory meetings should, among other things, feature good initial examples of SMEs participating at the ECM. KOSGEB is cooperating with the ISE to introduce the ECM to its vast SME database. Information and awareness campaigns also need to focus on the benefits to SMEs as well as the requirements and why they are in place. For instance, disclosure requirements to produce, submit, and make public a number of financial reports (i.e. year end financial reports, annual independent audit reports semi-annual financial statements, board of directors' operations reports and representation letters), might discourage some SMEs to apply for admission to the ECM. In view of this, it is important that SMEs be made aware of how



these requirements can help professionalize their operations and increase their ability to access finance for their growth and sustainability.

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UNITED KINGDOM:

Using financial inclusion as a tool for social justice

Summary

The UK is rightly recognized as having one of the most established and diverse financial services sectors. But in such an environment, the costs and consequences of financial exclusion are comparatively as high or even higher than in countries with greater numbers of unbanked. In the late 1990s, a government report vividly highlighted these consequences, and financial inclusion became a policy priority across numerous departments—reflecting its strong links to social inclusion.

Over the following decade, a Financial Inclusion Taskforce was established that provided a wealth of evidence and input to shape policy and engage the financial and third sectors in understanding and responding to the issues. In particular, the Taskforce was responsible for monitoring and driving progress towards a goal agreed by government and the banks: to halve the numbers of unbanked adults in the UK. A new model for basic bank accounts was introduced, and all the leading commercial banks offered accounts along these lines; welfare benefits were increasingly paid directly into accounts; access to credit was increased through initiatives such as a Growth Fund for non-profit lenders; and considerable emphasis was placed on financial education and consumer protection.

By 2008/09, the number of adults in the UK living in households without a transactional bank account had fallen by nearly 60 percent compared to the 2002/03 to baseline. Further work continues, however, to ensure that those new to banking are equipped to use these accounts effectively, and to develop new models of banking such as e-money.

Principles in practice

The UK's work around financial inclusion in the last decade particularly demonstrates the following principles:

- **Leadership**, cooperation and knowledge – the creation of a dedicated Financial Inclusion Taskforce helped support the development of a national strategy, based on solid evidence and the engagement of a wide range of stakeholders.

- **Diversity and innovation** – despite the broad range of products and services available within the UK financial marketplace, there was a willingness to develop more innovative ways to reach the unbanked, including the introduction of a new basic bank account.
- **Empowerment** – the UK’s strategy involved complementing initiatives to increase the supply of financial services to the poor and the vulnerable with effective demand-side strategies focused on consumer empowerment, financial education, and a comprehensive framework for consumer protection.

Country context: an advanced nation with the most vulnerable at risk of exclusion

The case of the United Kingdom demonstrates that financial inclusion should not cease to be a significant policy concern in developed countries, despite the much greater numbers with ready access to a diverse range of financial services. As the proportion of those without access to a transactional bank account or other basic financial products declines, those who remain largely outside of the formal financial system—whether through lack access to some or all formal financial products or through mistrust of financial institutions—face ever greater costs as a consequence of their exclusion. Research findings in the UK show that without a bank account, the financially excluded may:

- Face higher costs to cash a check or to pay bills;
- Face additional barriers to employment;

- Be unable to replace household necessities in the event of burglary or flooding, due to a lack of savings or insurance;
- Pay a high cost for credit, in some cases including facing the added risks of intimidation and violence when forced to borrow from illegal loan sharks.¹

These costs are often borne by the most vulnerable in society. A range of studies in the UK has identified general characteristics of the financially excluded as disproportionately likely to be living on a low income; in receipt of state welfare payments; living in socially rented accommodation; and living in single-headed households (including lone parents).² Financial exclusion is often concentrated geographically in urban areas characterized by high levels of social deprivation (although rural exclusion as a consequence of isolation cannot be ignored).

The UK experience has also highlighted that financial inclusion or exclusion is not a fixed state. There are many consumers who may have a simple bank

¹ Financial inclusion evidence review: the costs of credit exclusion and the benefits of access to affordable credit; Financial inclusion evidence review: the costs of banking exclusion and the benefits of access to bank accounts; Financial inclusion evidence review: the costs of financial distress and the benefits of access to debt advice (Claire Whyley for the Financial Inclusion Taskforce, 2010).

² See In or Out?: Financial Exclusion: A Literature and Research Review (Financial Services Authority, 2000), Promoting Financial Inclusion (HM Treasury, 2004).

account but still operate largely in cash; there are others who drop out of the formal financial system owing to negative experiences such as incurring bank penalty charges. The case of the UK suggests that a broad and diversified financial sector is not in itself a sufficient condition for financial inclusion; policymakers must also give due consideration to the specific product and service needs of different population segments, and particularly those on low incomes.

Due to the concentration of exclusion among those out of work or on low incomes, the promotion of financial inclusion in the UK is seen as both a question of social justice and economic efficiency, and therefore an important element of government community engagement and welfare to work programs.

As a result, the United Kingdom has developed and maintained a strategy for the promotion of financial inclusion at the national level over the last decade, and in 2005 established an independent Financial Inclusion Taskforce to monitor and evaluate financial inclusion initiatives, build the knowledge base on financial exclusion, and advise on the direction of policy. Among the responsibilities of the Taskforce, which concluded its work in March 2011, were to monitor progress toward a goal shared by government and the banking sector of halving the numbers of unbanked, and assess the effectiveness of initiatives funded by a Financial Inclusion Fund.

The UK government has since committed to furthering progress to address financial exclusion by embedding financial inclusion programs in government department activities, prioritizing the issues of financial education, and establishing a new framework for financial consumer protection in the wake of the financial crisis of 2008. Despite these achievements, a number of challenges remain to enable all those on low incomes to meet their financial needs, discussed below.

Leadership, cooperation, and knowledge: developing a national strategy and the Financial Inclusion Taskforce

Financial inclusion began to be considered a distinct policy area within government with the publication, in 1999, of the Social Exclusion Unit's "Access to Financial Services" report. The report made a series of recommendations, including the introduction of basic (no frills) bank accounts, supporting the work of credit unions, increasing the availability

The UK established a dedicated Financial Inclusion Fund focused on expanding the provision of affordable credit by non-profit community lenders such as credit unions, and increasing the availability of face-to-face debt advice services.

of insurance-with-rent schemes,³ and improving access to financial services in disadvantaged neighborhoods.⁴ Following the introduction of a number of these measures, including each of the major banks developing a basic bank account product that can be accessed at local post offices, in 2004, the Government announced, in Promoting Financial Inclusion, a shared goal committed to by government and the banks to halve the number of adults living in households without a bank account. It established a dedicated Financial Inclusion Fund focused on expanding the provision of affordable credit by non-profit community lenders such as credit unions, and increasing the availability of face-to-face debt advice services. It also launched a Financial Inclusion Taskforce to evaluate the impact of these initiatives and advise on the future development of a national financial inclusion strategy.⁵

The key goals of UK governments for financial inclusion have been based around assessment of the financial needs of those on low incomes, and were set out to ensure that everyone has access to appropriate financial services, enabling them to:

³ Home contents insurance for tenants in social housing, with premiums paid together with rental

⁴ Access to Financial Services: Report of PAT14 (HM Treasury, 1999)

⁵ Promoting Financial Inclusion (HM Treasury, 2004)

- Manage their money on a day-to-day basis, effectively, securely and confidently, by ensuring access to, and effective use of, basic banking services;
- Plan for the future and cope with financial pressure by having the opportunity to save, take out insurance, and access affordable credit;
- Deal effectively with financial distress, through access to face-to-face debt advice, and by tackling illegal lending.⁶
- Gathering further evidence on the usage of basic bank accounts, monitoring developments in the way banking services are delivered, and working with government and the Payments Council to assess the potential impacts of new payment services on the opportunities and threats for financial inclusion;
- Monitoring and influencing the design of government-funded initiatives such as the Growth Fund for third sector lenders, financial inclusion champions initiative, debt advice projects, and pilots to crack down on illegal moneylenders;

The resulting financial inclusion strategy and current Government priorities in the UK demonstrate that enhanced access to the financial system needs to be complemented by sustained efforts to support effective usage and awareness of products, to tackle over-indebtedness, to have a clear strategy for increasing financial capability, and to provide a comprehensive framework for financial consumer protection. These are much broader issues that are faced by a wider range of the population, and are a vital complement to initiatives to increase the supply of financial services as part of a holistic financial inclusion strategy. However, it is also important within each of these initiatives to have a specific demand-side strategy for those on low incomes, focused on targeted engagement through locally-based intermediaries such as local government, housing associations, charities, and others.

Delivering such a holistic strategy has also required concerted leadership from government and cooperation of government departments, industry, the non-profit (third) sector, and other partners such as local government and housing associations. The Financial Inclusion Taskforce, which operated between 2005 and 2011, served as a forum to bring together expertise in the field from a wide range of sectors, engage the formal financial sector and non-profit providers of financial services, and provide a strategic direction and evidence base to inform the development of policy. The Taskforce was an independent body with members acting in a voluntary capacity. Members were drawn from industry, the third sector, consumer advocacy, local government, and education.⁷ The broad base of the membership proved to be critical in giving the Taskforce legitimacy, and it was supplemented by smaller subgroups that met more frequently and moved detailed work forward in particular areas, such as increasing the supply of affordable credit and debt advice.

The terms of reference of the Financial Inclusion Taskforce included:

- Evaluating whether the goal of halving the number of adults in households without a bank account had been achieved;
- Considering ways to increase appropriate access to insurance and savings products for those on low incomes, working with industry and other stakeholders to develop products that met the preferences of those on low incomes and could be delivered through trusted and accessible outlets such as social landlords, supermarkets, and post offices;
- Advising the government more widely on its financial inclusion strategy and opportunities to extend access to products and services for low-income and vulnerable groups.⁸

The Taskforce was not a decision-making body; the Government continued to take ownership of the national strategy and associated spending decisions. However, with the authority bestowed on it by government, the Taskforce is credited with taking on a significant advocacy role, driving the agenda forward, engaging with the financial sector, and ensuring an ongoing and sophisticated national level debate on financial inclusion in the period of its operation.

The success of the Taskforce has been attributed to:

- Its clear influence and credibility with government, the financial sector, and other stakeholders as an authoritative voice on financial inclusion;
- The broad membership, which brought together financial institutions with consumer advocates, academic researchers, the credit union, debt advice sectors, and others;
- Clear terms of reference and the focus on monitoring specific, clearly understood objectives such as the shared goal for access to banking;
- Secure funding, and in particular a budget for research, to compile comprehensive evidence on the nature of financial exclusion in the UK;
- A model of feeding into government policy development at regular intervals rather than compiling a comprehensive report of issues for presentation after a number of years.

⁶ Financial inclusion: The way forward (HM Treasury, 2007)

⁷ http://webarchive.nationalarchives.gov.uk/20100104214853/http://hm-treasury.gov.uk/fit_members.htm

⁸ http://webarchive.nationalarchives.gov.uk/20100104214853/http://hm-treasury.gov.uk/fit_terms.htm

One of the Financial Inclusion Taskforce's key responsibilities was to monitor the shared goal agreed by the Government and the banking industry in 2004 of halving the number of people in households without access to any kind of bank account. A primary focus of financial inclusion policy in the UK has been to encourage the uptake of basic banking services by the poorest households. Ensuring access to a basic transactional bank account has been seen as an important first step into financial inclusion, due to the role of the bank account as a secure vehicle for accessing cash, the potential savings in making payments electronically, and its role as a gateway to other appropriate financial products and services.

In the period for which data are available, the number of adults in the UK living in households without a transactional bank account fell by nearly 60 percent from 3.57m in 2002/03 to 1.54m in 2008/09. Two factors are widely perceived as critical in driving this process:

1. In 2000, the Government changed the way it made government-to-person (G2P) payments. Now, virtually all welfare benefits are paid electronically into either bank or post office accounts (the latter allow electronic payments in and withdrawals at the post office or at ATMs, but have no wider electronic functionality (such as the ability to make bill payments) and therefore do not constitute bank accounts in official data).
2. The commitment of the banks to meeting the shared goal has resulted in the wider availability of basic bank accounts—as assessed by the Banking Codes Standard Board (BCSB), a body charged with conducting 'mystery shopping' exercises to assess the ease of availability of basic accounts in each of the banks using a traffic light system.⁹

In October 2009, the Government and the Financial Inclusion Taskforce announced that the shared goal had been met.¹⁰ However, the Taskforce has cautioned that there are some important qualifications to this story of progress. First, access to a bank account itself does not constitute financial inclusion unless the account is used to manage money effectively on a day-to-day basis; poor usage of a bank account can in fact increase financial difficulties if substantial penalty charges are incurred (this group are sometimes referred to as "the underbanked"). Second, some groups such as undischarged bankrupts continue to be prohibited by most of the major banks from opening even basic accounts. Third, those still without a bank

account are likely to be the most vulnerable in society—for example those with physical or mental disability or with chaotic lifestyles—and therefore require particular attention to meet their needs.

The Taskforce concluded its work on access to banking by highlighting the potential of new technology, such as e-money services, to engage those who continue to be excluded, and by calling on the Government to engage with banks, e-money service providers, bill payment organizations, retailers and the Post Office to pursue new ways to tackle financial exclusion and to improve the opportunities for low-income households to make the most of their money.¹¹

The UK is widely acknowledged to have developed a comprehensive evidence base on financial inclusion. The Taskforce, with a significant research budget, was asked to identify and address gaps in the evidence base, and subsequently managed a substantial program of research. This has been critical in ensuring a sophisticated policy debate and appropriately influencing policy.

One aspect of the program focused on diagnosing the nature of the problem of financial exclusion in the UK, both through examining supply-side and demand-side factors.¹² The Taskforce also mapped the availability of financial services across the UK,¹³ and evaluated government spending on financial inclusion to determine the projects' impact and value for money.¹⁴ Finally, the Taskforce published research to explore the potential for product innovation that better meets consumer needs – including through harnessing the impact of new technology.¹⁵

Following the work of the Taskforce, a NGO called Transact was established as the national forum for financial inclusion in the UK. It intends to play a role in developing and delivering a research hub and facilitating improved coordination between researchers, funders and other stakeholders.¹⁶ A number of charitable foundations in the UK also play an important role as sources of funding for research to improve the financial inclusion knowledge base.

One key focus area in the research commissioned by the Taskforce was mapping financial exclusion. This research made use of datasets and research information relating to individuals' financial behavior to identify and map levels of demand for, and supply of, a range of financial services across Great Britain (such as availability of affordable credit, from third

⁹ http://www.hm-treasury.gov.uk/d/mystery_shopping_basic_bank_accounts_2010.pdf

¹⁰ http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/press_95_09.htm

¹¹ Banking services and poorer households, Financial Inclusion Taskforce (December 2010)

¹² http://www.hm-treasury.gov.uk/fin_consumer_fininclusion_taskforce_research.htm

¹⁴ http://www.hm-treasury.gov.uk/d/fitf_research_programme_2005_2011.pdf

¹⁵ A new approach to banking: extending the use of jam-jar accounts in the UK (Social Finance for the Financial Inclusion Taskforce, 2011), http://www.hm-treasury.gov.uk/d/social_finance_jamjar_acc_report_042011.pdf

¹⁶ <http://www.transact.org.uk/>

sector lenders within a local area). This analysis and mapping helped to identify concentrations of exclusion and select priority areas on which to focus targeted initiatives such as the Growth Fund and the Financial Inclusion Champions initiative.¹⁷

Diversity and innovation: supporting new delivery channels in the not-for-profit sector

There is significant demand in the UK, particularly by those out of work or in low-paid work, for small-sum credit (loans of less than 500 GBP). This demand is not met by mainstream banks due to the high interest rates required to break even, and the high administrative costs for each loan. Many consumers requiring this type of credit also prefer a face-to-face service and cash repayments to relying on automatic payments from a bank account. Consequently, they typically turn to providers of home credit (with repayments collected by agents weekly at the doorstep), pawnbrokers, or other sources. Such sources can be costly due to the high costs associated with making these loans (a Competition Commission investigation also found some evidence of excess profits in the sector),¹⁸ and often do not allow for data collection on repayment by credit reference agencies, and thereby preventing these consumers from building a credit history to facilitate wider financial inclusion.

One alternative way to fill this gap and extend financial inclusion in the UK has been through third sector lenders—credit unions and community development finance institutions (CDFIs)—which have shown the potential to meet the credit needs of low-income consumers at an affordable cost, and can serve as a bridge to other forms of inclusion such as banking and savings. The challenge has been to grow these relatively small community-based lenders to a scale at which all consumers have this option, and increase awareness of such lenders among communities often tied to using forms of high cost credit. What’s more, there was a need to modernize the regulatory framework for credit unions, which must operate within the restrictions of a “common bond” and are also capped in the rates of interest that can be charged.

The Growth Fund, managed through the Department for Work and Pensions (DWP), with ring-fenced funding from the Financial Inclusion Fund, has since 2006 provided a combination of lending capital and revenue support to about 150 third sector lenders serving about 400 towns, cities, and rural areas

across Great Britain—identified as key locations through the mapping research described above.

This level of service to financially excluded communities did not exist prior to the Growth Fund’s inception,¹⁹ and the latest data show that:

- From July 2006 to the end of September 2010, some 317,798 Growth Fund loans were made in deprived communities with a total value of over GB£137 million;
- An average of 30 percent of all successful loan applicants to these lenders reported having a recent record of borrowing from a high cost lender and 98 percent had borrowed from a high cost lender at some point in their lives;
- 79 percent of Growth Fund borrowers were in the lowest two income quintiles, with 20 percent lacking a current or basic bank account—suggesting that the Fund was successfully targeted toward meeting the needs of the most vulnerable groups;
- The Growth Fund also served a completely new market: only 4 percent of applicants were either a credit union member or CDFI customer at the time of their Growth Fund loan application.

A key objective of the Growth Fund has been to challenge a widespread dependency among low-income groups on credit from relatively costly sources such as home credit (where repayments are made weekly to an agent at the doorstep), pawnbrokers, or cash converters. Almost all users of the Growth Fund service had previous contact with these forms of non-bank and high-cost credit.

A further priority objective was not only to extend affordable credit to low-income communities but to also serve the objective of greater financial inclusion. Third sector lenders seem to be a gateway to more holistic financial services provision, and evidence shows that many borrowers subsequently opened bank accounts and savings accounts: a tactic known as ‘soft compulsion’ at the point of lending proved effective in encouraging saving among low-income borrowers.

There is evidence of increased levels of financial education accompanying the project. Thirty-nine percent said they felt their money management skills were better since they started using a Growth Fund lender, and similar proportions said they felt more in control of their finances (41 percent), more financially secure (39 percent), less worried about money generally (37 percent), and also reported more general (non-financial) well-being, and feeling more

¹⁷ Mapping the supply of, and demand for, a wider range of financial services providers, Experian for the Financial Inclusion Taskforce (2009), http://www.hm-treasury.gov.uk/d/fitf_mapping_financial_services_report.pdf

¹⁸ http://www.competition-commission.org.uk/rep_pub/reports/2006/517homecredit.htm

¹⁹ Data on the Growth Fund are taken from Evaluation of the DWP Growth Fund



included in society.

An enabling regulatory environment was critical to achieving growth in this sector. To facilitate participation of credit unions in the Growth Fund, in 2006 the Government amended regulations to increase the rate of interest that could be charged by credit unions on loans, from a 1 percent per month ceiling to 2 percent per month (26.7 percent APR). This has been key to enabling such lenders to expand their lending to groups that may previously have been considered too high risk, and to offer loans without a requirement to first build up savings (a traditional requirement in the credit union sector).

The impact assessment of the Growth Fund suggests that it has successfully reduced the total interest paid by borrowers on their lending, both by reducing the interest rate paid and by shortening the period over which borrowers repaid their debts. Based on the 317,798 loans made to the end of September 2010, total interest savings to financially excluded individuals in deprived communities are estimated at between GB£119.1m and GB£135.1m.

There is also evidence to suggest that the approach used in managing the Fund, with specified contractual targets, has driven changes in lending approaches. The Taskforce concluded that in six years of delivery, the project had:

- Significantly improved understanding of how to

deliver small-sum credit effectively to borrowers perceived as high risk, and;

- Successfully delivered credit to its target market, bringing them savings in the overall cost of credit and wider improvements in their financial position.

Importantly, robust contractual management was perceived to have driven up professional standards in the sector, helping institutions to advance on the path to sustainability. Lenders were required to make detailed management information reports, and DWP retained the ability to redistribute funding between contractors.

The challenge that remains is to find a pathway for the sector toward sustainability, so that such lending activity can be maintained without the need for continued subsidy from government. In 2007, a Working Group of the Financial Inclusion Taskforce published a report setting out a potential pathway to sustainability and recommended roles for Government (through its Growth Fund and ensuring enabling regulation), the banking sector (through financial and in-kind support), and lenders (through a drive toward greater professionalism), together with other key partners such as local authorities and social landlords.²⁰ The evaluation of the Growth Fund however suggests that significantly higher interest rates than the 26.8 percent charged by most Growth Fund lenders may be needed to achieve this, and there is some evidence of greater acceptance of this, particularly if the provider is not-for-profit. Thus an interesting dilemma arises regarding the extent to which government funding can continue to subsidize such innovative delivery practices, and the time period in which the sector might reach sustainability and be able to compete freely in the marketplace for small sum credit in the UK.

In a further effort to encourage sustainability in the sector, the Government has followed the Growth Fund with a modernization and expansion fund, through which a further GB£73 million will be available to lenders. However, to be eligible, lenders must demonstrate how they will use the funding to reduce their need for ongoing government subsidy in the future. The stated intentions of the fund are to make financial services available to one million consumers on low incomes and to make credit unions sustainable within five years, including through upgrading IT platforms and driving cultural change.²¹

Although the focus of the UK's drive towards financial inclusion began with the issue of access to the traditional transactional bank account, recent years have seen great interest in harnessing new technology to both reach those who remain unbanked, and enhance the customer experience

²⁰ <http://www.ecosocdoc.be/static/module/bibliographyDocument/document/001/347.pdf>

²¹ <http://www.dwp.gov.uk/other-specialists/the-growth-fund/latest-news/>

for those who struggle and fall into difficulties with traditional banking products. A new Electronic Money Directive was adopted by the European Parliament and Council in September 2009, and transposed into UK law in April 2011. The GSM Association (GSMA) which represents the interests of mobile operators worldwide, has welcomed the UK's proportionate implementation of the Regulation as a model that many developing countries could follow. In particular, the GSMA highlighted the UK's balance limit of €150 on e-money accounts, its decision to relax customer identification procedures on accounts with annual turnover of less than €2,500, and its setting of an initial and ongoing capital requirement for small e-money institutions that is sufficiently low to enable non-bank providers to enter the market.²²

Many commentators now expect considerable growth in areas such as mobile banking, including accounts that are not connected to a conventional bank account, in the coming years to enable bill payments, person-to-person payments, and the mobile device as an electronic wallet. Given the findings of the Taskforce that many newly banked struggle with conventional bank accounts due to the penalty charging structure, such products are likely to be attractive, particularly for the young. The UK is also experiencing significant growth in prepaid cards. There is potential for such products to meet the needs of low-income households, though consumer groups have raised concerns about charges and price transparency.²³

Empowerment and protection: tackling the demand side of financial exclusion

One of the key additions to the Government's strategy for financial inclusion, has been that efforts to increase the supply of appropriate products must now be complemented by efforts on the demand side to increase awareness among consumers of the financial products and services available to them. This reflects the findings of the Taskforce, who advised the Government that a balanced financial inclusion strategy needs to focus on the demand as well as the supply side of the policy equation. Many financially excluded people do not come into regular contact with government or the financial services industry, and may not have the confidence to choose appropriately from the range of options in the marketplace.²⁴

The Government ran a one-year campaign to increase

The key value added by the Champions was that they created and deepened the quality of local networks of stakeholders.

awareness among the hardest to reach groups, working through trusted intermediary groups such as housing associations, charities, and community groups. The campaign was succeeded by a project to recruit teams of dedicated financial inclusion Champions, working either in a local area identified by the mapping research as a likely concentration of financial exclusion (17 teams), or focusing on particular cross-cutting themes at a national level such as housing, banking, and a rural area focus. The Champions aimed to stimulate the demand for and, where possible and desirable, increase the supply of basic services for the financially excluded through the work of local delivery partnerships. Champions' activities fell into three main types; developing strategies, building capacity, and supporting providers' operations. Evaluation of the Champions initiative concluded that the initiative had been successful in terms of:

- Expanding and improving local financial inclusion networks;
- Providing valued resources to agencies working in this field;
- Influencing the development of services that reach a significant proportion of the financially excluded population and that can make a difference in the lives of service users;
- Representing value for money.²⁵

The key value added by the Champions was that they

²² <http://mmublog.org/blog/e-money-regulation-that-is-enabling-news-from-the-uk/>

²³ <http://news.bbc.co.uk/2/hi/8475335.stm>

²⁴ Financial Inclusion: An action plan for 2008-11, HM Treasury, p.13

²⁵ www.hm-treasury.gov.uk/d/fitf_research_champions_initiative_2011_report.pdf, p.12

created and deepened the quality of local networks of stakeholders. Independent evaluation of the initiative estimates that the number of people using services influenced by the Champions is equal to at least one in four of the population of financially excluded individuals in the target areas. A social network analysis (SNA) completed found that in the financial inclusion networks evaluated, over 25 percent of contacts between organizations had been made as a result of the Champions' work, while in over 40 percent of existing relationships the quality of relationships improved as a result of the Champions work.²⁶ The challenge now will be to determine if these new financial inclusion networks and partnerships at the grassroots level can be sustained following the formal end of the Champions program in March 2011.

The UK government has committed to a number of measures to enhance consumer financial protection through a combination of education, choice and disclosure. This agenda extends far wider than the issue of extending access to financial services to the most vulnerable; instead, its focus is to encourage all consumers to take responsibility for their finances and choose the right financial services for their needs.

The measures taken include:

- Reforms to the regulatory framework for financial services to include the establishment of a new Financial Conduct Authority (FCA);
- Consideration of launching a new range of simple financial products—to be developed by industry working with consumer groups—to help consumers easily understand and compare products;
- Assessment of how to improve existing savings products such as ISAs, in response to an Office of Fair Trading (OFT) report;
- Establishment of a National Money Advice Service, funded by a levy on the financial services industry, which has a remit to improve consumers' understanding and ability to manage their own financial affairs. From April 2012, the service's remit will expand to include the coordination of debt advice.

The FCA is tasked with ensuring confidence in financial services and markets, and will ensure that the interests of consumers and participants in financial markets will be placed at the heart of the financial regulatory system. This is a core component of the government's shake up of financial services regulation in the wake of the financial crisis. The new framework is intended to be in place before the end of 2012.

Moving forward: challenges and opportunities

A number of key challenges remain for the UK financial inclusion agenda:

- First, there is the challenge of sustaining leadership of the agenda at the national level following the cessation of the Taskforce. Continued government leadership will be central to this, and other institutions will also have an important role in ensuring that dialogue continues around the key issues.
- In terms of access to banking and basic bill payment facilities, the focus is likely to switch from a question of access to one of usage. Although very significant progress has been achieved in the UK on the issue of extending access, evidence suggests that the experiences of those new to banking have been mixed, with some having been hit by hefty penalty charges. This suggests strongly that extending access to formal banking products must be accompanied by appropriate education on how best to use such products to budget appropriately and avoid significant charges. It also remains to be seen how far new technology, particularly e-money products such as mobile payments and pre-paid cards, can extend a range of financial services to new groups. Current findings indicate that the ability to use mobiles to store and send money, as well as make bill payments, would be extremely popular among those under 35 relative to conventional bank account products.
- Finally, in respect to third sector lenders, it is clear that the sector has yet to reach the position where it can fully cover the costs of this innovative form of lending without continuing government subsidy. It remains to be seen whether the level of this subsidy will reduce over time so that the sector can serve such communities in a cost-effective way. Regardless, there remains a dilemma about how best to support the most vulnerable households for whom borrowing may not be appropriate.

Nevertheless, the UK experience shows the importance of committed government leadership, establishing platforms for coordination, dialogue and advocacy at the national level, to helping increase financial inclusion, and equally the value of a thorough evidence base to inform policy approaches. The model of establishing a broad-based Taskforce with a clear mandate to develop evidence and inform the direction of policy is credited with bringing

²⁶ p.8



stakeholders together and ensuring a sophisticated dialogue around the complex elements of financial exclusion, and potential policy solutions. It has also proved invaluable to balance overall strategy between supply and demand side elements, which has led to more fruitful engagement with the financial sector. Other countries – whether developed or developing – may learn from these elements. Likewise, the UK can learn from others’ experiences of harnessing technology for product innovation that meets the needs of those on low incomes, and of developing not-for-profit providers of financial services so that they operate sustainably on a large scale, to go to the next level and achieve universal financial inclusion.

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MOVING FORWARD

The current economic and financial environment reinforces the need to accelerate actions to encourage financial inclusion. Greater financial inclusion is not only essential for enhancing global financial stability but can also boost economic prosperity. And the most effective way to make more rapid progress in the field of financial inclusion is through innovation.

As the case studies in this report demonstrate, there is no single, simple solution to innovation; every country has to chart its own course, taking into account its individual circumstances. Likewise, the G20 Principles for Innovative Financial Inclusion provide not a single solution but a roadmap for moving forward, reflecting the characteristics that are needed to foster greater financial inclusion and that are distilled from concrete country experience. It is how they are brought to life that matters. The 11 case studies in this report provide valuable lessons and insights into the challenges and opportunities of turning these principles into a reality. They represent the beginning not the end of the process. More examples of equally impressive innovations need to be documented, and they need to be widely shared. True innovations are never conceived in a vacuum; they build on their predecessors' successes and failures.

Based on the findings of these initial case studies, the following policy actions are recommended:

Organizing for financial inclusion: Leadership and Cooperation

- *Harness both political and regulatory leadership to promote financial inclusion:* the case studies in this volume show that the most effective approaches to financial inclusion have been backed by leadership at both a political and regulatory level, harnessing ambitious policies and a will to bring about change with full commitment and capacity building from central banks and other regulators of financial services.
- *Treat financial inclusion as a distinct policy area and identify complementarity with other long-term strategies for growth, financial stability and development:* countries are likely to achieve the greatest impact where identifying the cross-cutting impacts and relationship to other strategic objectives, not simply treating financial inclusion as an end in itself.
- *Collaborate across institutions to build financial inclusion strategy:* creating an enabling policy and regulatory environment is a task that, in all of the studies here, has required building of effective partnerships across institutions, with an emphasis on clarifying roles and responsibilities to avoid duplication.

Creating an enabling environment for financial inclusion: Innovation and Diversity

- Seek to create a range of channels for the delivery of financial services: the case studies illustrate that in no case has a single delivery channel (whether through traditional bank branches, agents, or e-money) been able to deliver full financial inclusion; policies are needed that identify the role that a range of different channels can play, with government taking a coordinating role.
- Harness commercial opportunity as a driver of innovation in financial inclusion: these studies show that, from mobile banking in the Philippines to agent banking in Brazil to Sharia-compliant banking products in Indonesia, the most scalable and sustainable solutions to financial exclusion stem from product and service development in the commercial sector. Governments and regulators must therefore engage early and openly with private sector providers to fully understand opportunities and risks of product innovation.

- Identify carefully where and how government intervention in the provision of financial services may be required: nevertheless, due to market failure, commercially viable models alone may not always bring about full financial inclusion. Korea and the UK show that, particularly where financial inclusion initiatives are focused on targeting disadvantaged low-income communities, there is likely to be an important role for the non-profit sector and targeted state subsidy. The key here is developing sustainable solutions with a clear objective and exit strategy for government interventions.

Promoting financial inclusion, integrity, and stability together: Proportionality and Framework

- A tailored regulatory approach is key to extending access: many of the countries documented in this volume have introduced specific KYC and other requirements for small-value transactions. While continuing to be in line with the requirements of the global standard setting bodies, these modifications have been shown to have a very significant impact in extending access.
- Prompt action and continual review of financial regulation are required to ensure an enabling environment for financial inclusion: a number of the studies highlight the risks of regulation falling behind product innovation, particularly in the area of e-money. This runs a high-risk of inadequate protection for consumers.
- Regulators need to focus on internal capacity building to ensure sufficient staffing and expertise to keep pace with product and service delivery innovations.

Safeguarding consumers: Empowerment and Protection

- Integrate demand-side policies within financial inclusion strategy: these studies suggest that those countries that have been most successful to date in promoting financial inclusion have been able to effectively integrate supply-side strategies (boosting access to financial services) with demand-side initiatives (such as financial education projects and consumer protection frameworks).
- Consider consumer protection requirements as a core part of innovation. Consumer protection and enabling regulation in areas such as e-money and agent banking should be considered together, with clear risks present if consumer protection framework does not keep pace with new technology.
- Establish clear objectives in respect of the usage of financial services: these studies show that financial inclusion policy should not be focused solely on boosting access to financial services, but must also look carefully at whether the services in place are effective in empowering consumers. This is true from developing countries—where consumers may be reluctant to switch from cash to new technology—to developed countries, where over-indebtedness from inappropriate usage of financial services has become a significant policy concern.

Learning for financial inclusion: Knowledge

- This volume highlights that Knowledge has in many cases been the most difficult of the principles to implement since it requires clarity of goals and leadership to collect better information and data over a sustained period of time.

- The cases of Mexico and the UK documented here highlight the importance of building a clear evidence base on which to base financial inclusion policies. These examples show that a comprehensive and focused effort on researching the nature of a country's financial inclusion challenges can enable a more sophisticated level of dialogue, and the establishment of clear messages for government, the private sector, and other partners with a stake in promoting financial inclusion.
- Countries should also give emphasis to designing strategies to accelerate the dissemination and sharing of knowledge about technological innovations and new business models and the associated opportunities and risks in the financial inclusion arena.

To ensure that all countries learn from each other so that they can innovate in line with the policy recommendations above, it is intended to undertake the following peer learning, knowledge-sharing, and knowledge-development initiatives:

- Update the 11 case studies as the innovations documented in this report continue to progress;
- Collect further evidence of innovations in financial inclusion and disseminate these insights via the GPFi website and other forums and networks;
- Support financial inclusion capacity building in regulatory agencies and policymaking bodies through knowledge exchanges;
- Organize cross-border exchanges of experiences regarding the process of transforming general policy principles into a framework for financial inclusion, including peer reviews among countries;
- Design communication strategies to accelerate the dissemination of knowledge about technological innovations in the financial inclusion arena;
- Explore options to scale up ongoing initiatives on consumer protection and financial education;
- Disseminate experiences of creating and implementing proportionate and enabling policy and regulations that balance risks and rewards;
- Share the challenges of different countries' data collection initiatives, developing a framework to link financial inclusion measurement with setting clear financial inclusion objectives and targets.



GPI

Global Partnership
for Financial Inclusion

Global Partnership for Financial Inclusion

www.gpfi.org

The Global Partnership for Financial Inclusion (GPI) is the main platform for implementation of the G20 Financial Inclusion Action Plan. The group engages partners from G20 and non-G20 countries, private sector, civil society, and others. It is chaired by the G20 troika countries, currently Korea, France, and Mexico. The GPI is supported by three implementing partners: the Alliance for Financial Inclusion (AFI), the Consultative Group to Assist the Poor (CGAP), and the International Finance Corporation (IFC).



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