ATIUR RAHMAN

THE MUTUALLY-SUPPORTIVE RELATIONSHIP BETWEEN FINANCIAL INCLUSION AND FINANCIAL STABILITY

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Bangladesh Bank

FOREWORD

For some years now Bangladesh Bank has engaged the country's financial sector in a social responsibility driven campaign of financial inclusion, in support of the government's strategy of speeding up socioeconomic growth and development by harnessing the creative energies of the entire population with inclusive policies for social and financial empowerment of the weaker, less advanced population segments. In the real economy, the financial inclusion drives extending financing support to productive farm and non-farm micro and small scale enterprises are generating incremental output on the supply side and at the same time generating incremental demand with increased employment and income, maintaining balance. In the financial economy, banks and financial institutions in their inclusion initiatives are building up portfolios of numerous diverse small sized loans that won't go bad all at the same time; unlike large loans to small number of big borrowers whose difficulties can put the lender's solvency in sudden trouble. Also, the numerous small deposits they amass from the new clients in their inclusion initiatives are much more stable funding bases than large deposits from small number of big corporates etc., abrupt withdraw of which can put the deposit taker in liquidity difficulties. The financial inclusion campaign is thus enhancing stability side by side with augmenting inclusive growth; well evidenced in Bangladesh's socioeconomic growth with macroeconomic and financial stability during the global financial crisis and the subsequent ongoing global growth slowdown.

BB Governor Dr. Atiur Rahman's article in this booklet lucidly explains the financial inclusion-stability linkage, and the way our ongoing financial inclusion campaign is utilizing this in promoting inclusive growth. The booklet is intended to broaden understanding of the financial inclusion-stability linkage among students of development issues as well as general readers.

THE MUTUALLY-SUPPORTIVE RELATIONSHIP BETWEEN FINANCIAL INCLUSION AND FINANCIAL STABILITY*

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August 9, 2007 is a day that will forever be remembered as the beginning of the great global financial and economic crisis of the new millennium. On that day, BNP Paribas SA, at the time France's largest bank, stopped redemptions from three investment funds it managed because it could no longer value the holdings of mortgage-related securities that constituted about a third of the funds' total investments. Although it wasn't the first such action by a major fund manager, the announcement by BNP Paribas was laced with unusual candor about the condition of the securitized mortgage market in the United States.

That day started just as any ordinary day in the global economy. But now, nearly six years into a seemingly endless period of financial and economic instability, as the world appears to lurch from one crisis situation to another, we are realizing its full impact. Millions of jobs lost, trillions of dollars worth of asset values wiped out, dreams of financial security shattered for countless families - the global financial and economic crisis has truly been a setback in the march of the world community toward a better life for all.

But not for all have the recent years spelled doom and disaster. All the time, while big banks have reached for lifelines to their governments and corporate clients, big and small, have faced obstacles in raising funds, a quiet revolution has continued apace in many countries. That revolution, the revolution of financial inclusion, has persevered, in the midst of financial turmoil in bringing formal financial services to thousands upon thousands of households and small entrepreneurs who previously never had a relationship

*First published in 'The Financial Express' titled "Financial inclusion and financial stability complement each other" on Sunday, 21 April 2013.

with a financial institution. And a great many of the "newly-banked" are women, low-income families, rural dwellers, and members of marginalized groups such as religious and ethnic minorities. Doors are opening to a more secure future for the beneficiaries of financial inclusion, most of whom live in the developing world, even as they unfortunately seemed to be closing for millions of families scarred by the financial meltdown in the more advanced economies. Bangladesh, however, has become a role model for financial inclusion particularly for the courageous regulatory moves by its central bank, Bangladesh Bank, for guiding the banks, both private and public, in embracing financial innovative inclusive products even during this challenging time of global financial crisis. 10 taka (12 Cents!) bank accounts for millions of farmers and social safety net beneficiaries, bank-led mobile banking, school banking, small medium enterprise loans including for women entrepreneurs and green banking are only a few of these inclusive financial products.

A question is often asked of financial sector policymakers: why emphasize financial inclusion at a time of global turmoil? Why not concentrate all the attention on dealing with sick banks and insulating the healthy portion of the system from systemic shocks? Can banks and other financial institutions be profitable and build capital while reaching out to these new and inexperienced customers? Isn't financial inclusion a diversion, a luxury, that can be pursued only when times are good? Even one commentator wanted me to make a 'soul search' and refrain from this non-conventional journey of financial inclusion. I, of course, stuck to my guns. Yet, we need to respond to these reservations.

An answer to this question can be given by exploring the linkages between financial inclusion and financial stability. If financial inclusion can be shown to contribute positively to financial stability, then regulatory authorities can pursue both objectives even with scarce supervisory resources. Research on these linkages is only just getting started, but already several important relationships have been identified.

Defining financial inclusion

The G20 association of major world economic powers added its imprimatur to financial inclusion by recognizing it as one of four pillars in the financial sector reform structure of its Global Development Agenda, and given equal standing along with financial integrity, financial consumer protection, and financial stability. In so doing, the G20 defined financial inclusion as:

"…a state in which all working age adults have effective access to credit, savings, payments, and insurance from formal service providers…"

The "newly banked", as the beneficiaries of financial inclusion are often called, have not necessarily been deprived of all financial services. They may have significant, and often negative, experience with informal moneylenders, unofficial exchange houses, and ancient transfer systems such as *hundi* and *hawala*. However, financial inclusion offers them the possibility of dealing with rules-based institutions that are regulated, more transparent in their pricing, less likely to cheat their customers, and often even cheaper to use than the informal service providers.

Direct impact of financial inclusion on financial stability

To understand how financial inclusion can promote financial stability, it is convenient to discuss both direct and indirect impacts. Research on these links is just beginning, but analysts have pointed to the following direct links:

- ***Financial inclusion promotes a more diversified funding base.*** Periods of financial instability are more often related to crises of liquidity than crises of solvency. In turn, liquidity crises arise when financial institutions are unable to retain funds or attract additional funds to meet their payment obligations. Recent liquidity crises have originated in wholesale markets - banks unable to obtain funds from other banks, unable to roll over existing bond market obligations, or unable to keep foreign depositors from repatriating their funds. Apart from some well-publicized cases, usually traced to policy incompetence (such as Northern Rock and the current situation in Cyprus), runs on retail deposits have fortunately been relatively rare.

  Accordingly, in any banking sector, the higher the proportion of funds the sector obtains from retail depositors, the more stable it tends to be. And within the broad category of retail deposits, it is plausible that small deposits are more stable than large deposits. This assertion is certainly true when comparing the reaction of holders of small accounts to holders of large accounts at a given bank when the remuneration offered to the depositors on these accounts lags behind competitors' offerings. Small depositors tend to stay put; large depositors tend to shop around. It is also likely, though not demonstrated through research, that small depositors are less likely to create a run on a bank than large depositors.They are less likely to be exposed to negative media coverage about a bank, and perhaps less likely even to hear rumors about a particular institution. Although small depositors do participate in bank runs once they get going, they very rarely start them.

With financial inclusion, a bank can diversify not only its deposit base, with numerous small accounts comprising a greater proportion of total deposits, but it can even expand the total deposit base to comprise a greater proportion of total attracted funds.

- ***Financial inclusion promotes a more diversified loan base.*** It is just as important for a bank to be diversified on the asset side of its balance sheet as it is on the liability side. If solid underwriting is maintained, it is logical that a loan portfolio consisting of thousands of small loans to households and microentrepreneurs will suffer fewer aggregate loan losses over a given period of time than a portfolio consisting of a few loans to large corporate borrowers. Indeed, before banks began to lower their underwriting standards in the United States in the early 2000s, loans to the household sector did have lower rates of default, and lower losses given default, than loans to the corporate sector.

  From a risk management standpoint, it is also true that loan losses on a portfolio of many relatively homogeneous loans are easier to model, if data are available over a long period of time, than losses on a "lumpy" portfolio of few large corporate loans. And better modeling and prediction of loan losses can lead to better loan pricing, more accurate provisioning, and consequently more stable profits.

- ***Financial inclusion diminishes the appeal of potentially unstable savings channels.*** Admittedly, the formal financial sector has not consistently and uniformly been a safe haven over the last decade. However, in countries with a low penetration of formal financial services, alternative savings channels have sometimes caused disaster for many families. In Albania in the 1990s, for example, in spite of a fairly robust switch from a centrally-planned to a market economy, the formal financial sector was very limited. Households had few reliable savings options. Quickly, financial crooks took advantage of the situation. Fully two-thirds of households faced financial ruin when they invested in one or more "pyramid schemes." When the schemes collapsed, the resulting riots and instability led to the deaths of some 2,000 people, rampant inflation, a 7 percent decline in output in one year, and currency depreciation.

Kenya has also had a long, unfortunate history with pyramid schemes. A recent report listed 271 different schemes that were active in the 2006-2007 period, targeting all segments of society, but having particular appeal to those without a connection to a formal financial institution. Fortunately, the amounts lost were nowhere near as great as in Albania, but they undoubtedly caused financial distress to a large number of households.[1] Bangladesh too has experienced a few tragedies of pyramid schemes mainly due to lack of financial literacy and enhanced greed. Financial inclusion if started earlier could have a void such tragedies to some extent.

- ***A more inclusive financial sector has greater political legitimacy.*** Bankers have never really been loved anywhere, and in the aftermath of the financial crisis there has been even more public anger directed at bankers who, fairly or unfairly, have been judged to be at fault, and, in many cases seem to be escaping punishment and are even seeming to be rewarded by their firms. The main reason for this public anger is that in the minds of the public, banks are run by rich people for the benefit of other rich people.

In the advanced industrialized economies that have been hit hardest by the financial crisis, there are calls for restrictions on bankers' salaries, and calls for the largest financial institutions to be broken up. In some countries, such as Jordan, a negative public attitude has led to higher corporate profits taxes being imposed on banks, compared with other corporations. In other countries, such as Venezuela, banks have even been nationalized. In Greece, banks have been vandalized and their customers harassed. In these and other countries, there is the sense that private banks are somehow illegitimate, creating profits out of thin air. Although some proposals, such as capping salaries or requiring divestiture of risky activities may have legitimate public policy purposes, interventions in banks' affairs that reduce their profitability, force them to invest in assets not of their choosing, or expropriate shareholders surely do not contribute to financial stability.

[1] It should be noted that pyramid schemes do not target only the unbanked. As recently as 2011 and 2012, hundreds of thousands of investors in the United States were bilked by a scheme that ultimately resulted in losses of $600 million. Most of these people also utilized formal financial services but were enticed by the high returns promised.

Financial inclusion, by encouraging a customer base that is more representative of the general population, especially low-income, rural, and minority segments, can go a long way towards legitimizing the financial services industry in the minds of the public and politicians. Banks will be viewed as helping people, not hurting them. And when banks become less and less of a political issue, the risk of destabilizing statements made by prominent individuals, and worse, destabilizing public policies, is reduced.

Indirect impact of financial inclusion on financial stability

In addition to the direct impact of financial inclusion on financial stability, there are several potential indirect effects. (It should be noted that these indirect effects are desirable in themselves, regardless of whether or not there is a strong linkage between these effects and financial stability.)

- ***Financial inclusion promotes financial stability at the household level.*** There is considerable evidence to support the idea that providing formal financial services to the previously unbanked encourages savings. If households have a safe place to save, they will save a higher percentage of their disposable income. These savings can be used to smooth out consumption during periods of lower incomes, or to finance necessary, unexpected consumption (such as medical expenses), reducing the chances that a household will be driven into debt. And lower levels of household debt are positively correlated with overall financial stability.

- ***Financial inclusion promotes greater income equality, thereby fostering financial stability.*** Recent economic research has shown that greater income equality is associated with longer spells of economic growth, interrupted by shorter slowdowns. The precise mechanisms are unclear, but the hypothesis is that concentrations of income and wealth foster the buildup of imbalances, such as asset price bubbles and rapid credit growth, that are associated with subsequent downturns. In turn, longer periods of economic growth foster financial stability, not only by reducing debt-to-income ratios, but also by allowing banks and other financial institutions to build capital. To complete the indirect effect, financial inclusion has been shown to contribute significantly to income equality and poverty reduction.

Increases in income equality, which can be promoted by financial inclusion, are also associated with greater social stability, which can also help promote financial stability. When all segments of society believe that they can more fully participate in, and benefit from, the production and distribution of goods and services, there is a lower likelihood of disruptive social activism, and a stronger resistance to the falsely hopeful messages of demagogues whose primary targets are often banks and other financial institutions.

Feedback effects: financial stability leading to financial inclusion

Although the available literature and analysis has stressed the contribution made by financial inclusion to financial stability, there can also be a useful "feedback effect" from financial stability to financial inclusion. This "virtuous circle" comes about because a more stable formal financial sector will be a more attractive option for the unbanked. It is more attractive not only for the obvious reason that people want to place their wealth in stable institutions, but also because a stable financial sector - one in which financial institutions aren't constantly trying to make up for declining profitability from loan losses and other asset devaluations - can afford to reduce fees for everyday transactions and accounts, bringing financial services into the realm of affordability for many people.

Conclusion and a small word of caution

Certainly, there are many reasons to believe that financial inclusion can support financial stability. In order to play this supporting role, however, it has to be the right kind of financial inclusion. By its very nature, financial inclusion is bringing in people who have no track record in the use of formal financial services. They have no formal credit history, may be unfamiliar with filling out forms, and may lack proper identification. Accordingly, products must be tailored carefully to their needs, at a reasonable cost, and they cannot be "overloaded" with financial services that they do not need or want. In some cases, financial literacy education may be required, so that the tools they are provided can be used properly.

But if these conditions are met, financial inclusion can open up worlds of opportunity for those who were previously excluded, expanding the customer base for a whole range of financial products, and in so doing contribute mightily to a vibrant -- and stable - financial sector.

Bangladesh Bank embarked on financial inclusion from a strategic vantage point to align itself with the national planned strategy of inclusive growth as reflected in both sixth five year plan and also the perspective plan. In the process it has been able to reach millions of unbanked population which has helped Bangladesh economy maintain a six plus growth rate for years. The more diversified deposit and loan bases created through strategic financial inclusion has led to a desirable financial stability in Bangladesh despite prolonged global financial crises. The end results of this strategic option of Bangladesh may not be visible immediately. But all indications are that the on-going financial inclusion drive of BB will certainly lay a solid foundation for an inclusive sustainable growth process for Bangladesh.

Some facts and figures on the latest state financial inclusion in Bangladesh is given at Annexure-A.

Annexure: A

Coverage of Financial Service Access Points for the Population in Bangladesh

Banks	Coverage
1. Population (15+)	**95.6 (mil.)**
(i) Economically active population (15+)	56.7
(ii) Population not in labor force (15+)	38.9
2. Total No. of bank branch outlets (up to June 2013)	**8,427**
3. (i) Total No. of deposit accounts in banks (up to June 2013), Of which:	**61.2 (mil.)**
(ii) No. of no-frills accounts of small holder/tenant farmers and other low income individuals opened with nominal Tk. 10 initial deposits (up to 22nd August 2013)	13.2 (mil.)
(iii) No. of mobile phone banking accounts. (up to July 2013)	7.2 (mil.)
(iv) No. of agent outlets serving mobile phone banking users (up to July 2013)	108 (thousands)
(v) No. of ATM outlets of banks (December 2012)	5,248
MFIs	
1. No. of licensed NGO-MFIs (June 2012)	618
2. No. of branches (June 2012)	17,977
3. No. of clients (June 2012)	24.6 (mil.)
Post Office and Cooperatives	
1. No. of Post Office branches	10,000
2. No. of Post Offices with facility of Electronic Money Transfer (EMT) services	1,150
3. Post Offices with postal cash cards services	31
4. No. of Cooperatives	183 (thousands)

Comments

- It has been observed from the above data that total number of deposit accounts in banks (up to June 2013) stood at 61.2 million which is about 64 percent of the total population of age 15+ and 108 percent of the economically active population.

- Financial inclusion due to opening of no-frill accounts (13.2 mil.) constitutes almost 25 percent of the total economically active population.

- There are around 8.4 thousands bank branches along with about 18 thousands branches of NGO-MFIs, 1.2 thousands post offices and 183 thousands cooperative outlets totaling about 210.6 thousands branches/outlets for 56.6 million economically active population generating at least one financial service point per 270 people.

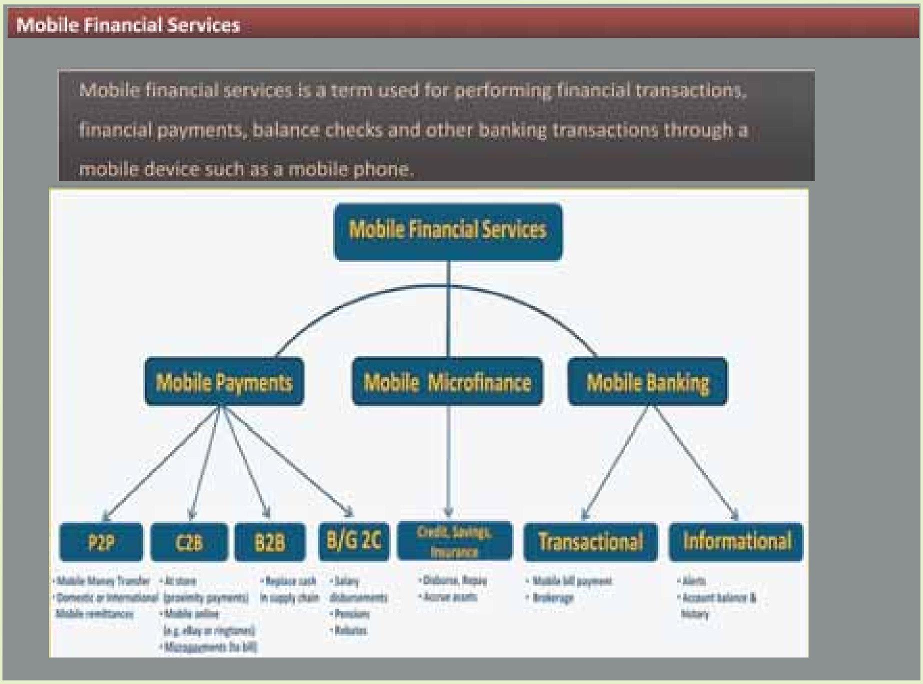
- As of July 2013, there are around 7.2 million mobile banking accounts which are growing at around 10 percent per month during the last few months.

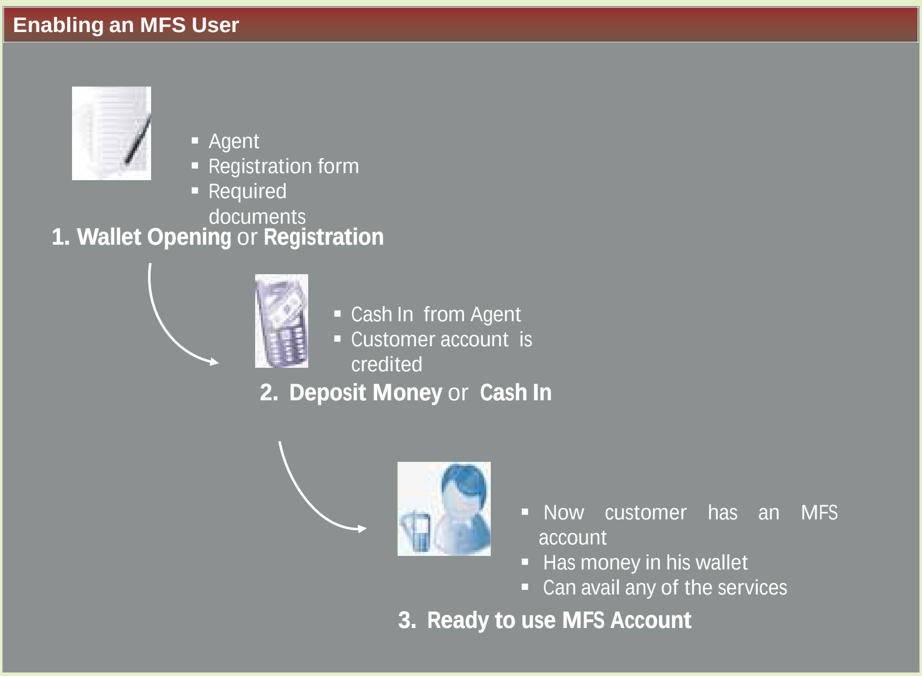
Boxes

Box 1 : **Financial Inclusion and Mobile Financial Services (MFS) in Bangladesh**

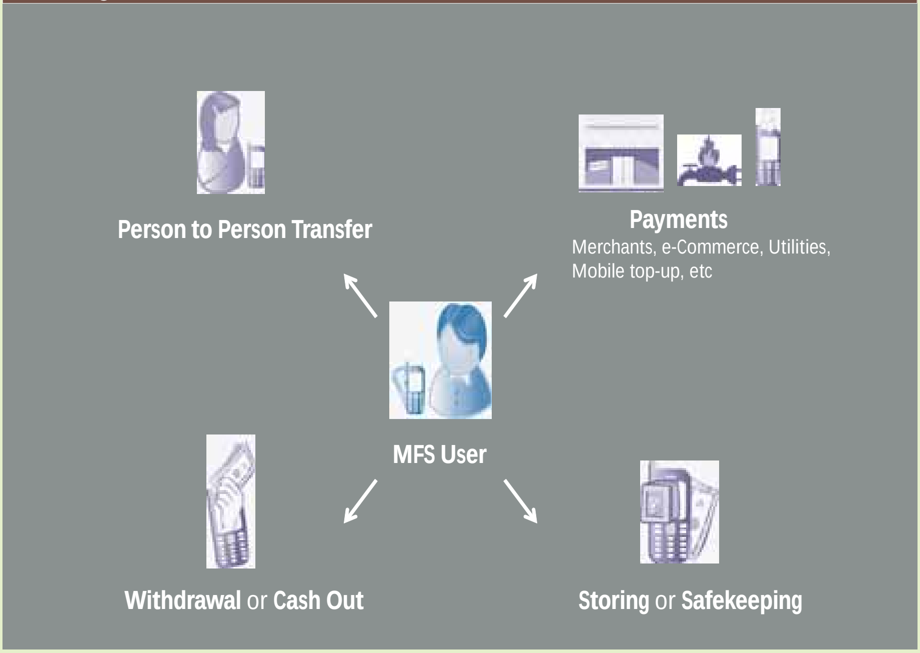
Box 2 : **BB Governor's inclusive financing interventions**

Box 1 : Financial Inclusion and Mobile Financial Services (MFS) in Bangladesh





Enabling an MFS User



Present & upcoming services of MFS

MFS: The ecosystem

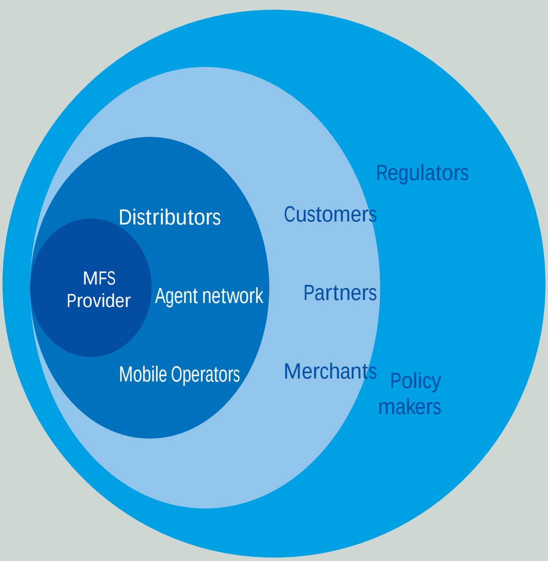
Secure technology
Easy-to-use interface
Compliance

Widespread availability
Visibility
Liquidity management

Awareness
Behavioral change
Multiple usage

Regulatory framework
Broader financial inclusion

MFS: The ecosystem



Current Status

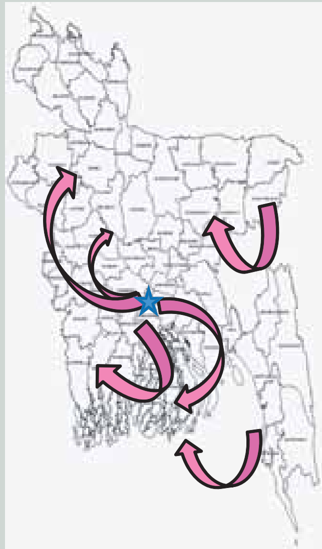
- Key players: bKash, DBBL Mobile Money and M-Cash of IBBL
- 7.2 million registered customers
- 108,000 Agents nationwide
- All mobile phone operators are involved with MFS providers in some capacity

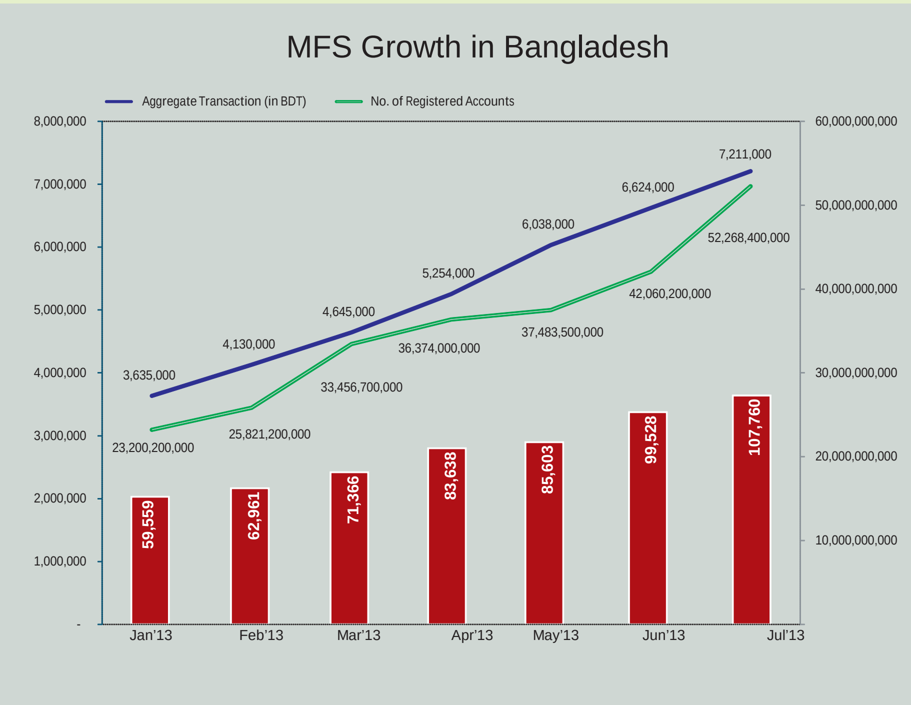
Fund Flows

Top **Cash In** Markets are urban industrial and commercial hubs

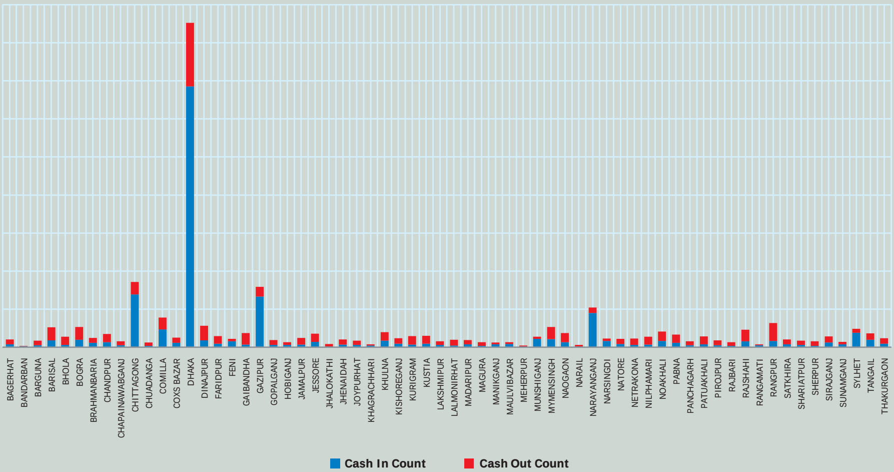
Top **Cash Out** Markets are remote rural areas

Fund Flow is from Urban to Rural markets





Evidence of Financial Inclusion



Urban : Rural customer base = 49 : 51 and Funds are flowing from urban centers to rural regions

Average ticket size per transaction is USD 25

MFS beyond Money Transfers

- Microfinance loan re-payments
- Collections and disbursements
  - Labor intensive sectors
  - Remote outreach
- Government employment generation program and safety network
- Poverty alleviation program in ultra remote areas
- mCommerce through more than 1000 Merchants
- All the little amounts accumulate to provide large capital opportunities at a macro-level to contribute in the country's economy.

A typical beneficiary

Box 2 : BB Governor's inclusive financing interventions

Published by:
F.M.Mokammel Huq, General Manager
Department of Communications and Publications
Bangladesh Bank, Head Office, Dhaka-1000
Website : www.bb.org.bd

Printed by : Srout Advertising

DCP : 09-2013-1000