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Financial Inclusion: The Role of Finthech and Digital Financial Services

by

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FINANCIAL INCLUSION: THE ROLE OF FINTECH AND DIGITAL FINANCIAL SERVICES

Session 3: Services policies and regulation for structural transformation

Presentation Summary

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Financial inclusion is measured in three dimensions: (1) in terms of access to financial services, (2) usage of financial services, and (3) the quality of the financial products provided and the way in which they are delivered. Financial inclusion has become an important international financial policy objective and financial regulatory principle and has been incorporated into a number of international declarations and codes of good practice. Some of the international initiatives to promote financial inclusion include the Maya Declaration on Financial Inclusion (2011) that was set forth by the Alliance for Financial Inclusion, a network of central banks, financial supervisors and other regulatory authorities from developing and emerging market economies, to improve the economic and social potential of the world's poorest by improving their access to financial services and products. Significantly, the Maya Declaration states that financial inclusion is critical for empowering and transforming the lives of all people, especially the poor, and that policies designed to promote it should also enhance global and national financial stability and market integrity. The G20 has recognised the importance of digital financial services in supporting the objective of financial inclusion. Also, international regulatory bodies, such as the Basel Committee on Banking Supervision, have identified technical guidance for banking supervisors to facilitate the use of digital technologies that enhance financial inclusion.

Fintech and Financial Inclusion

Fintech has the potential to facilitate increase financial inclusion by enhancing access to financial services for those individuals and businesses that have been excluded from formal financial markets. Fintech companies are developing digital services that could result in billions of people having greater access to the banking sector and to new investment products. Digital innovations across different areas of the financial sector have had a tremendous impact in enhancing the provision of financial services. Specifically, digital technologies have spread rapidly in many areas of the global economy, yet there is potential for increased use of these technologies.

To support the spread of digital financial technologies, the G20 has adopted High Level Principles for Digital Financial Inclusion (2016) that place great emphasis on using digital technology to enhance financial inclusion. The principles emphasise finding the right balance between innovation and risk in achieving greater financial inclusion and how to utilise legal and regulatory frameworks for using digital technologies to increase financial inclusion. This involves establishing responsible digital financial practices to protect consumers and to improve financial literacy and awareness so that digital financial products are better understood by users.

Internationally, the world has 2.5 billion “unbanked” individuals and 200 million small businesses without formal access to financial services. High percentages of unbanked individuals and businesses are in Africa, Latin America, Asia, and the Middle East. Of unbanked individuals, 1 billion have mobile phones, meaning for many that financial mobility and enhancements in services used could occur in the near future.

The role of e-finance in enhancing financial inclusion in financial services for individuals and small businesses, especially in developing countries, is based on making financial services available to those who would normally not have access. Fintech expands availability of information on financial services, such as investment advice and online and mobile banking services and products. Fintech firms have a market niche in developing products and services for previously under-served markets. All you need is access to the internet and mobile network. The spread of mobile technology, smartphones and mobile network coverage will lead to more and less costly options for individuals and small and medium enterprises, for example, with peer-to-peer lending, borrowing funds on electronic platforms directly from creditors (direct finance), rather than borrowing indirectly from savers through banks and other financial intermediaries.

Barriers for Developing Countries

Despite the obvious benefits of using digital technology to increase financial inclusion, there are significant barriers to financial inclusion, especially for developing countries, involving geographical distances between service providers and users and the lack of market infrastructure (i.e.,, payment systems and securities settlement). In many countries that rely heavily on agricultural production and services, weather risks are important and can dictate when loans are repaid and whether investments are profitable. Also, in many countries, there is little effective competition in the financial services industry which leads to higher operating costs and thus high costs and charges for individuals in opening bank accounts. Moreover, in many developing countries, weak regulatory institutions and legal uncertainty for the enforcement of contracts leads to moral hazard among market participants and to adverse selection and thus to unnecessarily higher costs of capital resulting in a misallocation of capital to less efficient projects.

Each economy is unique and presents its own separate challenges. In the Philippines, the widespread availability of mobile money payments and high demand for international money transfers contrasts with other countries, such as South Africa, where there is less incentive for financially-excluded individuals to replace their existing methods of accessing funds. In Mexico, banks have a reputation for poor customer service and are very inefficient relative to banks in other similarly-sized Latin American economies. As a result, the availability of smartphones and relatively low barriers to entry, are leading to a growing number of fintech firms entering the Mexican market to provide payment services and lending through smartphones and other digital technology. In Bangladesh, a firm called ‘BKash Limited’, a subsidiary of BRAC Bank Limited, was launched in 2011 to provide mobile phone financial services, including payments and money transfers, to both unbanked and banked individuals and businesses.[1]

Peer-to-Peer Lending

[1] Upon registering with BKash, each user receives a mobile wallet that serves as a bank account.

Financial technology also enhances financial inclusion by facilitating the bringing together of lenders and borrowers: small businesses and start-ups with investors. In Europe, over a dozen 'peer-to-peer' lending platforms have been established for small and medium businesses and entrepreneurs to obtain credit: for instance, Zopa, Funding Circle. These fintech businesses that provide electric or digital lending platforms are not legally defined as banks; for instance, they do not leverage their balance sheets, nor do they accept deposits. As a result, they are not regulated as banks or other financial intermediaries and thus are not burdened by regulatory costs and therefore can pay higher interest rates to savers (or lenders) and charge lower interest rates to borrowers.

The advantages of these P2P lenders are as follows. There is no channeling of investment money through traditional banks and therefore it avoids the higher charges of banks as compared to digital lenders that do not have bricks and mortar operations and do not have to comply with costly regulation. Also, by using these e-loan platforms, investors and business borrowers can identify each other and agree their own terms without the intrusion of an intermediary. There is much transparency between lenders and borrowers that does not exist between savers and borrowers of banks.

Also, e-lending platforms provide alternative sources of credit for many small businesses and start-ups – which may have difficulty obtaining credit from traditional banks because of stricter regulation and previous lack of access to credit.

The disadvantages of P2P pending platforms are several including the credit-worthiness and other information about the borrower and lender are more difficult to ascertain. This leads to a higher risk of default as the lender cannot rely on the veracity of the information provided on the e-lender's platform and it is difficult for the lender to seek compensation for any defaults. These greater risks are not absorbed by the e-lending platform business and instead are covered by individual lenders – many of whom may be unsophisticated in high they assess credit and other market risks. However, the greater risk of default in P2P lending does not appear to be systemic risks for the banking sector as the amount of credit provided through e-lending and other P2P platforms is very limited in comparison to the amount of credit provided by the whole banking sector.

However, the number of borrowers is growing rapidly along with limited competition there is an incentive for some platforms to become too big too quickly. E-lending businesses may not be as sophisticated in managing risks as traditional banks and therefore there may be the need for regulation.

Financial inclusion has become an important objective of international policy and financial regulation. Fintech can be used to support financial inclusion but it also poses business, regulatory and technical challenges.