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Understanding financial access through an evolutionary lens

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Introduction

- Chick's evolutionary theory of banking is essentially a relational theory – interplay of innovation the banking sector with regulators, their mandate and political will to enforce
- Point of entry to understand the rise of financial inclusion - especially previously-excluded households, and how over-indebtedness can be a consequence of this evolution – including the drive by banks to originate loans at all costs

Agenda

- Stages of evolutionary theory of banking
- Application to South Africa
- Failure of African bank (micro-credit bank)
- Financial inclusion and evolutionary theory

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Stages

- The ‘stages of banking’ (Chick: 1992, 1993) can be seen to explain how the evolution of banking overturns the ‘prior-savings’ argument, and how - through testing and extending risk - banks convert the theory of money supply into a theory of banking policy
- Each stage of banking is associated with an innovation, itself a consequence of, or catalyst for, change in bank regulation
- This in turn creates a change in behaviour and response from the public - who rely on the convention of confidence in bank money (intrinsic to the regulation of banks) but of course they are also the users of banking services.

Banking evolution and associated activities

Stage/ Innovation	Banks	Central banks	Inclusion of Consumers
1 Mere Conduits	Deposits required for reserves and lending Extension of credit depends on loanable funds “prior-savings”	Free banking – no regulatory role	Wealthy and merchants Personal introduction

Banking evolution and associated activities

Stage/ Innovation	Banks	Central banks	Inclusion of Consumers
2 Branches & multiplier	Bank deposits move from bank to bank and branch to branch, but remain in the system	Responsible for MP and bank regulation public confidence in "money-ness" – reserve requirements	Convenience of using bank deposits as means of payment – cheques, enlarge network of those served

Banking evolution and associated activities

Stage/ Innovation	Banks	Central banks	Inclusion of Consumers
3 Clearing & Settlement	Interbank payments facilitated Over-night shortage & exchange of reserves	Clearing and settlement	Public confidence continues to grow Current accounts for creditworthy Banking becomes aspirational

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Banking evolution and associated activities

Stage/ Innovation	Banks	Central banks	Inclusion of Consumers
4 Beyond reserves	Banks expand beyond reserve capacity Loans provided if Marginal profitability loan expansion exceeds Marginal cost of reserves	Lender of last resort Financial stability	Uptake of accounts for salaried workers Saving for large purchases Formal credit evaluation by committee

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Banking evolution and associated activities

Stage/ Innovation	Banks	Central banks	Inclusion of Consumers
5 Liability management	Liability management – banks actively seeking to attract deposits in order to fund aggressively marketed loan book No side of the balance sheet passive	Change to regulation, blurring between banks and building societies/co-operatives	Unsolicited offers of credit spurred by scoring algorithms Pool of inclusion expands

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Banking evolution and associated activities

Stage/ Innovation	Banks	Central banks	Public/ Consumers
6 Originate and distribute	Securitisation of credit, off-balance sheet operations- assets move off balance sheets Volume of loans determined by appetite of capital markets for securitized loans Outsourcing of credit evaluation – repackaging of assets means nature of collateral unknown	Application of Basel minimum standards leads to regulatory arbitrage Fee and commissions grow in importance Central bank oversight undermined	Systemic overestimation of credit-worthiness and under-pricing of credit – makes it readily available – sub-prime lending to those who have never received credit before. Increasing over-indebtedness.

South African context -

- After the 1994 democratic elections, very strong political pressure to improve financial inclusion, at the time financial provision was strongly along racial/economic lines.
- From 1998, unsecured lending could be provided under exemption to Usury Act and then under generous terms of National Credit Act. Exceptionally high returns achieved by microlenders and other high street banks in this segment.
- Apart from a transactional account, micro-loans were most likely to be the first financial product to be extended to previously excluded consumers.

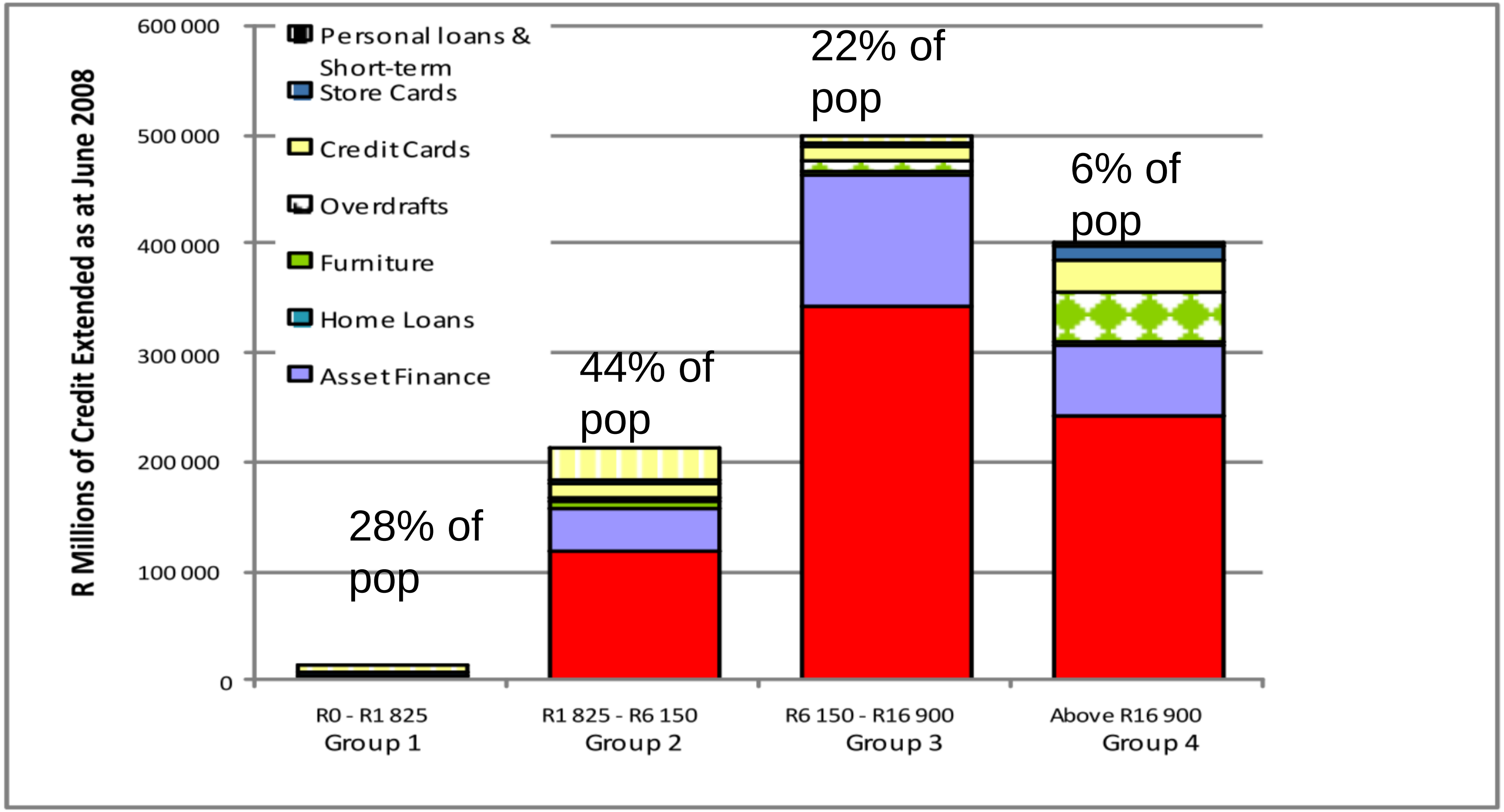
Leap-frogging inclusion

- In around 2001, the first guestimates were made of financial inclusion – around 40% of the adult population was being served by formal financial providers
- By 2006, this number had increased to 51%with a big push for those in domestic service and itinerant jobs to have a Mzansi account.
- By 2008, this had increased to 63% and essentially flat-lined, until around 2012 when results of an annual survey suggested the national target of 70% had been achieved

Regulation

- Plethora of new legislation – prominent was the National Credit Act – within scope of the Department of Trade and Industry
- New regulator, new provisions - debt review, credit register and reckless lending
- NCA – passed in 2005 and effective in 2006
- Regulatory overlap – almost always at least 2 regulators – Financial sector regulators were considered pre-eminent

Credit extension by income category



The failure of African bank

- Micro-lending bank – started in 1998, on the basis of Usury Act exemption
- Liabilities: Only wholesale funding, no retail deposits
- Assets: Only small consumer loans and credit cards
- Most clients black and in formal employment – especially state sector - “on a mission to lend money to those shut-out by the apartheid state”.
- Sweetheart of investors and policy makers
- 2012 – Banker of the Year, first Swiss bond issued
- Fair-weather balance sheet – while attractive returns were being made, wholesale funding was available.

The failure of African bank

- By 2014 it was the sixth biggest back in SA (ito of assets) and served over 3 million clients
- Aggressive extension of loans was the logical outcome of the business model – the only way to ensure revenue growth.
- However, bad debts took over – at the time of its demise in August 2014, over a third of the book was in default and the bank was making an operational loss, loans had been re-extended to no avail...
- For some time, its precarious position was hidden. (Delinquency - 120-days overdue instead of the industry standard of 30 days, bad debts were written off after 17 consecutive months of no payment.)

Failure of African bank

- National Credit Regulator and South African Reserve Bank were regulators. Fined by former for R300m for reckless lending, persuaded to reduce fine to R20m – only one branch involved
- SARB engaged from a distance, reduced reserve requirements by more than half at one stage
- Fitness of the board, failure to correct long-term discounting of provisions (Underestimated this ten-fold), misinformation to the investing public.

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Stages of banking and financial access

- Financial Inclusion of consumers is typically seen as a “Good Thing”
- However, financial inclusion must deliver perceived value, its no accident that transactions capability and credit are the most likely services to be used.
- Everyone has a mobile phone - but financial services have to prove their use.
- Moreover, if the push toward financial inclusion co-incides with a particularly aggressive stage – then consumers can be where their access to credit exceeds their financial literacy as well as their capacity to re-pay.

Aggressive lending…

- **In South Africa, consumers receive unsolicited offers of credit – (frequently and frequently at work)**
- **Loans are on a pre-scored basis, where consumers did make application themselves, they were offered loans many times the value they requested**
- Most respondents felt incompetent or inferior in the processes around the financial transaction. They lack confidence in asking the appropriate questions. Most feel their education has failed them.
- There was a sense of personal complicity in their (over) indebted situation – but often felt misled by terms and conditions.

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Aggressive lending…

- Factors working against ”shopping around” for the best deal:
  - The **offer at hand** is what concerns the consumer, the “best deal” typically not top of mind (mortgages and car finance the exceptions)
  - Obtaining credit **affirms** the individual (power relations)
  - Offers **unsolicited or linked** to supply of goods
  - Where consumers do shop around - **first response** likely to be accepted
- Contracts wordy and confusing or incomplete - little evidence of “clear and simple language”
- **At the point of sale, the incentives for transparency (on the part of the provider) and understanding (on the part of the consumer) are poor.**

Financial inclusion and evolutionary theory

- Keynes - Banks liquidity preference to "fringe of unsatisfied borrowers"
- Stage 3 - Financial inclusion is economic imperative for consumers - both because of the role of money in the economy and because being banked is linked to social status and reduced transactional friction
- Stage 4 – saving is simply old fashioned and not necessary
- Stages 5 and 6 – originate and distribute model – less to do with charcterstics of fringe and everything to do with profit maximisation

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