

POLICY AREA:
Financial Resilience

Broadening the G20 financial inclusion agenda to promote financial stability: The role for regional banking networks.

Matias Ossandon Busch (Halle Institute for Economic Research (IWH))

April 27th, 2017

Abstract

Policies that foster the expansion of regional banking services can be an effective tool to enhance financial inclusion by facilitating the access to deposit services. Financial inclusion, in turn, can expand banks' deposit base with positive spillovers for financial stability, both at the bank and country levels. Governments' support to unconventional branching via correspondent banking, to the proportionality of regulation, and to the harmonization of banking services can provide the conditions to stimulate banks to reach customers that remain outside the financial system, especially in emerging countries. By encouraging these conditions within its Financial Inclusion Action Plan, the G20 could effectively link its financial inclusion and financial stability objectives within a consistent policy framework.

Challenge

The 2008-2009 global financial crisis highlighted how **financial shocks can have large and long lasting real economic consequences**. The fact that the crisis originated in large, well-developed core economies of the international financial system further stressed the role of cross-border financial linkages in shaping the transmission of the crisis across the globe. The literature has profusely documented how these financial shocks translated into real economic outcomes, affecting firms' access to credit (Popov and Udell, 2012) and profitability (Ongena et al., 2015) as well as countries' capacity to create jobs (Noth and Ossandon Busch, 2017).

To mitigate the effect of financial shocks on the real economy numerous changes in the financial regulatory framework have been decided worldwide. International initiatives have focused on achieving higher levels of **harmonization in banking regulation**, thereby improving the **coordination of banking supervision** between countries. Basel III and the European Banking Union are examples of this endeavour. At the national level, several countries have introduced **countercyclical liquidity and capital requirements**. Especially emerging countries have complemented these measures with ring-fencing policies and capital controls to assess the risk of booms and busts in capital flows. Despite the undisputable benefits of some of these innovations, important limitations and potential drawbacks exist as well. For instance, international actions have become difficult to implement and remain mainly focused in the industrial world. Moreover uncoordinated local regulatory innovations can limit the benefits of financial globalization by introducing market distortions.

Financial inclusion —defined as the integration of households, corporates, and other agents in the financial system via accessing deposit and credit services— can **complement current regulatory efforts to enhance financial stability**. In this context, G20 initiatives within the Financial Inclusion Action Plan (FIAP) have remain focused on the consumers' side of financial inclusion, proposing alternatives to underpin households and SMEs own capacity to access financial services, via measures such as financial literacy, or consumer protection laws. In contrast to this angle, policy proposals aimed at facilitating the expansion of **bank branches networks have remained absent** from the G20 agenda. Individual initiatives by G20 countries show, however, that these policies —including the support of correspondent banking, the proportionality of banking regulation and the harmonization of banking products— can effectively encourage banks to attract and accept new depositors, with positive spillovers on financial resilience.

In particular supporting the regional extension of banking services can —especially in emerging countries— lead to a **reallocation of savings from physical to financial assets**. At least three channels linking this reallocation with financial resilience have been stressed in the literature. First, more deposits can help to smooth consumption over the cycle, offsetting the lack of credit supply when financial shocks strike. Second, a larger deposit base can increase the effectiveness of monetary policy by widening the share of the economy subjected to changes in interest rates. Third, deposits provide a liquidity buffer against shocks both at the regional and country level, as discussed below.

In emerging countries **regulatory burdens and the lack of infrastructure have prevented a more forceful expansion of banking services**. Banks' incentives to expand their activities also crucially depend on market conditions —such as financial literacy and digital infrastructure— that due to their public good nature remain often undersupplied. In this context, there is scope for the combination of policies tackling different dimensions of financial inclusion in order to support the G20 financial resilience agenda. The extension of the FIAP-agenda is of foremost importance considering the still **limited coverage of financial services worldwide**: whereas on average only 64% of the world's adult population reports holding a banking account as of 2014, this number drops to 54% in emerging countries (Demirguç-Kunt et al., 2015).

Proposal

Promoting access to deposit accounts via banking networks

G20 efforts to improve financial inclusion have been concentrated since the Seoul Summit in 2010 in the **Financial Inclusion Action Plan** and the **G20 Global Partnership for Financial Inclusion**. Working groups within the FIAP have achieved an important success in promoting policy agendas in the member countries concerning topics like SME finance, financial literacy, and digital finance. These proposals have focused on the consumers' side of financial inclusion, whereas no suggestions have been made concerning the expansion of **banking activities across regions in order to stimulate the use of deposit accounts** by customers excluded from the financial system. Comparative experience suggests that policy options to this respect might consider the promotion of regional branching and non-banking correspondents, the harmonization of banking products within countries, and the proportionality of regulation. As explained below, this proposal suggests that the G20 should consider these policies as part of the FIAP-agenda, linking its financial inclusion and financial stability goals within a consistent framework.

Several arguments support the inclusion of the aforementioned objectives in the FIAP. First, the still large share of the world population that is excluded from the financial system suggests that a **nonreserved demand for deposit services exist**. This is of foremost importance for emerging countries in which on average only half of the adult population reports holding a bank account (Demirguç-Kunt et al., 2015). Second, the empirical evidence suggests that the **proximity of bank branches networks is a key driver of financial inclusion** (Brown et al., 2016). This means that physical banking infrastructure is important to attract new customers, even considering the expansion of financial digitalization. Third, **banks might be reluctant to invest in issues like financial literacy or digital infrastructure**, limiting the benefits of a regional expansion. Governments can therefore intervene to provide better conditions that encourage banks to reach new customers. Finally, regional bank branches are likely to suffer for problems of **market incompleteness in their funding structure** because of their direct dependence on intra-group liquidity. This restricts their ability to raise new funds when financial shocks occur. By incorporating new depositors, these branches might improve their financial resilience by creating more robust liquidity buffers. All in all, these interventions can help emerging countries to develop a better capacity to absorb cross-border liquidity shocks, achieving a better balance in the trade-off between access to cheaper foreign wholesale funding and the stability of a broader local deposit base. The importance of this latter objective is stressed by the fact that banks' foreign funding exposures were a significant transmission channel of the global financial crisis across the globe.

This proposal suggests complementing the FIAP-agenda with feasible and measurable objectives of financial inclusion related to **facilitating the access to banking services via bank branches and correspondents**. This action should consider financial inclusion as a complementary tool next to globally coordinated financial regulatory reforms to improve financial resilience and to overcome the limitations of current efforts for regulatory reform. With this action the G20 should enhance its commitment with financial inclusion and with the build-up of stronger capacities to confront financial shocks. In particular three policy agendas should be encouraged and monitored by the FIAP. First,

customers' access to deposit accounts should be stimulated by **harmonizing deposit and payment services** for low-income customers. Second, **correspondent and branch banking should be encouraged** as a mechanism to improve customers' proximity to banking services. Third, the FIAP should provide countries with guidelines to **introduce proportionality criteria in banking regulation** so as to facilitate banks' regional expansion. Ultimately, these policy agendas should aim at widening banks' deposit base. This would improve banks' resilience against negative shocks from abroad without hindering banks' access to foreign markets, in comparison to caps on cross-border credit operations and other forms of capital controls. The policy agenda suggested here could be implemented at a relatively low cost and without inducing further distortions in the banking sector, as it would be the case with regulatory requirements on deposits' interest rates or quotas on specific funding sources. Facilitating customers' access to deposit services would also avoid the risk of affecting the risk of banks' credit portfolio, as it is the case with policies directly promoting credit supply to increase financial inclusion.

Using G20-countries experiences to foster financial inclusion

G20 member countries' own experience in promoting financial inclusion agendas can provide a fruitful starting point to generate policy recommendations. Regrettably, **most of these experiences have not been considered within the FIAP** yet, leaving open scope for further extensions of the current agenda.

1. Simplify and harmonize deposit and payment services for low-income customers.

The empirical literature suggests that **accessing saving and payment services is often a more urgent need** for low-income customers than credit itself (Hawkins, 2011). In line with this, several countries have introduced the so called **"basic accounts"** to reduce information asymmetries and facilitate a simple access to deposit and payment services. Basic accounts typically set a maximum balance limit so that they represent a low risk for financial institutions. Opening basic accounts is further facilitated by requiring only simple identification documents and by charging no service fees. Although being a market-led initiative, basic accounts have been usually **enforced by regulatory requirements** that define their features. This further improves customers' capacity to compare between banks, fostering competition.

Countries like Brazil, Mexico, and South Africa have reported success in setting up basic accounts. Despite of its advantages, large regulatory burdens, the thin profits obtained by banks and the difficulties of cross-linking these services with other banking products have discourage the use of basic accounts (BIS & World Bank, 2014). To overcome these difficulties countries might impose minimum and maximum volumes to be held in basic accounts, adapting the regulation and facilitating the access to other banking products (e.g. credit cards, electronic payment devices) linked to the basic accounts. Moreover, the use of basic accounts could be encouraged by **using these accounts to transfer social program payments and government salaries**, setting a benchmark for similar uses by the private sector.

2. Encourage correspondent banking and regional bank branching.

The FIAP has promoted financial digitalization in order to facilitate customers' access to banking. Despite of its clear benefits, this agenda is crucially limited by peoples' access to digital infrastructure,

especially in emerging countries. Therefore these efforts should be complemented with policies aimed at **widening the physical access to banking services** in regions where banks and other financial companies have been absent. To this respect, the FIAP should incorporate lessons learned by G20 member countries in creating incentives for regional bank branching both conventionally and via the establishment of regional bank correspondent agencies. For instance, countries like Brazil and Mexico have shown that allowing small shops to act as bank correspondents can facilitate the access to financial services.

Bank correspondents have been defined as **service points** that offer a limit set of financial services acting as representatives of financial institutions. By adapting their financial regulation, countries have allowed for the extension of banking services via these non-conventional networks. An important advantage of bank correspondents is that they can **exploit the benefits of digitalization without necessarily requiring high levels of digital literacy** in the population. Moreover, expanding the banking network in this unconventional way entails low marginal costs and is institutionally simple to implement. The FIAP could support countries by defining guidelines to adapt regulation for non-conventional banking networks and by providing an harmonized evaluation framework to monitor the developments in correspondent banking.

3. Proportionality of financial regulation.

The G20 should mandate the FIAP to include a systematic **monitoring of the proportionality of regulation** across member countries. The proportionality of regulation has become an important supervisory criteria in the international debate (see BIS, 2012). This idea refers to the fact that regulation should be **calibrated to approach different financial services** differently, depending on the risk they represent for the financial system as a whole. The efforts to implement non-branching banking via correspondents or to harmonize the offer of deposit accounts are only possible if governments support these policies with a flexible regulatory environment. In particular, new products and financial infrastructures should not face the pressure of a high regulatory burden during their implementation phase. The final objective should be to balance the benefits and potential risks of policies fostering financial inclusion. In line with proposals by the BIS and the World Bank (2014), the G20 should mandate the FIAP to provide guidelines for a **risk-based, instrument-neutral and forward-looking regulatory environment** that promotes innovation by also containing the risks involved in testing new financial services and infrastructures.

Considering the discussion above, three important aspects should be taken into account to ensure proportionality in financial regulation to foster financial inclusion. First, authorities should be provided with the **technical capacity to evaluate and assess the risk** of new financial services and networks. Second, the regulation of digital finance, non-branching banking and basic deposit accounts should consider **countries' regional diversity**. While policies in this area can be easily implemented in urban regions by making use of the existent infrastructure, challenges are likely to be larger in rural sectors. Third, the FIAP should **pull together information on countries' experiences** in setting-up consumer protection schemes regarding new financial services. The experience of the American Federal Deposit Insurance Corporation in providing deposit insurance on prepaid transaction accounts, as well as

similar policies in India and Turkey could be used as a starting point to set international standards for a regulatory environment adapted to promote financial inclusion.

References

1. Bank of International Settlements and the World Bank Group (2016): "Payment aspects of financial inclusion". Technical report by the Committee on Payments and Market Infrastructures and the World Bank Group, ISBN 978-92-9197-216-6.
2. Bank of International Settlements, Committee on Payment and Settlement Systems (2012): "Innovations in retail payments". Technical report by the Working Group on Innovations in Retail Payments, ISBN 92-9197-127-8.
3. Brown, Martin, Benjamin Guin and Karolin Kirschenmann (2016): "Microfinance banks and financial inclusion". *Review of Finance*, Vol. 20, pages 907-946.
4. Demirguc-Kund, Asli, Leora Klapper, Dorothe Singer and Peter Van Oudheusden (2015): "The Global Findex Database 2014, Measuring Financial Inclusion around the World". World Bank Group, Policy Research Working Paper 7255.
5. Hawkins, Penelope (2011): "Financial access: What has the crisis changed?". BIS Papers, No. 56, September, pp. 11-20.
6. Noth, Felix and Matias Ossandon Busch (2017): "Banking globalization, local lending and labor market outcomes: Micro-level evidence from Brazil". IWH Discussion Paper 2017/07, Halle Institute for Economic Research – Member of the Leibniz Association.
7. Ongena, Steven, Jose-Luis Peydro and Neeltje van Horen (2015): "Shocks abroad, pain at home? Bank-firm level evidence on the international transmission of financial shocks." *IMF Economic Review*, Vol. 63, pp- 698-750.
8. Popov, Alexander and Gregory Udell (2012): "Cross-border banking, credit access, and the financial crisis." *Journal of International Economics*, Vol. 81, pp- 147-161.

Implementation Overview

The G20 should mandate the FIAP to include in its agenda objectives related to the expansion of regional banking networks in the member countries, with a special focus on emerging countries. This mandate should have the objective of widening banks' deposit base to contribute to financial stability. The FIAP should incorporate topics related to the harmonization of financial services, the extension of non-branch banking and the proportionality of financial regulation. Based on the experience of individual countries, the FIAP would provide guidelines for policy actions in these three dimensions of financial inclusion.

Existing Agreements

The G20 has implemented a number of initiatives related to financial inclusion. Different initiatives during the last decades were combined into the Global Partnership for Financial Inclusion (GPFI), created during the Seoul G20 Summit in 2010. As part of the GPFI, the G20 created the Financial Inclusion Action Plan (FIAP), defining four priority areas related to financial inclusion in which member countries have been working since then, organized in different task forces. The GPFI has defined the G20 Principles for Innovative Financial Inclusion, in which the policy agenda encouraged by the G20 for its member countries is currently based. Several G20 Communiqués during recent G20 Summits have stressed the importance of the financial inclusion agenda. Among these are:

1. The Communiqué of the G20 Finance Ministers and Central Bank Governors Meeting in Chengdu, China, on July 24, 2016.
 2. The Communiqué of the G20 Leaders' Summit in Hangzhou, China, on September 5, 2016.
 3. The Communiqué of the G20 Finance Ministers and Central Bank Governors Meeting in Baden-Baden, Germany, on March 17-18 2017.
-

Existing Policies and Monitoring

The G20 has agreed on several instances to monitor the implementation of its financial inclusion agenda. Examples of this are the G20 Financial Inclusion Indicators that evaluate countries' advances in complying with the G20 agenda. Other initiatives include the individual progress reports of the GPFI subgroups and the progress reports to G20 leaders of both the GPFI and the FIAP. This is complemented with country-specific reports and publications regarding specific areas of the FIAP agenda, such as financial literacy and digital finance. Despite of these efforts, different initiatives have lead to somewhat inconsistent monitoring schemes that translate into difficulties when it comes to understand the current stage of the financial inclusion agenda. Therefore, this proposal suggests consolidating the monitoring efforts into the FIAP as the instance that has lead the implementation of policy recommendations in the member countries.