

1. Introduction: financial inclusion – an overview of key issues

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There are many reasons why financial inclusion is important in a country: it has implications for economic development and the economy and society more generally, it often requires public policy initiatives, and it may impact on the efficiency, structure and stability of the national financial system. There is also the issue of the extent to which the structure of the financial system (such as between financial institutions and markets, and the relative role of foreign versus indigenous banks) has an impact on financial inclusion. The World Bank has adopted Universal Finance Access, which outlined the objective that everyone should have access to at least a basic bank account by the year 2020. While financial access has been advancing globally for several years, the World Bank estimated that in 2017 this still left around 1.7 billion adults unbanked (World Bank, 2018).

For recent surveys of some of the key issues in financial inclusion, see Beck and de la Torre (2017), Barajas et al. (2020), Claessens (2005) and Carbo et al. (2005). The most comprehensive data set (the Global Findex Database) is produced and regularly updated by the World Bank.

An important issue for society is the extent to which all households and firms have access to the products and services provided in the financial system and the degree to which some agents are excluded from some or all of these products and services. This is an issue for both developing and developed economies, though the focus in this volume is predominantly on the former. The economic, social and individual costs of financial exclusion can be substantial, with many studies indicating that it can have a negative impact on a country's economic development. This raises the question of what can be done by governments, regulators, financial firms and educators to address the costs of financial exclusion. There is also the issue of the extent to which new and emerging technology has the potential to impact on financial exclusion in both positive and negative ways.

The International Monetary Fund (IMF) collects detailed granular data on access to, and use of, financial services, including digital finance, in its regularly updated Financial Access Survey (IMF, 2020). The World Bank's

Global Findex Database provides the most comprehensive data, which tracks patterns of access to savings, borrowing and payments facilities across the world. It provides excellent data on the varying degrees of financial exclusion in different countries, and notes that in 2017 financial exclusion was particularly high in sub-Saharan Africa, East Asia and the Pacific, the Middle East and North Africa, and Latin America and the Caribbean. The vast majority of the unbanked population is located in developing countries and particularly China and India; although a substantial proportion of the population in these countries has a bank account, because of the size of their populations the absolute numbers of unbanked are the highest in the world. Globally, around 50 percent of the unbanked population are located in just seven countries. The evidence also indicates there are substantial differences in the degree of financial exclusion and policy responses between countries and between different sectors within countries, as the various chapters in this volume demonstrate. Financial exclusion may also be linked with more general economic and societal exclusion where causation may run in both directions, each interacting with the other (see, for instance, European Commission, 2008).

This chapter sets the scene of the volume and offers a brief overview of the key issues discussed in the following chapters, many of which are focused on specific country case studies.

NATURE OF FINANCIAL EXCLUSION

Financial exclusion is sometimes focused almost exclusively on access to a bank account. While this is an important dimension, this focus is too narrow. Nevertheless, as a point of perspective, it is estimated that in 2017 around 1.7 billion adults lacked a basic bank account, and this was particularly the case for poor people and women in developing countries (World Bank, 2018). There is a spectrum of different elements of financial exclusion, encompassing:

- The degree of exclusion (partial or full).
- The range of products and services to which it is relevant. For instance, a distinction can be made between the unbanked (no access to a bank account at all) and marginally banked (access to a limited range of banking services). With respect to the latter, some countries (for example, Belgium, Germany, Italy and the UK) have created simple, low-cost, transactions-only accounts with limited access to the services (such as credit) that are usually offered through a bank account.
- A distinction is also to be made between financial exclusion per se (that is, access to financial services and products) and the degree of usage of financial services. It has been estimated that globally around 20 percent of

bank account holders use their accounts less than once each year. The use of accounts has not kept pace with access.

- A distinction is also to be made between demand and supply factors determining the extent of financial exclusion. Some people financially excluded from mainstream institutions may choose this; for instance, for religious reasons or because they find alternatives more convenient or efficient for them. In this regard, there is a distinction between mainstream (or traditional) financial service providers and alternative routes to financial inclusion. Financial exclusion from mainstream markets and institutions does not always mean the absence of access to financial services. A range of financial institutions (such as savings banks, non-profit institutions, credit unions, microfinance institutions, mobile network operators offering mobile money, cooperatives and mutual institutions) fill the gap left by more traditional sources of financial products and services (European Commission, 2018).

The literature offers several alternative definitions of financial inclusion, each with a different focus and particularly between a narrow and wide focus. An early definition is offered in Leyshon and Thrift (1995, p. 41): “The process whereby people encounter difficulty accessing and/or using financial services and products in the mainstream market that are appropriate to their needs and enable them to lead a normal social life.”

The IMF (2020, p. 16) suggests that there is a broad consensus in the literature: “Financial inclusion is a multifaceted concept, encompassing various dimensions, including access to and use of financial services as well as other aspects such as affordability, usefulness, quality, and awareness of financial services and products.”

The World Bank (2018, p. 3) also offers a multifaceted definition: “Financial inclusion entails individuals and businesses having access to useful and affordable financial products and services that meet their need for transactions, payments, saving, credit and insurance and are delivered in a responsible and sustainable way.”

Sahay et al. (2015, p. 6) define financial inclusion simply as “access to and use of formal financial services by households and firms”. A broader focus is also offered by the UK’s Financial Inclusion Commission (2015, p. 42): “A financially inclusive society is one in which financial services are accessible to all, easy to use and meet people’s needs over their lifetime. Financial inclusion also means that people have the skills and motivations to use financial services and to benefit meaningfully from them.”

A common feature of the various formulations of the nature of financial exclusion is that they emphasise the impediments and barriers for some groups to access the full range of financial services.

While a broad focus is taken here, it is evident that the starting point needs to be access to a basic transactional bank account enabling people to manage their money and transactions in an efficient manner, and give access to saving and borrowing facilities and mechanisms to deal with emergencies. A bank account may also open access to other financial services. While having a bank account may be a necessary condition for access to a wider range of financial services, whether offered by the bank or other financial institution, it is not always a sufficient condition. This is the reason why public policy in some countries has focused on the provision of a basic, limited transactional account with no overdraft facility.

Much of the literature is focused on barriers with respect to financial institutions and particular financial markets. An alternative and more appropriate paradigm which is relevant for all types of economy is to apply a functional approach with a focus on the basic and universal functions of a financial system: payments services, savings facilities, access to credit, allocation of capital, insurance and the shifting of risk, and fund management.

The financial system exists to supply a range of products and services through institutions and markets to facilitate these functions. As a response to financial exclusion, alternative non-mainstream institutions and markets sometimes emerge to fill the gap. However, these alternatives are often inefficient and costly to use, partly because they lack the economies of scale available to institutions operating in the mainstream system. Financial exclusion focuses on the limited, or total, access to these basic functions. Lack of appropriate savings products does not necessarily mean that no saving takes place by the excluded group, as this can also be done outside the traditional financial system via, for instance, cash savings (Kempson, 1999). Other methods of saving include savings clubs and through family networks. Less formal mechanisms can also apply in the case of insurance, as in some rural agriculture sectors in some countries, where a form of insurance is created by farmers devoting a percentage of their output to a central pool to be drawn upon by those whose harvest has been severely disrupted.

FINANCIAL INCLUSION AND THE ECONOMY

A substantial theoretical and empirical literature examines the impact that finance in general, and financial inclusion in particular, has on the macro economy, economic development of a country and its rate of growth, and income distribution (see Beck and de la Torre, 2007; Beck et al., 2000; Levine, 2005; and Popov, 2018).

As there is a substantial literature on the relationship between finance and economic development, the discussion here is very brief. In general terms, most studies indicate that financial development, and the depth of the financial

system, can be building blocks for both economic development and poverty reduction. Recent studies include World Bank (2017a), which suggests that the financial system helps drive economic development. Many studies indicate a correlation between the depth of the financial system and higher long-run rates of growth, capital accumulation and poverty reduction (see, for instance, Levine, 2005; Popov, 2018).

Financial inclusion has also been shown to reduce income inequality and the extent of poverty (see, for instance, Beck et al., 2000; Cihak and Sahay, 2018; Demir et al., 2020; Zhang and Sami, 2019). Other studies indicate that enhanced financial inclusion can contribute to inclusive growth and economic development in a country (for example, Demirgüç-Kunt et al., 2017). Furthermore, financial inclusion has been identified as contributing to seven of the World Bank's Sustainable Development Goals. A study published by the IMF (Barajas et al., 2020) concludes:

The broad process of financial development has been shown to promote economic growth at the national, industry and firm levels, as well as to enhance productivity growth and capital accumulation. It has also been shown to reduce income inequality and is strongly associated with poverty alleviation ... [F]inancial inclusion can be thought of as an aspect of financial development, and therefore potentially is associated with many of the benefits that are derived from this process.

The expectation is that normally the degree of financial inclusion would be positively correlated with financial depth (IMF, 2020). While this is not invariably the case, most evidence suggests that financial inclusion has a measurable impact on growth over and above what would normally be expected from financial depth per se (Sahay et al., 2015). In other words, the impact of financial depth on economic growth increases with the level of financial inclusion.

Summarising the evidence on financial inclusion and growth, two routes can be identified: (1) increased financial depth improves growth performance, and (2) increased financial inclusion raises the impact that financial depth has on a country's growth performance.

BARRIERS TO FINANCIAL INCLUSION

A multitude of factors and barriers can contribute to various degrees of financial exclusion, dependent on the country concerned and which of the financial functions is the focus of analysis. These issues are discussed in some of the case studies in the following chapters. As an excellent and extensive survey is to be found in European Commission (2008) and IMF (2020), the discussion here is brief. Four generic sets of barriers to financial inclusion can be identified: structural factors, institutional constraints, demand factors and educational limitations. There is no single structure that applies, as considera-

ble differences exist between countries in the relative role of the constraints to financial inclusion, and often between sub-groups within countries.

Structural Factors

A major factor in some countries, and for some sub-groups within countries, structural factors relate to inadequate financial infrastructure. In particular, access constraints partly associated with banks reducing the size and coverage of their branch networks arise in many cases as it is too costly to serve a dispersed population given the importance of economies of scale in the provision of local services. While this has been partly alleviated by new technology, this does not always apply to all groups or individuals (see below). Some potential users of financial services may also be inhibited by a perceived lack of appropriate regulation and consumer protection (World Bank, 2017b). Weak contract enforceability may also apply in some cases.

The IMF examines the link between structural factors in an economy and the degree of financial inclusion (IMF, 2020). A “structural benchmark” matrix shows the inverse relationship between structural constraints and the degree of financial inclusion in various countries. Countries vary in the role of structural constraints. A country may lie above the structural benchmark line (indicating a level of financial inclusion which is greater than what would be expected given its structural conditions) or below it. In the latter case, other factors are determining the country’s low level of financial inclusion.

Institutional Constraints

These relate to intended, unintended or perceived barriers created by financial firms. These include inter alia the economic status of potential customers (income, unemployment, immigration, job security, and so on), the lack of proof of identity or a permanent and easily accessible address, credit-scoring models used by financial institutions, and perceptions of risk and risk aversion. In addition, offering a bank account to excluded groups may be perceived as being unprofitable because of, for instance, the small size of loans and an inability of the bank to cross-sell other services and products. Small and dispersed populations may make the provision of financial services uneconomic for providers. In some cases, particular aspects of regulation (such as high capital requirements imposed on high-risk loans) may have a negative impact on financial inclusion. Overall, risk-analysis models and risk aversion may induce banks to engage in standard credit rationing (Stiglitz and Weiss, 1981).

Demand Factors

On the demand side, there may be difficulty in accessing financial services, either through the internet or a branch network. Some products and services can be excessively complex and inappropriate for some groups. Costs and charges attached to financial products and services can also act as a barrier. A lack of trust and confidence in financial institutions may also be a factor in some countries, and this can again be related to actual or perceived regulation and limited consumer protection. Religion can also be a factor in limiting the use of some financial products and services. In some localities there may also be convenient and low-cost alternatives to mainstream financial institutions. Furthermore, in some localised subsistence economies the need for the full range of financial services is limited.

Educational Limitations

These can play a role in that a lack of understanding about financial products, the functions that are performed in the financial system, the types of products that are available for these functions and an inability to utilise financial services and products may all act as deterrents. Limited financial literacy (understanding basic aspects of finance and information) may be a limiting factor in some cases, as can weak financial capability (knowledge, skills and ability to use financial products and services to best advantage). These issues are discussed in Kaiser and Menkhoff (2017), Xu and Zia (2012) and HM Treasury (2019).

Societal factors may also play a part. In subsistence economies, for instance, there may be self-contained social groups where the members deal directly with each other and where barter may limit measured income and thereby create the image of individuals being non-credit-worthy. There may also be a long-standing tradition of using cash, where there is an attitude that financial inclusion “is not for us” along with a perception of a “loss of control” when using mainstream financial institutions and markets.

COSTS OF FINANCIAL EXCLUSION

There are clear and identifiable costs to financial exclusion, and therefore benefits of removing the barriers. These can be classed as: impediments to economic development, costs to the individual, and costs to the economy and society more generally. A substantial literature, including from the World Bank, establishes that financial exclusion has a negative impact on the development of an economy. The costs to individuals derive from no (or limited) access to some or all of the key functions of the financial system (access to savings instruments, credit, insurance, and so on) as outlined above.

Having a bank account, however basic, also enables a consumer to build up an identifiable payments history. Some of the alternatives to the use of mainstream financial institutions and markets (such as borrowing through informal arrangements like money lenders) can also be costly. Some particular services can also be expensive if accessed on an ad hoc basis without a relationship with a financial firm. More generally, sub-prime borrowers pay an enhanced risk premium. In some cases, financial exclusion can lead to a more general societal exclusion as many aspects of normal economic and social activity are denied without a bank account. There is some evidence that the incidence of financial exclusion is more evident with women than men, and financial inclusion has the potential to boost inclusive economic growth and reduce income inequality (Cihak and Sahay, 2018).

As for the government, three costs in particular can be identified: increased tax evasion, difficulty and cost in making safety-net transfers to financially excluded people in receipt of state support, and reduced efficiency in providing some government services. It can also be the case that inclusive financial systems can increase the effectiveness of fiscal and monetary policy by broadening financial markets and the tax base (Cihak and Sahay, 2018).

IMPACT OF TECHNOLOGY

Technology and FinTech are transforming many aspects of finance, and the future evolution of financial systems is likely to be dominated by the impact of innovations in technology. A key issue is what impact (both positive and negative) it might have on financial exclusion. The general benefits are clear: lower transactions costs; a greater variety of access channels, including remote access to financial services and products; more convenient access channels (smartphones, tablets, and so on); the availability of and access to information and a wider choice and variety of financial products and services; and enhanced access to digital payment services (Auer et al., 2020). FinTech has the capability of delivering banking services to rural and remote areas where there is no access to bank branches.

With respect to financial exclusion, technology and digitalisation have both positive and negative impacts. Some of the advantages could accrue to those who have been previously financially excluded. Using new technology means that developing countries can leapfrog traditional modes of delivery and, in the process, reduce financial exclusion and inequality (Demir et al., 2020). For instance, smartphones are widely used in some remote areas for some transactions where there is no access to banks' branch networks. Also, peer-to-peer lending and crowd funding are available in many developing countries when access to bank loans is limited or non-existent.

Technology in both developed and developing countries has had a particularly strong impact on the payments system through the use of smartphones and the internet. The World Bank estimates that 1.7 billion adults remain unbanked, and millions of under-banked households receive regular payments (wages, government transfers, and so on) in cash. Around the world, there is a trend for governments to favour digital transfers (such as social security payments) directly into recipients' bank accounts. In some countries, digitisation of these has had the effect of increasing bank account ownership and reducing the size of the unbanked population (World Bank, 2017a). Digitisation of payments has been a major route towards reducing financial exclusion in many developing countries. The World Bank also estimates that of the unbanked population, around two-thirds have smartphones giving access to financial services (World Bank, 2018).

Overall, a key factor in the steady rise in financial inclusion has been developments in FinTech and digitisation of many aspects of finance along with the adoption of mobile money. Technology can be a major driver of financial inclusion. It has had the effect of broadening financial inclusion in countries where traditional banking services have limited reach (IMF, 2020). It has also impacted on the way that people access financial services, particularly in sub-Saharan Africa.

A major technological development which has contributed to reducing financial exclusion has been the emergence of mobile money (Adrian and Mancini-Griffoli, 2019; IMF, 2019), which in some countries has proven to be a viable alternative to traditional approaches to some aspects of finance. Mobile money is a pay-as-you-go digital medium of exchange and store of value facilitated by a network of so-called "mobile money agents" which are independent of traditional banking networks. No bank account is needed to use mobile money services, though a basic mobile phone is required. Small retail shops and other retailers typically serve as agents in low-income and emerging-market economies. It represents a new type of payments service available to previously unbanked households. Mobile money has had a powerful impact on the way people access finance, particularly in countries with limited banking penetration and poor infrastructure (Adrian and Mancini-Griffoli, 2019). Users can carry out a range of transactions (for example, peer-to-peer transactions, the payment of bills, in-store purchases and remittances) without the necessity of having a traditional bank account. Several countries in Africa have been leaders in the development of mobile money. A key feature of mobile money, which makes it attractive to the unbanked, is that it can be operated through agents which may be located in small and local retail stores in remote areas with limited or non-existent ATMs or physical branches of financial firms.

On the other hand, the evolution of FinTech may also have negative impacts. Technology is likely to accentuate the trend for banks to close branches, which can be a problem for some partially excluded customers, and not everyone has access to the necessary technology or the ability to use it. Many excluded people do not have access to online financial services due to, for instance, a lack of affordability and low connectivity. There is a danger that the declining use of cash and the availability of ATMs will adversely affect the financially excluded (Auer et al., 2020).

ASSESSMENT

Financial exclusion is a complex subject and is multi-dimensional in several respects inter alia: the range and types of barriers to inclusion and the distinction between supply and demand pressures, the degree of exclusion at different points along the spectrum of financial services and products, the distinction to be made between exclusion and usage, and the ambiguous impact of technology. The costs of financial exclusion relate to economic development, individuals and governments. In the functional approach to financial exclusion, the focus is on the basic and universal functions of the financial system and the extent to which different groups are excluded from particular functions.

The chapters to follow include analysis of specific topics, such as the precise nature of financial inclusion and why it is important, and the nature and extent of the impediments to financial inclusion. Other aspects include: how the structure of the financial system may impact on financial inclusion and which sectors of an economy are affected, the relative role of institutions and markets, the relationship between trade finance and access to formal credit markets and institutions, the impact that financial liberalisation might have on financial stability, the role of regulation in promoting financial inclusion, the issue of bank efficiency and economic and financial development in a country, and the important role that financial literacy can have on financial inclusion/exclusion. In some areas these issues are addressed through national and international case studies.

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