

# Financial Inclusion in the Digital Age

## Key points

- Strengthen credit information systems to facilitate delivery of financial services to new customers.
- Develop new microinsurance services to reach the poor.
- Strengthen risk-based monitoring of cross-border transactions to protect remittance-dependent households and communities.
- Reform financial regulation to promote savings through formal channels.
- Develop financial infrastructure to extend financial services to small businesses.
- Improve financial education and financial literacy to ensure financial inclusion.
- Evolve and adapt financial regulation to suit digital finance.

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Financial systems have been expanding, offering more services for savings, credit, investment, insurance, and retirement. However, much remains to be done to provide quality services at low cost to people and small businesses in both urban and rural areas as well as in poorer regions where there are fewer profitable opportunities. The development of information and communication technology applied to financial services provides new opportunities to increase financial inclusion but also requires greater financial awareness and literacy. As the finance sector reaches new consumers who are inexperienced with financial services, consumers need to be fully informed of the costs and risks of the financial products on offer. Meanwhile, traditional commercial and retail banks are finding that digitized finance is disrupting their usual approaches to handling savings and lending; they need to adapt and find ways to provide electronic services to meet the growing demands of their customers.

The policies needed to promote financial inclusion in the digital age were discussed at an international conference held at the Asian Development Bank Institute. The event took place on 7–8 April 2016 and was attended by approximately 100 high-level government officials and banking sector employees. Key issues and policy suggestions arising from the conference form the basis of the following discussion.

## Strengthen credit information systems to facilitate delivery of financial services to new customers

Timely and accurate credit information is critical to a well-functioning financial industry and also essential for any government to fulfill its mandate for maintaining financial stability. About 32% of credit bureaus consider only negative data and provide an incomplete assessment of a borrower's risks (Garchitorea 2016). Instead, governments should collect comprehensive data at the "subject level" while recognizing that these individuals own their data and have the right to access them.<sup>1</sup> Data should also be made available to registries and bureaus to improve their abilities in providing public services, creating policy, and conducting statistical analysis. However, individuals also must have unilateral authority to revoke access by others.

These comprehensive data, paired with those from other sources, can present a more accurate and complete description of an individual so that financial services can be better tailored to suit the individual's needs. As an example using Experian's operations, areas where only negative information is available would have fewer value-added products available compared with those where comprehensive data are available.<sup>2</sup>

In the Philippines, local banks are serving microborrowers through communication and cooperation with cooperatives, rural banks, and microfinance institutions. These microborrowers also tap personal connections such as friends and relatives, which results in little formal data. Additionally, the Credit Information Corporation has found that institutions are more readily able to use data when they develop the capacity for submission.<sup>3</sup> Similarly in the Republic of Korea, the Subprime Credit Bureau was able to implement effective antifraud systems, offer customized credit scores for subprime lenders, and introduce application service provider solutions to start-ups and small subprime financial companies (Hunter 2016).

Given the lack of data used for credit scoring, readily available data may instead be used for smaller loans, provided there is proper monitoring and oversight by the authorities with a special focus on protecting borrowers from unscrupulous lenders who intend to acquire assets in the event of nonpayment. Furthermore, more effort is needed to convert subjective knowledge to transition into standard or traditional data forms through compliance and documentation, as this would create a formal credit identity and enable the borrower to access the wider financial system.

## Develop new microinsurance services to reach the poor

Microinsurance has a potential market of 3 billion people, with possibly \$30 billion in revenue from insurance premiums. Currently, however, only about 5% of the total market in Asia, Africa, and Latin America is covered, and only about 20% of microinsurance is being distributed by microfinance institutions globally (McCord 2016; Malagardis 2016; Yeo 2016). Microinsurance must expand globally to meet the needs of the poor.

In the Philippines, for example, widespread poverty and frequent natural disasters make microinsurance a vital financial service for the poor. The recent experience with Typhoon Haiyan in 2013, however, caused a rethinking of operations of insurance services and the spike in claims that threatened financial sustainability. Instead, offering a variety of financial products that address specific needs of the market would be more effective and provide better value than current standard single product solutions that miss these needs. Furthermore, new digital solutions may be more resilient to the physical challenges faced during disaster recovery.

Although the mobile phone is a useful tool for financial inclusion, the experience of BIMA shows that some developing countries still have a large gap between mobile phone penetration and usage, often 70% or more, and nearly half of their targeted customers do not have access to formal bank accounts or mobile money wallets; this is further exacerbated by the fact that 80% of these customers are also accessing these products for the first time.<sup>4</sup> Financial services still require human interaction as a necessity to build trust, assess the capability of new clients, and bridge the lack of education. BIMA was able to reach 20 million customers across 15 economies within 5 years of starting operations by combining these traditional approaches with modern tools (Yeo 2016).

Another area for improving microinsurance is the proportional regulation of products according to size and scope to nurture growth. Providers are hesitant to offer new products in the face of uncertain regulation while taking on traditional demand-side risk. Overregulation may also stifle growth as it might hamper firms from adapting to market demand in a timely and appropriate manner, especially given the unpredictable nature of disaster risks and the speedy evolution of digital finance. Considering the overlaps in jurisdiction pertaining to digital delivery of products, there is an urgent need for harmonized regulation across different government agencies; this process requires continued communication between public and private stakeholders.

### **Strengthen risk-based monitoring of cross-border transactions to protect remittance-dependent households and communities**

Cross-border transactions were the fastest-growing mobile money product in 2015. These remittances far exceed official development assistance and foreign direct investment as a source of funds for most developing economies. Competition in the financial market, in the form of other players as well as from social media firms, has exerted a downward pressure on prices and encouraged a shift toward digital payments because of their cost advantages. The rising number of remittance services means that the median cost of sending \$100 has fallen and global payments revenue is predicted to reach \$2 trillion by 2023 (Son 2016; Woodward 2016; Hose 2016; Junid 2016).<sup>5</sup>

Reducing the cost of remittances helps the poor, but people relying on remittances face other risks from the financial system. International

remittances justifiably raise concerns about corruption and money laundering and can lead to account closures, cutting off dependent households and communities from the financial system and vital sources of income. Local and global coordination between jurisdictions and engagement of regulatory bodies need to ensure that de-risking measures that affect money transfers follow risk-based regulatory models and maintain key services for migrant workers.<sup>6</sup>

### **Reform financial regulation to promote savings through formal channels**

Household savings contribute to domestic investment and reduce reliance on foreign funding sources. Formal financial service providers and mobile money operators are essential in collecting savings nationwide, including in remote rural areas, and they are a key distribution channel. Government and financial service providers need to approach financial inclusion through the whole financial system, wherein each agent has a role, using financial education to clearly communicate the idea behind the various financial products. Channel-specific regulation, such as designation of responsibility between agents and service providers, is needed. An adequate level of client information and protection is necessary. Clear rules governing these activities as well as an appropriate regulatory framework should result in an enabling environment to integrate households into the formal banking system.

In India, for example, the reliability of the system and of the reforms created an atmosphere that promoted savings through formal channels. The reforms tackled issues such as management of increasing costs, interchannel competition, disruptive technologies, coordination and trust, product

duplication and differentiation, and the risk of oversaturation of savings programs. Meanwhile, Pradhan Mantri Jan Dhan Yojana established banking outlets within reasonable distance to service areas and provided customers with debit cards as well as various insurance products.<sup>7</sup> Another example is an initiative led in partnership by Cashpor, ICICI Bank, and Eko India Financial Services that offers digital credit and savings products. The program is successful because existing infrastructure could be used to serve clients while investing in capacity building and training of staff in addition to repeated confidence-building activities for clients. This led to individual savings accounts doubling from 2010 to 2015 (Trivedi 2016).

### **Develop financial infrastructure to extend financial services to small businesses**

Micro, small, and medium-sized enterprises (MSMEs) need supporting financial services such as secured transaction frameworks, credit information systems, and insolvency regimes. These can be provided by a combination of public and private entities.

For example, among the Asia-Pacific Economic Cooperation (APEC) economies, MSMEs contribute to over 60% of total employment, 40% of gross domestic product, and 15% of total exports; however, approximately 40% of the financing needs of these MSMEs are underserved (Financial Infrastructure Development Network, as reported in Hunter [2016]). This is primarily because of several factors that stem from their size—MSMEs have a difficult time accessing formal credit because they lack hard assets (e.g., buildings, cash), which leads to limited options for collateral, and they struggle to finance their business or expansion because they lack cash while at the same time almost always facing

higher transaction costs. MSMEs also have limited ability for risk management, cash flow management, and resource management—they are often not very good at tasks outside of their core business. When they do manage to secure bank funds, the lending is localized where assessment is done by the branch manager, as MSMEs do not have the credit score required and their files are not substantial enough to qualify for the usual bank credit assessment process. As a result, this involves high costs to secure working capital, low transparency of the assessment process, and a poor user experience for the MSMEs.

These shortcomings may be overcome with digital technology solutions. For example, Mastercard has shifted its focus from retail payments more to wholesale payments, which increases financial inclusion by providing access to MSMEs. The development of financial infrastructure, specifically operating infrastructure, should be prioritized to achieve the economies of scale that will foster an enabling environment for greater efficiency, transparency, innovation, and convenience for both MSMEs and consumers. Financial infrastructure operators should use the latest modern technologies to upgrade their services so as to keep pace with the rapid evolution of digital finance. Private credit risk databases can be developed to improve credit information on potential MSME borrowers, following the model used in Japan.<sup>8</sup>

### **Improve financial education and financial literacy to ensure financial inclusion**

As finance becomes more inclusive, financial services will reach people who have no prior experience with formal finance. Some new consumers of financial services may lack understanding of financial services and fail to use the services fully or properly.

Financial education is therefore a crucial component of successful financial inclusion. Even in advanced economies, significant gaps remain in financial literacy.

Japan's experience with financial inclusion shows the opportunities and constraints in combining new financial services with financial education. The Government of Japan initially employed World War II widows to sell life insurance and provide the attendant financial education to their customers—the small business workers and agriculture sector workers. Further financial education was provided by Japan Post, one of Japan's main life insurance providers. When private insurers saw the profitability resulting from reaching new customers, they were motivated by profit to be more inclusive as well. Despite the successful expansion of financial services in Japan, financial literacy remains limited because schoolteachers themselves lack financial literacy skills; only 13% of economics and business graduates choose to teach (Yoshino and Morgan 2016). As a result of inadequate financial education in schools, it is common for small businesses in Japan to have to teach basic accounting and finance skills to their employees.

In Malaysia, the Credit Counseling and Debt Management Agency (APKP) has found that the main reason for loan defaults, at 52%, is poor financial planning (Azaddin 2016). Furthermore, it identified priority issues by age group: younger people lacked awareness; middle-aged people lacked cash flow, credit management, and long-term planning; and older people needed greater understanding of retirement issues and retirement planning. In response, the agency developed separate modules that address the needs of the various stages in a person's life to equip him or her with the knowledge needed to make sound financial decisions. The poor face greater risks of negative impacts on well-being if financial mistakes are made. Because

of its limited resources, the agency has chosen to prioritize vulnerable groups with the aim of reducing the frequency and level of their financial missteps.

Financial education should be included in standard school curriculums at every level. The most effective financial education has proven to be targeted to the needs of each age group. Teachers, however, need the appropriate training to successfully deliver results. The resulting higher levels of financial capability have been found to increase worker confidence, work ethics, and productivity and to discourage absenteeism as employees are better able to focus on their jobs.

## Evolve and adapt financial regulation to suit digital finance

Digital financial services (DFS) are being used as a tool to promote financial inclusion across the world. Consequently, DFS must be developed and regulated with proper measures to safeguard against risks and to secure consumer protection.

Different approaches to regulation, as in Cambodia and in the Philippines, show how regulations can hinder or spur growth. In Cambodia, a single DFS provider, Wing, covers 80% of the market, while other banking and financial institutions also provide mobile banking, online banking, and agent banking services (Sarat 2016). It is very difficult to enter the DFS market because of the need to find a partner bank that must also follow a set of compliance procedures set by the authorities. In contrast, in the Philippines, there are more than 100 banks offering e-banking facilities and 30 e-money issuers. Regulations issued in 2009 list specific prohibited activities and have allowed banks to outsource a wider range of activities without needing to seek prior approval from the regulator. This has enabled even the

rural banks to develop linkages with different partners. Cloud computing was also allowed and enabled medium-sized banks to gain access to infrastructure and computational resources; for protection, a public cloud is prohibited for core operations.

However, even with regulations that allow growth, the same environment can constrain development of DFS. According to the Better Than Cash Alliance, only 1% of the 2.5 billion transactions per month in the Philippines are made electronically; this is a result of limited interoperability of domestic payment systems. Major payment providers have their own ecosystems.

As a consequence, smaller institutions are unable to participate and the flow of funds is restricted to cash and checks; 36% of municipalities still have no financial institutions present (Estioko 2016).

Financial regulators should consider policies to allow potential DFS entrants to receive individual licenses without being attached to a bank and also to have separate safeguards for consumer protection specifically geared toward their markets. Governments and the private sector should consider how the finance sector infrastructure needs to evolve and adapt to both regulate and develop new DFS.

## Notes

1. Comprehensive data are defined as positive data, an individual's transaction, combined with negative data, which contain default information.
2. Experian is a global information and services group operating credit bureaus.
3. The Credit Information Corporation was created by the Government of the Philippines in 2008 as a public institution with the mandate to make accurate and low-cost credit information available to micro, small, and medium-sized enterprises while also ensuring the protection of consumer interests.
4. BIMA (<http://www.bimamobile.com>) is a microinsurance and health service provider primarily using mobile technology.
5. The cost of sending \$100 has fallen from \$4 in 2014 to \$2 in 2015.
6. According to the Financial Action Task Force (FATF), "de-risking refers to the phenomenon of financial institutions terminating or restricting business relationships with clients or categories of clients to avoid, rather than manage, risk in line with the FATF's risk-based approach" (FATF 2014).
7. Pradhan Mantri Jan Dhan Yojana is a financial inclusion initiative launched by the Government of India in 2014.
8. The Credit Risk Database (CRD) Association (which is unique to Japan) provides information on the creditworthiness of the average borrower in the group having the same attributes which were established for financial institutions to have an advance risk evaluation system for SMEs; the data in these databases cover financial data from more than 3 million of Japan's 4 million SMEs. Some of the association's members use CRD scoring models with its larger dataset to validate internal scores generated with institutional data, while others develop internal ratings models that also consider other qualitative factors for more accurate results (Kuwahara 2016).





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\*The Asian Development Bank refers to "Vietnam" as Viet Nam.

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