Models of Including Financially Inactive Population into the Financial System

Matić, Branko and Serdarušić, Hrvoje

Ekonomski fakultet u Osijeku, Fachhochschule Pforzheim
Hochschule für Gestaltung, Technik und Wirtschaft

2008

Professor Branko Matić, Ph.D.
Hrvoje Serdarušić, B.Sc. Econ.
Faculty of Economics in Osijek

Models of Including Financially Inactive Population into the Financial System*

Summary

Raising money and directing it into savings is the most important passive task in banking. Restrictive monetary policy makes it increasingly difficult for banking institutions to take loans, thus they turn to the general population as a money source. Their interest is partly served through inclusion of financially inactive population. As the new legislation will correct the current illogical situation (some deposit institutions have not been under control of the central bank), this will eliminate the unfair competition which is at the moment existing in the banking system. At the same time, the operation of a new form of non-profit deposit institutions, i.e. credit unions, will be regulated. With solidarity and common interest as the basic tenets of their operation they can be attractive to this particular segment of population. The paper explores and proposes some possible models and ways of including the financially inferior population into the financial system.

Key words: financial system, financially inactive population, money source, solidarity, common interest, credit union

* The presented results are the outcome of the following projects: 1. Bank System in the Financing of Polycentric Development (No. 010-0102290-1284), 2. Financing of Local and Regional Self-Government (No. 010-0102290-2446) and 3. Restructuring of Companies in Business Distress (No. 010-0102290-2292), conducted with the support of the Ministry of Science, Education and Sports of the Republic of Croatia

Introduction

The changes induced by globalization and informatization have prompted the financial system to adapt to new business conditions and requirements. The first noticeable development is increased transparency of the financial system as a whole, speed of financial transactions and increased competition. Rigid controls imposed on the banking system in view of its role in the entire financial system, and partly restrictive measures of monetary and foreign exchange policies have additionally limited the system's competitiveness. This fact has opened the field for the emergence of new financial institutions which are not subject to such rigid control, making them thus into partly unfair competition for the banking system. The interest of both types of institutions is to secure sufficient funds for their operations, so they are oriented towards:

- classic money sources (primarily different types of saving)
- modern (contemporary) sources of funds (issuing different securities etc.)

The banks have been forced by the current situation to adapt their business policies. They prefer the traditional approach to fund raising, and for several reasons. These are primarily the transparency of their customers, but also relatively low risk. Encouraged by positive experiences in operations with the general population, some banks have introduced new practices, and are trying to include into the financial system also that segment of financially inactive people who do not yet participate in it for various reasons. The topic of this paper is finding the ways and models of attracting and involving them in the system.

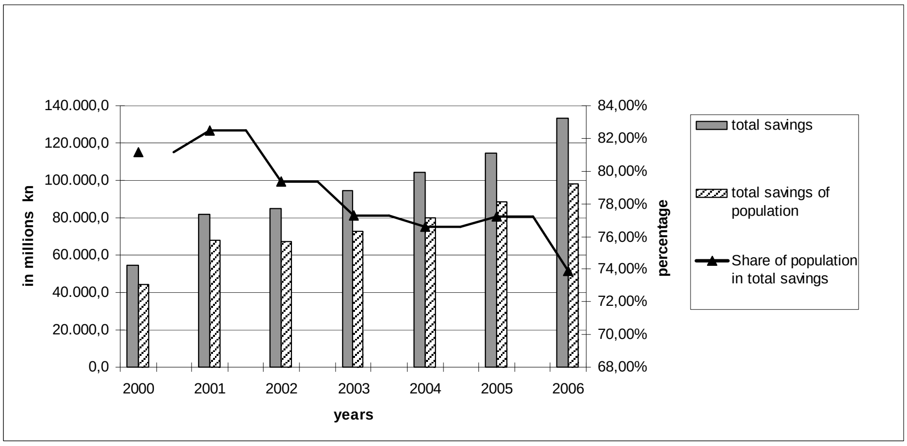
The basic hypotheses that the paper will attempt to substantiate are the following:

- a financial system will become more stable with the increasing number of people involved, i.e. participating in it, and
- common interest, based on trust, solidarity and social sensitivity can be an impetus for growth and development.

Financial assets belonging to Croatian population – savings vs. investments

Raising money and directing it into savings is the most important passive task in banking. Residents' financial assets are frequently the biggest source of funds for banking institutions. Similar experiences can be noticed in Croatia, as residents deposit their financial assets into banks in different types of deposit and savings accounts. This situation has resulted partly from the echoes of planned economy model, and partly from local traditions. Some reasons for high rates of savings in banks might be the confidence in the bank system stability, and the fact that bank deposits are mandatorily insured, in contrast to other non-bank financial institutions. Residents' savings account for more than 80% of total savings. As for the structure, foreign currency savings are dominant, especially in Euro. If we study the residents' savings in the Republic of Croatia between the years 2000 and 2006, we can see that within those six years the amount of resident's savings in banks has doubled, reaching 98 billion kunas in the year 2006. (Graph 1)

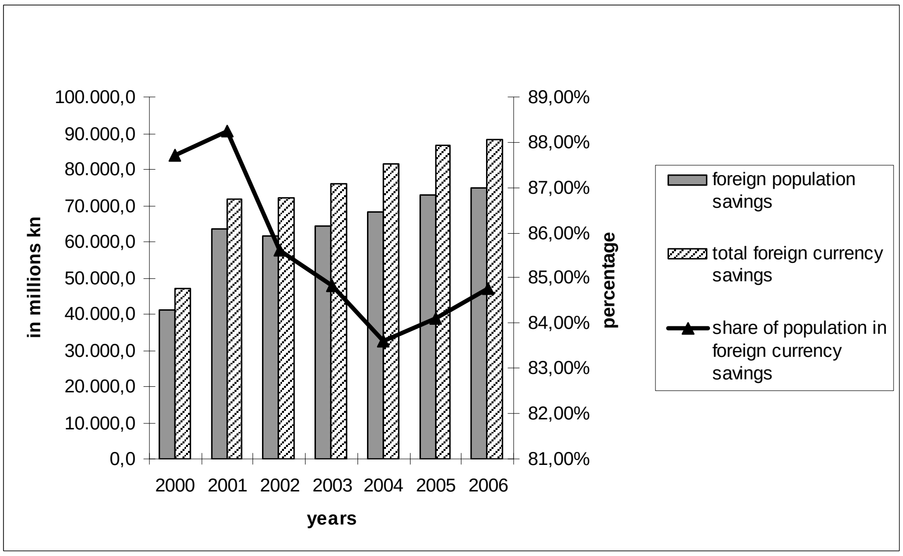
Graph 1: Share of population in total savings



Source: www.hnb.hr (20 September 2007)

Lack of confidence in the banking system stemming from pre-transition times, and partly negative experience with bank operations after that period (banking system crisis), can be a factor determining residents' behaviour as depositors, along with some other aspects, such as inflation and habits. A considerable portion of savings used to be kept outside the banking system in different foreign currencies (DM, USD, CHF, ATS). Such a situation motivated the banks to make efforts and persuade the owners to trust banks with their financial assets. This was done by offering no-fee conversion for deposited assets. Almost all the money hoarded at home ended up in the banking system, and after 2002 it was converted into Euro. After the conversion most of the funds raised in this way actually remained in the banking system (Graph 2).

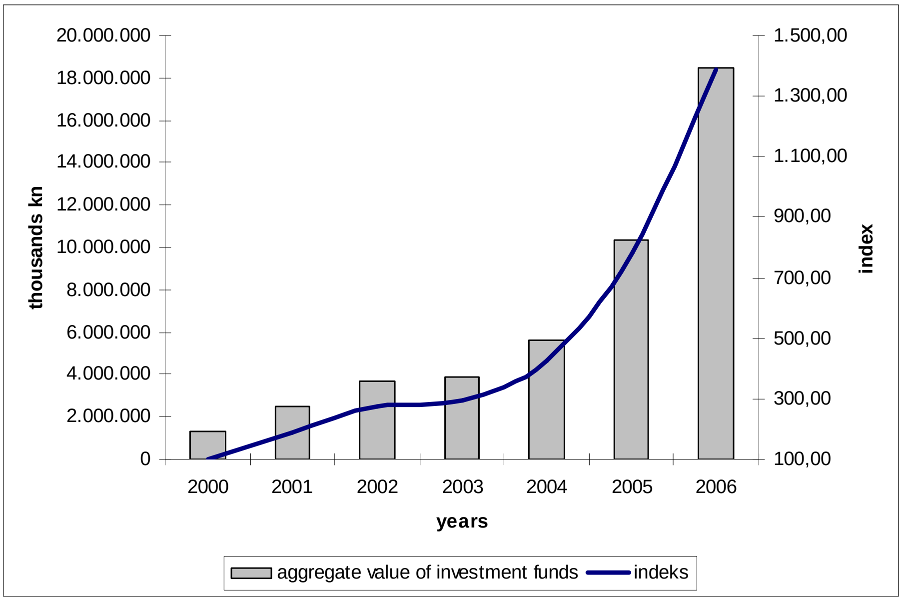
Graph 2: Share of population in foreign currency savings



Source: www.hnb.hr (20 September 2007)

The development of the financial and banking system have brought about new forms of investment. A noticeable trend in the financial system is that clear boundaries between banking and financial operations are becoming blurred. In addition to traditional bank savings, the majority of active work force has in recent years turned their attention to investment into different types of financial assets. This phenomenon was spurred by the development of the Croatian capital market and by institutional reforms, primarily the pension system reform, which indirectly and directly encouraged the capital market development. Another factor was the government decision to direct its borrowing to the domestic market. Also, there appeared different types of insurance and investment funds. For Croatia, these were all new types of investment, giving higher returns that traditional bank savings, and thus they initiated the change in the structure of residents' financial assets. This transfer of money savings from banking into non-banking institutions of the financial sector is typical of the world trend in modern finances. Given the increase in investment funds' assets, one can assert that the Croatian capital market sky-rocketed from 2 billion kunas in early 2000 to 18.5 billion kunas in the year 2006, which indicates that the increasing number of residents prefer to invest into capital markets (in addition to traditional bank savings), expecting higher returns on their assets (Graph 3).

Graph 3: Investment funds' total assets



Source: HANFA, Annual Report 2006

New possibilities and ways of raising financial assets

Given the fact that residents' bank deposits are diminishing as a financial source, some banking institutions are turning to financially inactive part of population, who have so far not participated in the banking system for various reasons. Experience from countries with a long banking tradition indicates that these categories of population, under certain conditions, can also participate in the banking system, and thus achieve multiple goals. These include satisfying more fully the interests of individuals (members), interests of bank, and achieving banking system stability. Having established the legal prerequisites in the Bank Act[2] and the Credit Union Act[3] Croatia now has the preconditions for achieving those goals. It is now possible to establish within the banking system new forms of non-profit banking institutions based on solidarity and fulfillment of common needs shared by their members. Furthermore, this legislation provides proper conditions for including the financially inferior population

[2] Zakon o bankama (NN 84/02, 141/06 – *Official Gazette*)
[3] Zakon o kreditnim unijama (NN 141/06)

into the banking system. In defining the common interest, they can specialize and target farmers, students, pensioners, homemakers, the unemployed and salaried workers.

Reasons for the emergence of credit unions and their role in today's world

The first credit unions emerged as far back as 1778 with the first savings cooperative in Hamburg. One of the reasons why credit unions came into existence was the need for mutual assistance of their members, based on solidarity, in times of economic crises, wars, natural disasters or currency instability. Their role in today's world has kept the crucial reason for their emergence, which is common interest of development and prosperity for all the members, based on voluntary and non-profit work. This statement can be substantiated by the idea of Nobel Prize winner Muhammad Yunus, the founder of the Grameen Bank from Bangladesh, which proved that you can conduct business by offering relatively small loans of up to 9 US$, without taking any collateral, to the segment of society too poor to qualify for traditional bank loans. With its successful application of the concept of micro-credit, this model has proved to be quite an innovative banking approach.

Principles of credit financing for members

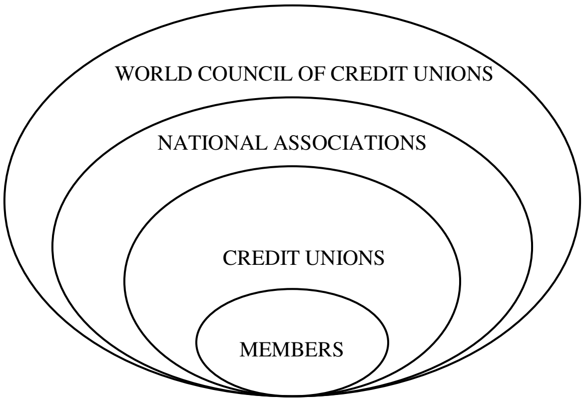
Granting loans to their members is closely connected with the operating principles of credit unions. According to the World Council of Credit Unions, their operation can be viewed through the following three dimensions:

1. democratic organizational structure
2. service provided to its members
3. social goals.

Democratic organizational structure refers to open and voluntary membership excluding any discrimination based on gender, religion or race. When new directors are elected, each member is entitled to one vote, regardless of how much money he or she has deposited so far, and has the right to vote and be elected. Being a member of the credit union board is based on voluntary work, which means that directors do not receive any salary or compensation, but work for the benefit of all the members, who can replace them if their work is not satisfactory. In this way there is transparent and public control of directors' performance, which in turn means that trust, integrity, moral and ethical standards are the foundation of this particular model of saving.

The second dimension includes achieving financial stability by extending micro-loans to its members and providing other services at lower than market prices, thus saving their money (this can include money transactions at lower rates, encouraging self-employment, etc). First some individuals join in the credit union, followed by association at higher levels, and the exchange and mutual assistance at different levels helps to maintain financial stability (Figure 1). Such association is the only way to achieve synergistic effects at the world level, which is important in setting the standards for financial services and the governance rules, supervision and anti-money laundering measures, as well as for exchange of experience between members of these associations.

Figure 1: Advocacy at multiple levels



Source: World Council of Credit Unions, A tehnical guide to increase citizen participation; p. 8

The social aspect of credit union operation must not be disregarded. Since credit unions have certain funds at their disposal, they can foster and offer education and training programmes to their members who would normally not be able to afford education. In this way they assist in creating the basis for further development of local communities, since individuals and society as a whole cannot move forward without knowledge and life-long learning. Mutual assistance, especially to disadvantaged and vulnerable groups, is one facet of socially sensitive activity which is the pillar of credit union operation.

Amount of funds at credit unions' disposal

The strength is not in individuals but in the community working towards a common goal – improving their living standards. This is noticeable in collecting small, sometimes minute and seemingly insignificant amounts of money that, put together, represent significant initial assets. If properly channeled, these assets can contribute to growth, development and mutual benefit of all the union members. The sheer number of 172.010.203 members in 97 countries of the world who are involved in credit union system is witness how widely spread and accepted this form of saving is. Until 2006, the total amount of deposits collected in 46.377 credit unions around the world exceeds 900 billion US dollars, which is the average of 5.200 US dollars per member. Taking into account the total assets, it is easy to conclude that these figures confirm the hypothesis that such deposit institutions are both significant and financially strong. (Table 1)

Table 1 : Credit unions in the world in 2006 **USA $**

Number of countries included in the credit union system	97
Number of credit unions	46.377
Membership	172.010.203
Market share	7.36%
Deposits	904.123.492.396
Loans	758.215.979.921
Reserves	106.831.725.217
Total assets	1.092.146.353.173

Source: World Council of Credit Unions, Statistical Report 2006**.**

Non-profit credit organizations in the Republic of Croatia

In Croatian history of banking one can notice protection of general interest through social approach and protection of interest of disadvantaged groups of population. Thus already in the Dubrovnik Republic, two of its financial institutions, namely the Mint (since 1337) and the Pawn Institute (since 1671), promote public interest through granting interest-free credit and loans to public institutions, the Church, and to citizens. As institutional banking developed in the 19th and 20th centuries, certain banks and savings cooperatives operated with the general public interest in mind. This is especially true of institutions founded with Croatian capital, such as *Prva hrvatska štedionica* (1846), i.e. the First Croatian Savings Bank.

All this shows a long tradition of organized deposit collection in Croatia, admittedly, with interruptions caused by different historical and political reasons. In the Republic of Croatia today there are various forms of regulated and unregulated institutions and organizations that extend more favourable loans to their members on a voluntary basis. These include:

1. savings and loan cooperatives
2. foundations and trust funds
3. trade unions – union assistance funds
4. mutual assistance clubs

Operation of savings and loan cooperatives is regulated by law[4]. They are based on the principle of voluntary cooperative association in order to extend favourable loans to their members. “A savings and loan cooperative is a financial institution of cooperative members in whose operations each member participates according to the principle of mutual assistance, at the same time improving and protecting his economic and other professional interests...” [5] The basic problem characteristic for Croatia is that savings and loan cooperatives are not supervised by the Croatian National Bank, nor are they included in the banking system. Their operation is actually subject to checks by the Ministry of Finance.

Inefficient, sloppy governance and operation of the majority of savings and loan cooperatives, together with the fact that savings deposits were not insured, resulted in a number of bankruptcies of such institutions and members losing their deposits, which in turn undermined the confidence in this type of saving. For these reasons the Croatian National Bank has initiated legislative intervention through the Act on Amendments on the Bank Act, which proposes a one-year transitional period in which savings and loan cooperatives will have to decide whether to be transformed into credit unions[6], savings banks, or simply to close, i.e. to liquidate.

Activities of foundations and trust funds are also regulated by law.[7] According to this law, a trust fund is “… such assets intended to be permanently used for achieving some public-interest or charitable cause, on their own or through generated income. In the sense of this Act a foundation includes such assets intended to achieve some public-

[4] Zakon o štedno kreditnim zadrugama (NN 84/02)
[5] Ibidem, Article 1.
[6] Zakon o kreditnim unijama (NN 141/06)
[7] Zakon o zakladama i fundacijama (NN 36/95, 64/01)

interest or charitable cause within a certain period".[8] These statements define the basic difference between trust funds and foundations, which have a time limit. Purposeful spending of money from these non-profit organizations is strictly controlled by the trust fund and foundation bodies, as well as by the competent ministry.

The need to enter into trade unions and achieve mutual help of the members has resulted in establishing of different union assistance funds. The purpose of such funds is providing housing, assistance in case of illness, non-repayable grants to members in need, etc. The basic source of finance is the membership fee collected at a certain percentage from the members, subtracting it from their monthly salaries. Another benefit of being a trade union member is the possibility of so-called trade union credit. This is "interest-free"[9] credit agreed between trade unions and retailers, paid back in installments over several months up to a year.

Although the operation of mutual assistance clubs is not regulated by law, i.e. they function without legislative basis this type of saving is practiced by employees in numerous companies. Its purpose is to grant interest-free short-term loans to the members, with the term of repayment normally no longer than a year. Their functioning is based on permanent monthly deposits by members. Although it seems economically imprudent to extend interest-free credit, the only reason for operating such clubs is solidarity and mutual assistance of their members.

All the institutions and organizations mentioned so far have their proponents and opponents. The current situation will certainly induce some changes in business policies and operating practices of banking institutions.

It is probably to be expected that some financial institutions will direct their operations and specialize in the segment of saving based on solidarity. Furthermore, it is expected that this way of including the financially inactive population will create an attractive source of finance.

Including the financially inactive population into the financial system

The notion of financially inactive population includes those people who do not have a single contractual depositing relationship with any banking institution. The following categories belong to this particular group of citizens:

1. financially inferior citizens
    - 1.1. economically inactive population
        - 1.1.1. pensioners
        - 1.1.2. permanent receivers of social welfare
        - 1.1.3. student population
        - 1.1.4. children
2. financially inferior citizens who could be gainfully employed
    - 2.1. working-age population
        - 2.1.1. the unemployed
        - 2.1.2. farmers
            - 2.1.2.1. farmers included in the system of old-age pension insurance

[8] Ibidem, Article 2
[9] The interest is incorporated in the product price, i.e. in the margin.

2.1.2.2. farmers not included in the system of old-age pension insurance

The category of economically inactive population (financially inferior citizens) includes all the pensioners who are not capable to continue working. According to the current legislation, a person is considered to be retired when they turn 60 (for women) and 65 (for men) and if they have a certain number of years of employment. Since this population is so numerous and their income does not permit any significant savings, the opportunity for their inclusion lies in the fact that a certain number of retired people still receive their pension in cash. (Graph 5)

In addition to the pensioners, there is also that part of population incapable of working, and without any livelihood, living on social welfare. As they are currently receiving their education, students are interesting as a potential future source of funds to all the deposit institutions. Most banking institutions have developed different models of attracting students and financing their life and education.

The category of children includes every person up to the age of 15. They do not have any permanent income, but mostly rely on gifts of money from the family. By motivating them to keep their small savings in deposit institutions, a good habit of saving can be established. In Croatia, this population currently numbers about 700.000, which is a respectable number.

Another category is working-age population (financially inferior population that could be gainfully employed). This group includes all the people capable of work aged 15 to 60 (for women), i.e. up to 65 for men. The category of unemployed includes all the people of working age, who are currently not in work for various reasons.

Farmers are a category of working-age population, defined as people who earn their income solely through farming. This population can be divided according to the criterion of being included in the system of old-age pension insurance or not.

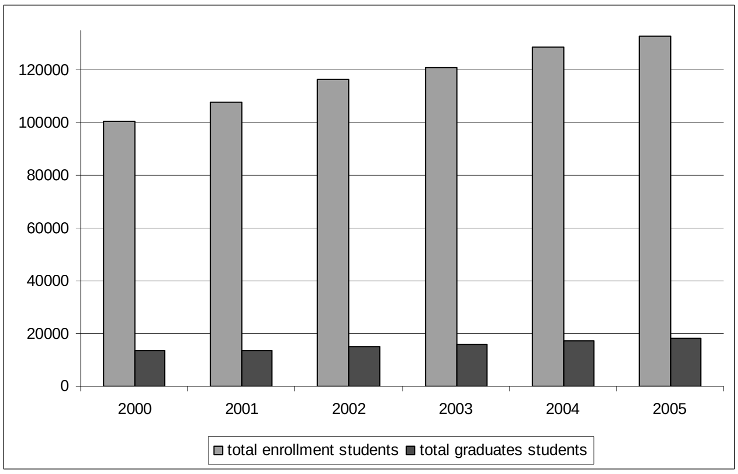
Models of including the financially inactive population

In defining the strategies for attracting financially inactive population, i.e. the people who do not save for various reasons, we would like to propose the following models:

1. saving for quality education
2. saving for health care
3. saving for housing
4. saving for old age
5. saving for interest on the loan

The model of saving for quality education would attract that part of population who cannot easily afford education for various reasons, and thus they would save for their own or for somebody else's education. This model would cover partially or completely the costs of education or training of savers. There is no doubt that this would also help to raise the number of students not only entering the higher education, but also graduating. (Graph 4)

Graph 4: Ratio of students enrolled in higher education and graduates in the Republic of Croatia



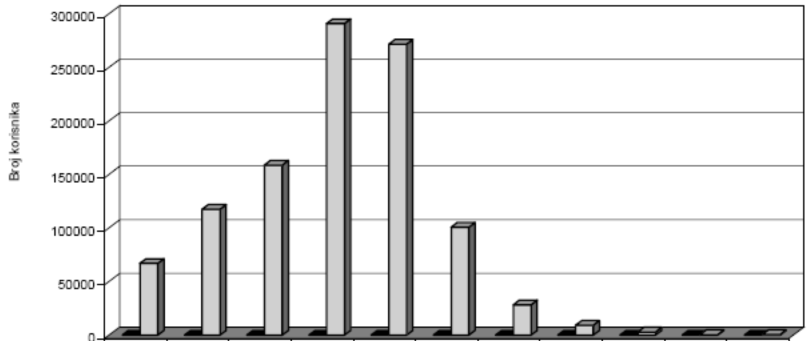
Source: DZS, The Official Yearbook 2006

In the modern world, being healthy and quality health care is everybody's ambition, but not accessible to everyone. The model of saving for health would try to attract a certain portion of society, as their own health care funds would bear those costs (some health care services, medication, etc.).

The model of saving for housing would try to attract younger working-age population, since this issue is at the top of their priorities. A preferable approach here would be the construction of apartment buildings and long-term renting rather than buying. This model would save the future income of tenants, leaving them some maneuvering space for future borrowing.

Old age and dying are integral parts of life. Everybody would prefer to enjoy their old age without too many worries. The model of saving for old age over a certain period of time would guarantee a safe standard of living for senior citizens. The claim that there is a market for such a model lies in the fact that more than pensions of 86% of retired people (i.e. about 900.000 pensioners) do not exceed 3.000 kunas. Another point is that pensioners are usually the most regular payers for the services they receive. (Graph 5)

Graph 5: Structure of pensioners in numbers and pension amounts

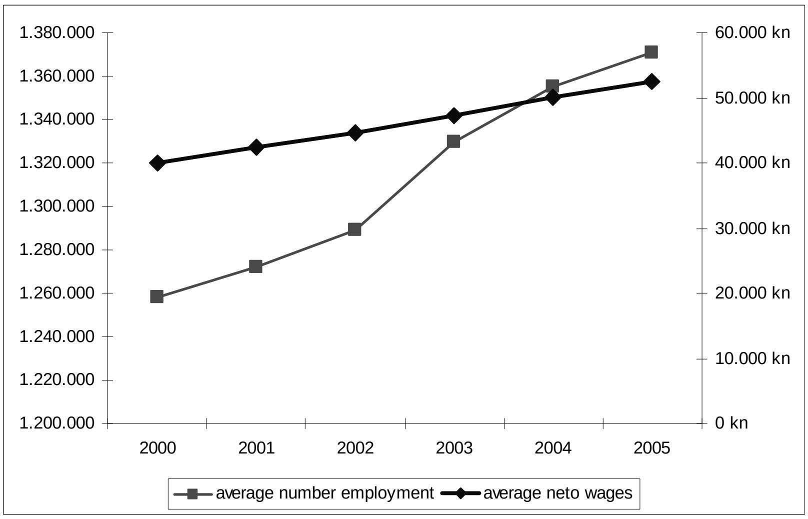


Svote mirovina	do - 500,00	500,01 - 1.000,00	1.000,01 - 1.500,00	1.500,01 - 2.000,00	2.000,01 - 3.000,00	3.000,01 - 4.000,00	4.000,01 - 5.000,00	5.000,01 - 6.000,00	6.000,01 - 7.000,00	7.000,01 - 8.000,00	veće od - 8.000,00
Postotak	6,39	11,21	15,15	27,76	25,93	9,61	2,7	0,89	0,27	0,03	0,04
Broj korisnika	66980	117438	158739	290855	271644	100680	28259	9277	2879	359	471

Source: DZS, The Official Yearbook 2006

The model of saving for interest on the loan should be attractive for a certain portion of 1.370.000 employees who would use part of thus accumulated savings to obtain cheaper, more favourable loans. (Graph 6)

Graph 6: Employment in Croatia and income growth



Source: DZS, The Official Yearbook 2006

Conclusion

The paper has reviewed the current situation and proposed concrete measures and ways of attracting new sources of money from those segments of population who have not been actively involved in the financial system. Countries with long banking tradition based on market principles have established various forms of attracting funds through the banking system.

The amount of total assets exceeding 1.100 billion US dollars (WOCCU, 2006) indicates the importance of institutions whose non-profitable operation is based on solidarity. Such experiences result in the greater number of citizens who participate in the financial system. In Croatia there are different institutions working along similar principles (savings and loan cooperatives, foundations and trust funds), whose operation is regulated by law, and also unlegislated organizations such as mutual assistance clubs.

By passing the Act on Credit Unions and amendments to the Act on Banks (2006), both of which come into force in 2008, legislative requirements are created for stronger development of this segment. Some institutions, which have so far not been a part of the banking system, are now integrated in it through the above mentioned legislation. In this way all the deposited funds will be included in the deposit insurance, which will certainly encourage the financially inactive population to become involved in the financial system. The principle of solidarity and common interest become the basic motive of any saving. This principle would encourage growth and general prosperity. By including the funds that are currently outside the financial system (i.e. money hoarded at home) the whole financial system will prove to be more stable as the greater percentage of population participates in it.

REFERENCES:

1. Leko, V., Stojanović, A.: Neprofitne uzajamne štedne institucije, u knjizi Novac, bankarstvo i financijska tržišta, Adverta, Zagreb, 2005., str. 131-156;
2. Srb, V., Matić, B., Marković, B.: Bankarsko poslovanje, Ekonomski fakultet u Osijeku, Osijek, 2003.
3. Zakon o bankama (NN 84/02, 141/06)
4. Zakon o izmjenama i dopunama Zakona o Hrvatskoj narodnoj banci NN (135/06)
5. Zakon o kreditnim unijama (NN 141/06)
4. Zakon o zakladama i fundacijama (NN 36/95, 64/01)
5. Zakon o štedno kreditnim zadrugama (NN 84/02)
1. www.woccu.org
2. www.creditunion.coop
3. www.dzs.hr
4. www.nn.hr
5. www.hnb.hr
6. www.hzmo.hr
7. www.grameenfoundation.org