Who loses in financial inclusion?

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1 January 2023

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ABSTRACT

Financial inclusion involves the provision of basic formal financial services to members of society. Policy efforts and collaboration with the private sector have helped to increase the level of financial inclusion in many countries. Such efforts give rise to net winners and net losers from financial inclusion efforts. This paper identifies the net losers from financial inclusion efforts. The lesson we learn from the net losers identified in this study is that being 'banked' is only a necessary condition to enjoy the benefits of financial inclusion. Being 'banked' is not a sufficient condition to enjoy the benefits of financial inclusion. We learn that a banked adult can be a net loser from financial inclusion despite being banked. This has wider implications for understanding the challenges to sustained financial inclusion.

Keywords: financial inclusion, banked adults, losers, access to finance.

January 2023

1. INTRODUCTION

Increasing the level of financial inclusion is good for society. Greater financial inclusion means that adults will have greater access to basic financial products and services which they can use to meet their day-to-day financial needs, raise capital to start a business, accumulate savings in a secure financial system, and to insure themselves against risks (Ozili, 2021a; Čihák, Mare, and Melecky, 2021). Greater financial inclusion in the form of more access to basic financial products and services will bring unbanked adults into the formal financial sector, and give them an opportunity to live a more financially secure and stable life.

Many developed and developing countries have used policy efforts, policy tools and collaboration with the private sector to increase access to formal financial services for unbanked adults. After granting access to formal financial services, people make decisions that are either welfare-enhancing or welfare-destructive. In the end, financial inclusion will give rise to 'net winners' and 'net losers'. The net winners are those who gain more than they lose from participating in the formal financial sector. Examples of net winners include wealthy individuals, middle-class citizens, government, banks, non-bank financial institutions, the central bank and the tax authorities (Oz-Yalaman, 2019; Ozili, 2022a; Shihadeh et al, 2018, etc). The net losers are those who experience huge losses, and the loss erode any gains that have been made from participating in the formal financial sector.

This paper focuses on the net losers from financial inclusion. Few studies in literature have examined the negative effects of financial inclusion while many studies show overwhelming evidence about the positive benefits of financial inclusion (Ahmad, Green and Jiang, 2020; Ozili, 2021a; Čihák, Mare, and Melecky, 2021; Ozili, 2020). There are no studies in the literature that examine the losers from financial inclusion. Even in the critical literature, some studies have examined several challenges of financial inclusion such as the potential of financial inclusion to encourage indebtedness (Natarajan et al, 2021); concerns that financial inclusion can lead to the financialisation of poverty (Mader, 2018), and formal lenders violating privacy laws by commercializing the private data of banked adults (De Koker and Jentzsch, 2013; Ozili, 2022b). Despite these challenges identified in the critical literature, the financial inclusion literature has not clearly identified the losers in a financially inclusive society. This study address this issue by identifying in clear terms the losers from financial inclusion.

The study contributes to the financial inclusion literature. It contributes to the literature that examine the challenges to financial inclusion. Studies in this literature identified several challenges of financial inclusion (see, for example, Milana and Ashta, 2020; Mani, 2016; Ozili, 2021b; Kulkarni and Ghosh, 2021). This paper adds to the literature by showing that some banked adults, despite being banked, may not be better off in welfare terms, and this presents a challenge to financial inclusion.

The rest of the paper is structured as follows. Section 2 presents the literature review. Section 3 presents the losers from financial inclusion. Section 4 concludes.

2. LITERATURE REVIEW

There is a consensus that financial institutions, technology companies and regulators are major stakeholders of financial inclusion. Financial institutions and technology companies use financial technology to offer financial products and services to banked customers to increase financial inclusion while regulators ensure that customers are treated fairly in the process (Ozili, 2018). Although financial inclusion efforts have been largely successful in developed countries, the progress made towards financial inclusion in developing countries has been very slow especially in some African countries and in some Latin America countries due to a number of issues that hinder access to basic and affordable financial services (Beck et al., 2015).

The literature points out some issues with financial inclusion that make it doubtful that financial inclusion will realise its potential benefits. Studies such as Llewellyn (2021) identified four barriers to financial inclusion, namely, (i) structural factors such as inadequate financial infrastructure, (ii) institutional constraints such as weak institutions, (iii) demand factors such as low demand for basic financial services due to lack of bank branch presence in communities, and (iv) educational limitations such as limited financial literacy. Sharizan, Redzuan and Rosman (2021) show that developing countries such as Malaysia, witness some hindrance to financial inclusion which are lack of financial education, lack of proper documentation and lack of financial literacy. Ozili (2021b) argues that although the financial inclusion agenda has good intentions, financial inclusion brings benefits that disappear after a few years, it promotes the use of transaction accounts, and digital financial inclusion efforts bear a resemblance to a campaign against having cash-in-hand. Varghese and Viswanathan (2018) point out that financial institutions may be reluctant to serve small value and unprofitable customers that have irregular income because financial institutions view financial inclusion as a business opportunity.

Chen and Divanbeigi (2019) note that despite the commitment of the development community to increase access to finance, financial inclusion rates worldwide are still unsatisfactory. In their study, they assessed whether regulatory quality improves financial inclusion outcomes using data from several countries. They find that countries that have low regulatory quality have low levels of financial inclusion. Beck, Senbet and Simbanegavi (2015) show that foreign banks from emerging markets, including Africa, have contributed to greater financial inclusion, but foreign banks from Europe and U.S have not contributed to greater financial inclusion and this is because financial inclusion is not a major issue in Europe and U.S. López and Winkler (2019) show that high and rising levels of financial inclusion might contribute to a destabilizing credit boom, and that policymakers will face the challenge of ensuring that high levels of financial inclusion does not lead to destabilizing credit boom.

Arun and Kamath (2015) point out that having a bank account does not guarantee long-term participation in the formal financial system, as households can move in and out of the formal financial system over time. They suggest that effort should be made to bring the unbanked into the banking sector, and banks should put in much effort to retain and engage current bank customers to prevent them from becoming un-banked/under-banked. Chen and Jin (2017) point out that limited access to credit can cause financial vulnerability for households and lead to economic loss in a country.

They studied the use of formal credit and informal credit in China. They find that 53.21 percent of households used informal credit, and only 19.77% used formal credit. The findings suggest that informal credit is more prevalent in China due to many households being at a social and economic disadvantage in China. In a related study, in the context of India, Ghosh and Vinod (2017) find that gender differences matter for financial inclusion. They find that female-headed households were less likely to access formal financial services and more likely to access informal financial services compared to households that were headed by males. The studies reviewed above shows that financial inclusion causes some issues for banked customers and households.

3. LOSERS IN FINANCIAL INCLUSION

3.1. Banked adults who are financially-illiterate

An adult who is banked can be financially-illiterate. Financial illiteracy is the inability to manage one's personal finance (Shambare and Rugimbana, 2012). It occurs when people lack the basic money acquisition skills, money saving skills, money management skills and basic financial risk management skills needed to participate in the formal financial sector (Albastiki and Hamdan, 2019; Turner, Klein and Stein, 2016; Shambare and Rugimbana, 2012). Banked adults who are financially illiterate will not enjoy the full benefits of financial inclusion. They will be at the losing end depending on the degree of their financial illiteracy. The reason why banked adults who are financially illiterate will be at the losing end of financial inclusion is because they can own bank accounts but they lack financial knowledge on how to use the bank accounts to improve their welfare in a sustainable way. Their financial illiteracy can lead them to make bad financial decisions and welfare-destructive decisions despite being banked (Turner, Klein and Stein, 2016). For example, banked adults who are financially illiterate can utilize the wrong type of financial products and services when searching for financial products and services to meet a particular need. Banked adults who are financially illiterate can open multiple bank accounts that they do not really need, thereby incurring huge account maintenance fees that ultimately worsen their welfare in the formal financial sector. Banked adults who are financially illiterate can easily become over-indebted (Kiesel and Noth, 2016), as they will likely borrow money from formal lending institutions just because credit is available and accessible without first assessing whether they have the ability to repay the loan from their own personal financial resources. Empirical studies, such as Gathergood (2012) and Gutiérrez-Nieto et al (2017), show a positive relationship between financial illiteracy and over-indebtedness. This suggests that banked adults who are financially illiterate adults are more likely to experience more losses from financial inclusion than the perceived benefits as they are more prone to becoming over-indebted and more likely to make financial mistakes and bad financial decisions. Financial illiteracy is a barrier to financial inclusion because it prevents banked adults from enjoying the full benefits of formal financial services. One reason why financial illiteracy among banked adults persist is because most financial inclusion efforts in many countries end at formal account ownership. Once citizens own a formal bank account, it is often assumed that financial inclusion goals have been achieved. Financial inclusion efforts need to go beyond formal account ownership.

3.2. Banked adults who are extremely poor

It is important to first distinguish between 'banked adults who are poor' and 'banked adults who are extremely poor'. On one hand, 'banked adults who are poor' are adults who have irregular low income and put small deposit in their formal account or bank account. On the other hand, 'banked adults who are extremely poor' are adults who have no income but put small deposit in their formal account.

Banked adults who are extremely poor will hardly enjoy any significant benefit from financial inclusion. This is because banked adults who are extremely poor have no income, and have only small deposit in their account from which formal financial institutions will debit to collect transaction fees and account maintenance fees. Formal financial institutions, including banks, often describe these category of adults as 'unprofitable customers'. In practice, we know that banks impose income thresholds as a part of the eligibility criteria to access formal credit. These income thresholds make it almost impossible for banked adults who are extremely poor to access formal credit due to their lack of income or little account inflow or deposit. By formal credit, I mean loans that are issued by regulated financial institutions. Although banked adults who are extremely poor will have access to savings and deposit products, they are unlikely to have access to formal credit because of their extreme poverty status.

Some may argue that banked adults who are extremely poor can access credit facilities from Fintech lenders who do not require documentation or income thresholds, thereby enabling them to bypass banks and formal lending institutions (Agarwal et al, 2020; Bernards, 2019; Ozili, 2018). A counter argument is that many Fintech lenders often embed sophisticated technology into their digital lending applications. The technology allows the Fintech lender to run a quick credit worthiness check on customers' accounts using the account number supplied by the potential poor borrower. The purpose of running the credit worthiness check is to determine whether the borrower is eligible to access Fintech loans based on the credit history information and other information about the borrower's account activity. The result of such credit worthiness checks is often unfavorable to banked adults who are extremely poor, thereby making it difficult for them to access Fintech credit because they fall short of Fintech lending criteria.

3.3. Banked adults who use only deposit account services

Another category of banked adults who lose from financial inclusion are banked adults that only use basic deposit account services. These banked adults are only interested in keeping their money in their formal accounts as deposit. They are not interested in accessing other formal financial services offered by financial institutions even when the services are advertised to them. They are not interested in using available investment and savings products even if the cost is low. They are not interested in mortgage finance products even if the cost of a mortgage is very low. They only care about the safe-keeping benefit of deposit account services. They only care about keeping their money in the bank as deposit, and collecting it whenever they want. Despite the safe-keeping benefit they enjoy, this category of banked adults loses from financial inclusion because the money they keep as deposit in their formal account may not earn interest. Moreover, the deposits are often subject to deductions in the form of bank charges, which reduces the value of customer deposits. Banks can also use the deposits placed with them to lend to others and make a decent profit (Ozili, 2022c), while depositors do not get a share of the profit that banks make from using depositors' fund for lending purposes. This means that owning a deposit account actually benefits banks and other financial institutions in many ways, meanwhile, it offers very little benefit to depositors. In fact, apart from the safe-keeping benefit of owning a deposit account, banked adults who choose to own only a deposit account loses from financial inclusion because they are unable to use other available financial services, such as investment and savings products, to increase their income.

3.4. People who are involuntarily banked

There are people who never wanted to be in the formal financial sector. They were either coerced or forced by their employers or the State to open a formal account or risk losing their expected income if they do not open a formal account or bank account. The fear of losing one's expected income or some benefits will make them open a formal account involuntarily. After involuntarily owning a bank account, many people who are involuntarily banked, especially those in the low income group, often withdraw their funds immediately they receive inflows from their employers or the State. The implication of this behaviour for financial inclusion is that this category of banked adults will not use existing savings products or loan products which the formal financial sector provides. People who are involuntarily banked will be less interested in using existing savings products or loan products because they did not see the need for these financial products in the first place. Rather, they are more concerned about using their bank account to receive inflow and withdraw it immediately before banks begin to collect charges from their account. This behaviour is often caused by a general lack of trust in banks. People who are involuntarily banked do not trust banks.

They believe that banks charge high fees even on small deposits thereby reducing the value of customer deposit.

3.5. The informal economy loses from financial inclusion

The informal economy refers to market-based value-creating activities which are not taxed, registered or regulated by the government and are therefore difficult to measure (Restrepo-Echavarria, 2014). The informal economy is visible in the form of survivalist business activities that are conducted from pavements, pedestrian malls, transport stations, road traffic, streets and from abandoned buildings (Smit and Musango, 2015). The informal economy has a bad reputation for conducting economic activities outside regulatory oversight, reducing government revenue collection, and for increasing corruption (Sakuhuni, 2014; Ouédraogo, 2017; Neef, 2002; Hoa, 2019). But the informal economy also has benefits that need to be acknowledged. Some benefits of the informal economy include lower prices of goods and services and job creation for people who cannot gain formal employment (Sakuhuni, 2014; Ketchen Jr et al, 2014; Alter Chen, 2005). People may not be able to gain formal employment either because they are too young, uneducated, unfit or unqualified for employment in the formal economy. These category of people often rely on the informal economy to find a means of livelihood. Most of the jobs they find in the informal economy are jobs that rely on cash-based transactions.

Greater financial inclusion will reduce the size of the informal economy and lead to a reduction in cash-based activities in order to bring informal economic activities into the formal economy. The government can reduce the amount of cash in circulation, which will make cash become limited in supply and scarce. Prolonged scarcity of cash will shrink the informal economy and displace workers in the informal economy. The consequence is loss of jobs for people who rely on the informal economy to survive. As a result, the informal economy loses from financial inclusion.

4. CONCLUSION

Financial inclusion will give people access to basic banking products and services which they can use to improve their welfare. However, despite the potential benefits of financial inclusion, there will always be net winners and net losers from financial inclusion. This paper identified some net losers from financial inclusion. It showed that the net losers from financial inclusion are: banked adults who are financially-illiterate, banked adults who are extremely poor, people who are employed in the informal economy and people who are involuntarily banked. The implication is that while efforts are being made to bring basic financial services to unbanked adults, policymakers have to deal with the problem of banked adults who lose out on the full benefits of financial inclusion. There is a need for policy makers to identify the losers from financial inclusion and reduce the number of losers from financial inclusion. Initiatives that are introduced to expand financial inclusion should be one that reduce the number of losers from financial inclusion in order to ensure that financial inclusion achieve its maximum benefits for all members of society. It is recommended that policymakers should provide mechanisms to ensure that those who lose out on the full benefits of financial inclusion are encouraged to increase their participation in the formal financial sector. Future studies can examine the net winners in financial inclusion. Future studies can also identify the compensation that can be given to losers from financial inclusion to compensate them for the net loss they experience in the formal financial sector.

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