Financial inclusion-exclusion paradox: how banked adults become unbanked again

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Abstract

This paper analyses how financially included adults might become unbanked again. Agents of financial inclusion incorporate economic and social constraints in the delivery of formal financial services. These constraints limit the ability of poor banked adults to use basic financial services to the fullest. The constraints affect agents of financial inclusion positively, and affect customers negatively up to a point where the marginal benefit of being financially included is negative for poor customers. When the marginal benefit of using formal financial services becomes negative, the affected banked adults may discontinue using their formal accounts or exit the formal financial sector when they can no longer bear the negative effect of social and economic constraints that hinder their ability to enjoy basic financial services to the fullest.

Keywords**:** Financial inclusion, financial institutions, financial exclusion, banked adults, formal accounts, paradox, access to finance, households, constraints.

JEL Classifications: G2, G21, O16.

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1. Introduction

How is it possible that people who have been banked or financially included in the formal financial sector after a while become unbanked again? This is a paradox. In this paper. The purpose of this paper is to describe how this happens.

Financial inclusion involves bringing a large segment of the unbanked population into the formal financial sector (Ozili, 2018). The literature show that financial inclusion efforts and policies have helped to bring a large segment of unbanked adults into the formal financial sector (e.g. Markose et al, 2020; Jones, 2008; Ouma et al, 2017; Ozili, 2020a; Ozili, 2021a). The most basic step to achieve financial inclusion is through formal account ownership (Demirgüç-Kunt and Klapper, 2013; Allen et al, 2016; Ozili, 2020a). An individual who owns an account in a formal financial institution is considered to be financially included (Allen et al, 2016).

Certain conditions, such as favourable policies and regulations, encourage greater formal account ownership (Arun and Kamath, 2015; Chen and Divanbeigi, 2019; Ozili 2018). Such conditions attract households and poor individuals to own a formal account which gives them access to formal savings, formal credit and other basic financial services. In contrast, other conditions such as institutional racial profiling, high account maintenance fees, multiple taxation, excessive bank charges and discrimination, can discourage formal account ownership and formal account usage. These conditions make people abandon formal financial services, leading to greater patronage of informal financial services such as peer-to-peer lending and increased patronage of the services of loan sharks.

This paper analyses how financially included adults might become unbanked again. Using discourse analysis methodology, I begin by documenting some financial inclusion success stories. Secondly, I present some antecedents to financial inclusion. Thereafter, I show how previously banked adults can become financially excluded again.

The analysis in this paper contributes to the financial inclusion literature in the following ways. One, it contributes to several studies that examine the challenges that hinder financial inclusion (e.g., Rao and Bhatnagar, 2012; Mehrotra and Yetman, 2015; Ozili, 2021b). Two, it contributes to the theoretical literature on financial inclusion (e.g., Kling et al, 2020; Ozili, 2020b). It contributes to this literature by providing insight on how banked adults can become unbanked again.

2. Financial inclusion - success stories

There are real world examples of successful financial inclusion programs and policies.

INDIA: The Pradhan Mantri Jan Dhan Yojana (PMJDY) financial inclusion program in India is the most notable financial inclusion program in Asia in recent years. At inception, the PMJDY program recorded an opening of over 18 million bank accounts in one week in 2014. The government introduced the PMJDY programme to provide financial services such as savings and deposit accounts, remittance, credit, insurance and pension. The objective of PMJDY is to ensure greater access to financial products and services. This was achieved by using technology to lower cost and widen the reach of financial services to rural communities. The number of PMJDY accounts rose to over 400 million in August 2020 from 179 million in August 2015. Also, average deposit per account rose to Rs. 3239 in August 2020 from Rs. 1279 in August 2015. The increase in average deposit per account shows the increase in the usage of PMJDY accounts. Also, the number of debit cards (or Rupay cards) issued to PMJDY account holders rose remarkably from 157.4 million in August 2015 to 297.5 million in August 2020.[1]

RWANDA: The creation of community saving and credit cooperatives, also known as Umurenge SACCOs, is one of the greatest success story for financial inclusion in Africa. These cooperatives attracted over 1.6 million customers in 3 years. The SACCOs serve almost the same number of people served by the entire banking

[1] https://pib.gov.in/Pressreleaseshare.aspx?PRID=1649091#:~:text=Pradhan%20Mantri%20Jan%2DDhan%20Yojana%20(PMJDY)%20is%20National%20Mission,Pension%20in%20an%20affordable%20manner.

sector. More than 90 percent of Rwandans now live within a 5 km radius of an Umurenge SACCO.

KENYA: The M-Pesa was introduced as a phone-based peer to peer money transfer service in 2007. In 2012, there were 19.5 million mobile money users in Kenya which represents 83% of the adult population in Kenya. The operators of the M-Pesa 'Safaricom' pays commission to its agents on a monthly basis. The amount paid to the M-Pesa agents is determined by how well they meet some target metrics such as agents' transactions per branch, customers per branch, quantities transacted, etc. This led to massive recruitment of agents. The agents penetrated all communities, villages and towns in search for customers. This led to the inclusion of rural people into the formal financial system through the M-Pesa mobile money service.

3. Some antecedents to financial exclusion

By antecedents, I mean factors inherent in society and in the formal financial sector that prevent unbanked adults from using formal financial services as well as factors that prevent banked adults from using basic formal financial services to the fullest.

3.1. Lack of access to modern information and communication technology (ICT) infrastructure

Poor individuals and households without access to modern ICT infrastructure cannot access finance in a convenient way (Chatterjee, 2020). They cannot remain online for a reasonable period of time and cannot access online banking products to manage their spending and saving habits. Andrianaivo and Kpodar (2011), Bansal (2014), Ozili (2018) and Chatterjee (2020) show that the presence of ICT infrastructure, such as digital channels and internet, can help to extend financial services to unbanked adults and households in remote areas, and lower the cost of delivering financial services to customers.

3.2. Lack of financial products and services that meet the needs of all customers

Banked adults, who are also customers, may not find the financial products and services that meet their specific needs. A household may need a savings product that allows savings that are as low as US$10 per year with a 5% interest. Many financial institutions do not offer a savings product for such low amount because they already have pre-determined minimum savings thresholds. For example, a bank may offer a savings product that require customers to save a minimum of US$500 every month and be eligible for 8% interest per annum, which is equivalent to 0.67% interest per month. In the case of loan products, low-income and poor households that do not have valuable collateral may want unsecured credit from formal lenders. They may not find a formal lender willing to offer unsecured loans due to lack of valuable collateral. One consequence of lack of financial products and services that meet the needs of all type of customers is that banked customers will rarely use their formal accounts, thereby leading to account inactivity which is a type of financial exclusion.

3.3. Social exclusion

People who feel excluded from society are more likely to be financially excluded. Ozili (2020c), in a cross-country study, finds a positive association between social inclusion and financial inclusion. This implies that socially excluded people are also likely to be financially excluded. In developed countries, unemployed people, migrants, asylum seekers, dependent adults and people without a credit history, face a high risk of being financially excluded due to their social status (see Datta, 2009; De Matteis, 2015; Pohlan, 2019). Without a credit history, a job and legal identification, it can be difficult for these people to access formal credit from formal financial institution (Ozili, 2020c).

3.4. Over-indebtedness and inability to manage existing debt

Over-indebtedness is an unintended consequence of financial inclusion. Over-indebtedness is often triggered by cross-borrowing and lack of credit literacy (Fanta and Makina, 2019). Having unpaid debt reduces the chance of getting more credit from the same formal lender. Households and poor individuals may obtain additional credit from another lender who is unaware of their existing debt level.

This will lead to over-indebtedness and can, in severe cases, put them at risk of being financially excluded when their credit history is shared with all lenders in the local credit market as they may not be able to access formal credit again. Also, financial institutions may refuse to grant credit to certain customers when they anticipate that the customers might face difficulties in repaying their debt and the interest payments (Gloukoviezoff, 2011). The study of Russell et al (2011) supports this argument. In a study of Irish households, Russell et al (2011) find that households with low income and low educational qualifications were more likely to be excluded from credit markets especially when lenders predict that the borrowers don't have the ability to repay their debt.

3.5. Lack of financial capability

Financial capability is how well people make ends meet, plan ahead, choose and manage money and make financial decisions (Lusardi, 2011). Many people lack the ability to manage their financial affairs in a manner that is consistent with their self-interest, values and personal situation (Marson et al, 2016). For example, heavily indebted households, instead of cutting down spending to save up some money to repay their debt, may rather increase borrowings to maintain their existing consumption level. Also, some low-income individuals may feel the need to increase spending to maintain a lavish lifestyle or to 'keep up with the joneses' in order to impress their richer neighbours not minding their low-income social status. For some households, financial incapability manifests through poor choices or a lack of savings culture, making it difficult for them to meet unforeseen emergencies. One consequence of financial incapability (or fragility) is that it creates consumption shocks when money runs out. This leads to the need for more borrowing, and the affected individuals may seek help from the informal financial sector when formal lenders refuse to lend to such customers.

3.6. Supply-side barriers

The presence of few number of banks and microcredit lenders in a community or town contributes to financial exclusion. When these agents are in limited supply, many individuals will not be able to open a formal account which leaves them unbanked. Also, the insufficient provision of automated teller machines (ATMs), point-of-sale (POS) devices and debit cards can reduce access to finance for banked adults who live far away from a financial institution or a bank and want to withdraw cash or pay for goods and services remotely. Similarly, limited supply of smart mobile phones can prevent access to mobile banking services that offer cheap banking products.

4. The financial inclusion-exclusion paradox

Formal account ownership will undoubtedly give unbanked adults access to formal financial services (Allen et al, 2016). Owing a formal account will improve access to credit, deposit and saving products from formal financial institutions in the absence of any constraints. When constraints are non-existent, the marginal benefit of using formal financial services is positive.

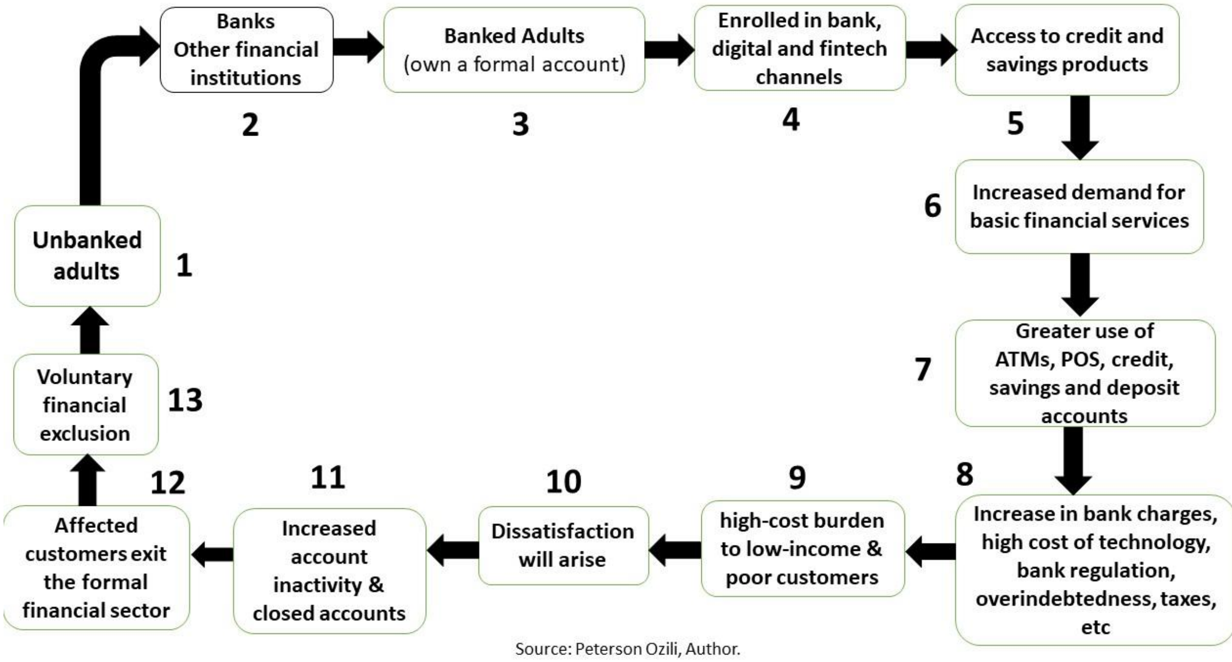
A paradox arises when agents of financial inclusion incorporate economic and social constraints in offering formal financial services. These constraints limit the ability of poor customers to use financial services to the fullest. The constraints affect agents of financial inclusion positively, and affect customers negatively up to a point where the marginal benefit of being financially included is negative for some customers.

When the marginal benefit of using formal financial services becomes negative, the affected customers (or banked adults) will evaluate the cost of each constraint they face, and make a decision on whether to discontinue using their formal accounts or to exit the formal financial sector when they can no longer bear the negative effect of certain constraints. These constraints can compel poorer customers to exit the formal financial sector while other customers may abandon their formal accounts, making it inactive and dormant for a long time, and after a while, the formal accounts are closed by the financial institution which leads to financial exclusion.

Figure 1 below provides a simple illustration of the financial inclusion-exclusion paradox. After extensive policy efforts, marketing and persuasion have been used to bring unbanked adults into the formal financial sector, the new entrants are handed over to profit-seeking agents such as banks and Fintech agents as shown in figure 1. The new entrants are offered formal accounts which gives them access to credit, deposit and savings products. Excitement about their new opportunity will make them invite family and friends to join the formal financial sector (Ozili, 2018), leading to higher demand for formal financial services. This then creates an opportunity for banks and fintech businesses to profit from the growing market by introducing fees and charges such as account maintenance fees, charges for using Fintech platforms, fees for using certain financial products, etc.[2] These fees usually have no effect on high-income users and users that receive frequent account inflows because their frequent account inflows (or infrequent large account inflows) helps to dampen the effect of the cost of financial services.

Fees imposed for using financial services can become burdensome to low-income customers, poor customers, and customers that receive little or no account inflows – this group of people may have been jobless or heavily indebted prior to joining the formal financial sector – and the fees imposed for using financial products and services can wipe away the cost savings that low-income and poor customers hope to gain by joining the formal financial sector. This can lead to dissatisfaction and frustration among low-income and poor customers, they can refuse to use formal financial services again until their accounts are closed while other dissatisfied customers will prefer to exit the formal financial sector immediately. This describes how previously banked adults can become unbanked again which is the financial inclusion-exclusion paradox.

[2] Bachas et al (2018)



Source: Peterson Ozili, Author.

5. Solving the paradox

1. **Eliminate all constraints faced by customers**

Significant policy efforts should be made to eliminate all constraints using all available policy instruments, private sector partnerships, cooperation and advocacy. Social constraints, such as informal norms, cultural barriers and racial profiling, should be eliminated through community orientation and re-orientation programmes. Economic constraints, such as high interest rates, unemployment, high cost of financial services, and high taxes, can be eliminated through job creation government policies, public works programmes, lower taxes, introducing regulation that lower that cost of financial services for low-end customers, etc.

2. **Introduce an income-based costing approach for financial products and services**

Many agents of financial inclusion such as banks and Fintech players adopt a fixed cost approach to pricing financial products and services. They charge the same fee to poor users, low-income users, middle-income users and rich users that use certain financial products and services. Such fixed costing approach affects low-income and poor customers more than it affects middle-income and rich users. An alternative costing approach is the income-based approach. This approach allows low-income customers to pay a low fee, and poor customers pay a much lower fee, when they use financial products and services than the fees paid by high-income customers. This approach will reduce the cost burden on poor banked adults and encourage them to remain in the formal financial sector for a long time, thereby preventing a situation where poor customers exit the formal financial sector due to high cost of financial services. To adopt this approach, agents of financial inclusion must develop a model that categorise customers into income groups, and then allocate a price to each income group so that customers are charged the fee associated with the income category they belong to.

6. Conclusion

This paper examined the financial inclusion-exclusion paradox. The main argument is that social and economic constraints exist in the formal financial system and these constraints can make banked adults become unbanked again. This situation describes a paradox because banked adults can become financially excluded (or unbanked) when economic and social constraints make it difficult for them to remain in the formal financial sector. They may feel better off when they are outside the formal financial sector.

Policy makers should identify these constraints and understand how they affect access and use of basic financial products especially how it affects low-income and poor individuals. Policy instruments can be used to eliminate some of these constraints. Public-private sector collaboration can also help to eliminate some constraints.

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