BANK FOR INTERNATIONAL SETTLEMENTS

Discussion on “The pros and cons of financial inclusion policy in Asia: evidence from the PMJDY” by Sumit Agarwal

October 2015

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The views reflect those of the presenter and not necessarily of the Bank for International Settlements.

Outline

- Main findings of the presentation
- Public policy approaches to expanding financial inclusion and the related trade-offs
- Balancing financial inclusion and financial system risks
- A few comments on the PMJDY

Main findings of the presentation

- Asia's rank in various measures of account penetration is low compared to OECD – South Asia is far behind East Asia and the Pacific
- The percentage of adult population covered through internet payment is about 15% in East Asia and the Pacific – under 5% in South Asia.
- In East Asia and the Pacific (excluding China) about 25% use any account to save - the ratio is less than 10% in South Asia.
- Less than 10% of adult population do any borrowing through formal financial systems in East Asia and the Pacific (about 5% in South Asia). A large majority did not borrow at all.

In sum, expanding financial inclusion remains a major challenge in the region

Can PMJDY be a solution to low financial inclusion?

- The case study on India is a very novel way of posing the public policy question : Not only is the access to finance quite low in India, the country has a long history of policy-led inclusion prgrammes.
- PMJDY is a big scale innovation in several ways:
  - A truly mass-banking programme (18% of population above 15 years of age have opened bank accounts; Rs16 billion have been mobilised)
  - Focus is on households rather than individuals
  - Promotes universal banking; offers saving, credit, payment, and insurance products for low income households.
  - Channels direct benefit transfers for government schemes.

Author’s evaluation

- Low viability because banks are likely to make losses (the losses could be reduced through commissions charged on government transfers)
- A large number of accounts are either dormant or have zero balance (duplicate accounts or accounts opened to benefit from overdrafts)
- Business correspondence model has not picked up: unprofitable and most overdue amounts are expected to be written off
- Public sector banks have dominated account opening suggesting mandated nature of the programme

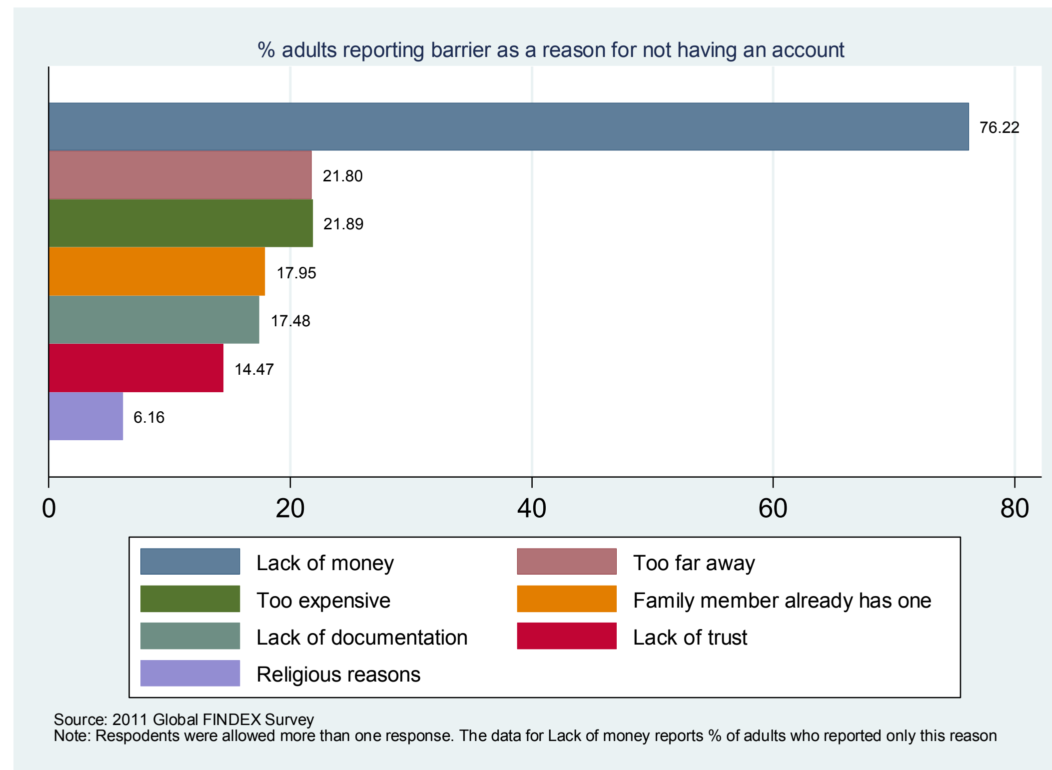
Public policy intervention to promote financial inclusion

- In a frictionless world, access to finance is demand determined – limited by intertemporal wealth constraint of the borrower and the availability of profitable investment projects.
  - Lack of borrowing reflects low permanent income and hence less desire to smooth consumption
  - Similarly, lack of borrowing by firms reflects lack of enough projects with a positive net present value.
  - In other words, financial development follows growth
- In the real world, various frictions mean financial access and growth opportunities can be limited.
- The types of frictions would determine the nature of government intervention

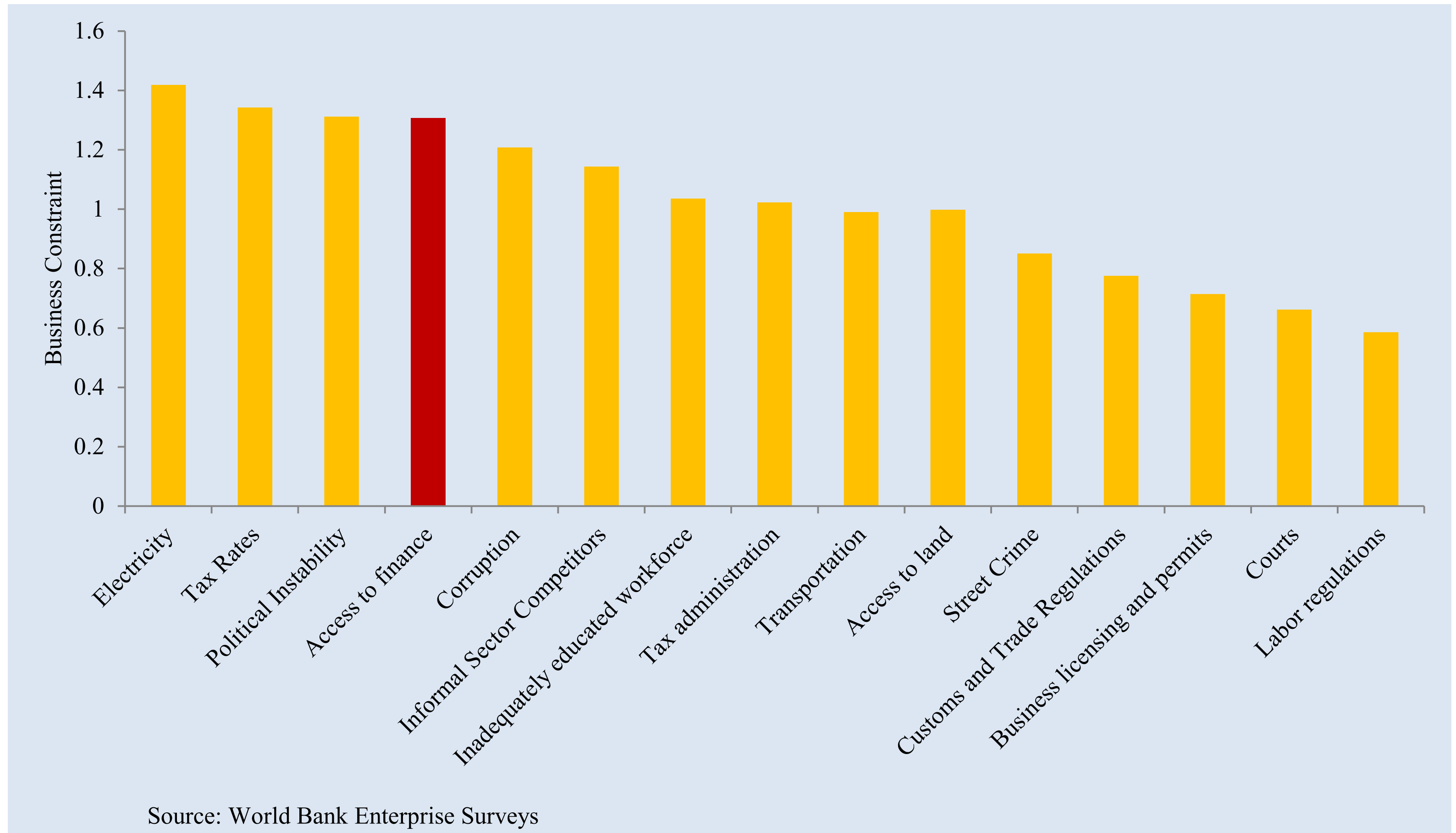
Types of frictions restricting access to finance

- Asymmetric information between borrowers and lenders: institutional and legal frameworks plays a role (collateral registries, credit bureaus, credit reporting systems, and microcredit).
- High fixed costs and externalities: banks require upfront investment to provide services while benefit to customers depend on the number of customers already using the service (technology could be a solution)
- Imperfect competition and regulatory costs (policy can play a major role in reducing these barriers)
- Self- exclusion because of lack of knowledge (policy can play a role in promoting financial literacy).

A global FINDEX survey reported reasons among individuals in developing Asia for not having a formal account (Ayyagari and Beck, 2015)



World Bank Enterprise survey on business constraints facing firms in developing Asia



Why do firms not apply for loans? (from Ayyagari and Beck, 2015)

	Developing Asia	Europe	LAC	MNA	Africa
No need	55.36	64.77	65.38	48.32	37.16
Unfavorable interest rates	14.75	19.84	12.30	11.74	19.25
Complex application procedures	10.81	7.13	5.81	9.64	17.41
Collateral requirements	8.21	4.94	4.62	7.55	11.56
Size of loan and maturity are insufficient	3.36	1.13	1.06	3.77	2.26
Did not think it would be approved	3.22	0.40	2.42	3.04	6.05
Other	4.29	1.80	8.41	15.93	6.32

Policy trade-offs

- While these surveys show that access to finance is not the only major constraint facing individuals and firms, it nevertheless does play a role in limiting growth.
- Certain policy reforms are clear winners, particularly those relaxing institutional and legal constraints and expanding financial literacy.
- A number of other public policy initiatives raise policy trade-offs:
  - Balancing bank profitability and financial inclusion objectives
  - At the same time, minimising risks to financial stability
  - And, preserving central bank's inflation-fighting credibility

Total credit to GDP gap[1]

As a percentage of GDP

[1] Difference of the credit-to-GDP ratio from its long-run, real-time trend calculated with a one-sided HP filter using a smoothing factor of 400,000, in percentage points.

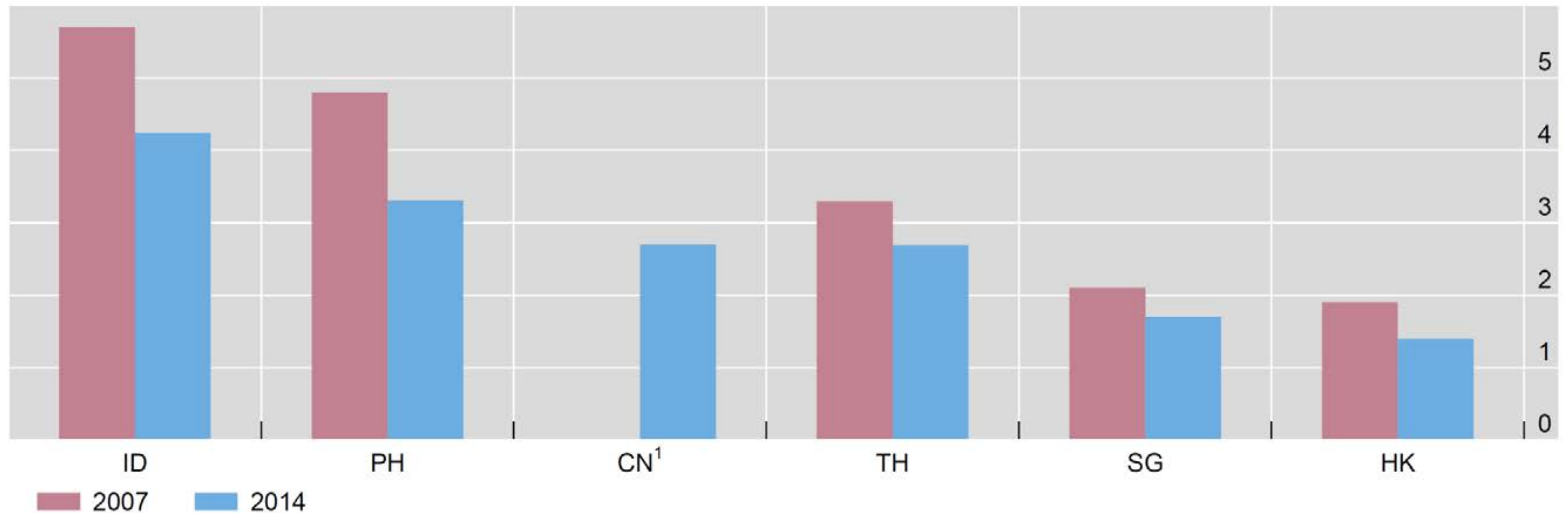
Source: BIS calculations.

Non-performing loans
As a percentage of total gross loans

Sources: IMF, *Financial Soundness Indicators*; CEIC.

Net interest margin

As a percentage of gross income



Sources: Bloomberg; CEIC.

Cross country experience shows that some models appear to perform better than others (CAFRAL, 2015)

- Financial inclusion using technology (eg M-PESA and M-shwari in Kenya): reduces costs and helps better monitoring of borrowers
- Inclusion based on profitability principles: customized business models with deep penetration and well-designed pricing strategy (eg BRI in Indonesia)
- Customer protection: not only from discriminatory practices but also over-indebtedness (eg South African model based on national credit registers, affordability tests and debt review process)
- Minimizing moral hazards: Avoiding partial credit guarantees or write offs.

PMJDY: is it different?

- PMJDY does not seem to perform very well on most parameters mentioned above.
- Yet it does address many shortcomings of the previous programmes that focused on geographical coverage and did not address the incentives issues and potential needs of customers.
- It is a experiment with large potential social implications (could sharply reduce leakages in social benefit schemes and the role of the informal finance. These could be big gains for the economy)
- Success depends on how it is integrated to other government welfare schemes leading to sustainable income generation through financial inclusion.