FINANCIAL EXCLUSION: A NEW ANGLE TO URBAN POVERTY IN LATIN AMERICA

Tova M. Solo

Background

The majority of the urban population in Latin America is unbanked and the majority of the unbanked are hard core poor.

Data gathered during studies conducted over the past four years in Mexico City, Mexico (Distrito Federal); Bogotá, Colombia, and in several Brazilian cities suggests that in these countries somewhere between 65 and 85 percent of households are “unbanked”, those who do not hold any kind of deposit or transaction account in any formal sector financial institution. As Figure 1 shows, the proportions in developed countries are dramatically different. Not surprisingly, the unbanked in all countries show other characteristics of marginality – low incomes, low levels of education, and, in developed countries, high rates among minority and immigrant populations.

Financial exclusion hinders economic development at both macro and micro levels

Figure 1: Financial exclusion is associated with developing countries as seen from comparative percentages of the banked population

<table>
<thead>
<tr>
<th>Country</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mexico, D.F.</td>
<td>24</td>
</tr>
<tr>
<td>Colombia</td>
<td>30</td>
</tr>
<tr>
<td>Brazil</td>
<td>43</td>
</tr>
<tr>
<td>USA</td>
<td>67</td>
</tr>
<tr>
<td>Germany</td>
<td>96</td>
</tr>
<tr>
<td>Spain</td>
<td>74</td>
</tr>
</tbody>
</table>

is no accident that Community Development Corporations in the United States frequently begin their strategies with the courting of local banks to establish branches in their neighborhoods.

In macro-economic terms, financial exclusion means a loss of system efficiency and inequities. Several recent World Bank documents have discussed the effects of financial exclusion on a national economy. A large unbanked population can mean a loss in aggregate saving, inefficiencies in transaction costs, and systemic inefficiencies resulting from investments in less than optimal choices. Finally, the concentration of bank accounts can be seen as a factor in the regressive redistribution of national income, since the earnings on government papers held by banks and the regulatory costs borne by government benefit the wealthiest 35 – 15 percent of the population.

On a micro-economic level, the unbanked pay a high cost for not having formal financial services. Unbanked households spend an estimated 2.5 - 20 percent of income on financial costs, considering:

- **Costs of making payments.** Meeting monthly bills for water, electricity, sanitation, telephone, for health insurance (required by law in Colombia) and for schools – for parents - means a day off work and a trip downtown with a wad of bills.
- **Costs of getting paid.** A full 85 percent of Mexico’s “unbanked” are paid by check. Between trips to the banks that have issued the checks, to check cashing outlets, commercial stores and commissions, they pay anywhere from 5-10 percent of the face value to cash in their earnings.
- **Costs of savings.** In Mexico and Colombia, where short term deposits pay a real return of about 2 percent, informal savings, in the form of cash held at home, represent an opportunity cost in earnings, and a potential loss from robbery.
- **Costs of sending and receiving money.** For the 5 percent who receive income contributions through national or international remittances, costs of sending and of receiving can run to 20 percent of the remitted amount.
- **Costs of borrowing.** Commercial stores (the main lenders to the unbanked), money lenders and pawn shops charge from 10 percent/month to 35 percent per month (150 percent to over 400 percent per year.) compared to current active annual bank interest rates of around 17 percent in Mexico and Colombia.

**Interest by Both Parties to Explore New Options**

The unbanked want deposit accounts but face several obstacles - Survey data confirms that the unbanked do mobilize considerable resources and save in cash, non-cash, and informal systems and that they recognize - and desire - the benefits of formal bank accounts. In the same surveys, the unbanked pointed to financial obstacles such as high initial deposits, minimum balances and fees, among other discouraging factors such as paper work, lack of convenient locations and condescending attitudes from bank employees. Bank regulators from all three countries confirm that most banks require proof of income and minimum deposits equal or above the legal monthly minimum wage. The first tends to disqualify informal sector workers and the second tends to discourage families earning below median income.

Many financial institutions are interested in trying out the new markets. Several commercial banks in Mexico, Brazil and Colombia have begun to test the waters, reaching down scale. At the same time, the non-bank financial institutions (NBFIs) including non-governmental organizations (NGOs) and micro-finance institutions (MFIs), which traditionally focus only on low income groups with credit products, are looking into broad-based banking to increase funding sources. Both banks and non-banks point to regulatory obstacles, however, that limit their opportunities to opening new branches, particularly in low income areas which are perceived as insecure, and, in the case of NBFIs that limit options for receiving deposits.

**What can be done to bring banking to the unbanked - and vice versa?: Five cases from the region**

Measures to reduce financial exclusion focus on three
targets: (i) the financial institutions themselves, helping to overcome obstacles of location and culture and to develop new and appropriate products; (ii) the unbanked populations, through financial education and grant programs; and (iii), on governments to promote new programs and new technologies to monitor information and regulate new institutions. Currently, several teams in Latin America and the Caribbean (LAC) are discussing or have developed projects or components that address financial exclusion.

The Nicaragua Broad Based Access to Finance Project focuses on increasing the number of points of service to remote and unattended communities through support to three levels of the financial system: (i) financial service providers, (ii) financial institution supervisors, and (iii) rural households and businesses. The project offers technical assistance and incentives, such as matching grants, to help supervised financial institutions develop a broader range of products, including low-cost attractive savings. The project also provides assistance to improve internal controls, loan portfolio management, and audits, as well as financing legal advice and other capacity building requirements to help transform MFIs into regulated full financial service institutions. The project supports the Superintendent of Banks and Other Financial Institutions to establish norms, supervision arrangements and consumer protection for financial service clients. To encourage rural savings, the project supports capacity building for financial cooperatives, while building the legal framework and national capacity to supervise and regulate these institutions. To ensure improved service for clients, and a broader menu of financial services (including savings), the project also finances household surveys to measure impact on the unbanked population.

The Colombia Business Productivity and Efficiency Development Policy Loan (DPL) also emphasizes increased service points through regulatory reform. The Colombia policy based loan promotes a regulatory reform to reduce the risks and costs faced by commercial banks offering services to low-income communities by permitting banks to open branch offices inside public buildings (thus helping to overcome cultural and security issues that come into play in low-income neighborhoods or remote areas). Another reform supports the development of a regulatory framework to permit the “Cajas de Compensación” to offer financial services to their affiliates. The “Cajas” are corporate-based social service organizations, financed through company and employee contributions. After forty years of providing health, education, and recreation services to middle and low income persons, the Cajas will now be able to offer savings and credit services as well. In preparation for the project, the government carried out surveys of financial products and costs (under the Superintendencia Bancaria) and of household use of financial service (under the Department of National Administration of Statistics, or “DANE”, household surveys.) The resulting baseline information will be useful to track future trends in the cost of savings products, and in the number and percentage of unbanked.

In Mexico, the National Savings and Financial Services Bank (BANSEFI for its acronym in Spanish) projects help to promote new service providers with state of the art technology and regulatory services. Two World Bank loans are being implemented by BANSEFI to support the sector by: (a) providing technical assistance through consultants to work with the sector entities to prepare them for certification, or merger/liquidation, under the new Law; (b) establishing a technology platform focused on banking-related packages, hardware, data centers, and connectivity services; (c) expanding and deepening the outreach of the financial institutions to the remote and underserved population in seven marginal regions; and (d) establishing a baseline of rural financial sector attributes, and focusing on areas of further study to inform policy and strategy relating to this sector. At the same time, the government is financing some thirty thousand “points of service” for credit, debit and stored value cards.

The Guatemala Community Infrastructure Project proposes a credit guarantee incentive for banks that offer affordable savings products. The Bank is currently discussing an operation with the Guatemalan government that would expand the existing mortgage insurance programs to cover commercial bank lending for a broad range of community services. The proposal is very attractive to commercial banks, such that dialogue has focused on requiring or encouraging participating banks to offer savings products affordable to the ultimate beneficiaries of the infrastructure loans – incidentally facilitating their payment of service fees.

Brazil’s government has developed alternative service payment systems and regulations to encourage access to savings. Measures taken by the government in 2004, at the time that the Bank’s studies on Access to Finance in Brazil were being carried out, follow a model based on the U.S. Community Reinvestment Act in requiring Bank disclosure of location and income levels of clients. At the same time, the government has introduced certain regulatory requirements to encourage
the offering of affordable savings accounts, to extend micro-credit, and initiate a housing subsidy credit-linked scheme to reduce the risk that banks perceive in working with the poor, while working with the judiciary to enforce legal dispositions to customers of all income classes. These efforts follow the government’s long-standing service of receiving utility payments in “lottery shops” and postal outlets, a measure that offers an important payment service, albeit at a high transaction cost, to the unbanked. Recent improvements were reached with the use of banking services in the administration of conditional cash-grants (e.g Bolsa Familia and Bolsa Escola), whereby families below a certain income level receive monthly allowances provided their children attend school regularly, get vaccinated, etc. These grants, targeting women in particular, are dispensed through very simple ATMs that do not require literacy skills, much less previous banking experience. They, however, have a tremendous impact on increasing the familiarity of the population in using banking technology and improving their self esteem and sense of social and economic inclusion.

Further possibilities

Programs in developed countries have focused on the unbanked populations with financial education programs and incentive programs to help the unbanked to save and accumulate assets. In a similar vein, the regulatory agencies in developed countries also actively promote the development of new products, technological advances and increased services for low income groups among bank and non-bank institutions. Development policy lending offers the possibility of rewarding such incentive programs through output based lending linked to increased “first-time saver” accounts and financing incremental government expenditures, such as increased supervisory activities, deposit insurance and incentive programs. Talks with the World Bank’s Operational Policy and Country Services (OPCS) Department representatives suggest that such a program could be feasible, depending, on careful calculations of government costs.

The Government’s role in supporting access to financial services

At a recent meeting with the World Bank, James Carr, Vice President of the Fannie Mae Foundation, stated that “No country has achieved widespread financial services, however profitable and sustainable, without government intervention at the outset.” A review of developed country policies, which paralleled the studies carried out in Mexico and Colombia, tends to confirm this declaration. It also suggests that the most important task for government is information gathering and public disclosure. Tracking the availability and costs of financial service products and making this information public, tracking and publicizing profits from the retail banks, and finally, monitoring the use of financial services as part of household and individual census activities can lead to greater competition (efficiency), stability and access in financial markets.

1 i.e. institutions regulated by government for receiving deposits from the public, as in commercial banks, “social interest” banks, cooperatives, credit unions, etc.
3 In simpler terms, savings under the mattress – which do not get reinvested in productive purposes.
4 Studies from the Mexican Central Bank point out that cash transactions are 5 times costlier than transactions by check, which are, in turn, 15 time costlier than electronic transactions.
5 Families who cannot afford a financial savings account invest in less productive substitutes - a frequent observation by visitors to slum communities.
6 See World Bank, AccessFinance, Volume 3, February, 2005
7 In Colombia and Mexico 60 percent and 63 percent respectively of the unbanked own their own homes, an impressive indication of capacity for investment.
8 A quick calculation based on the Mexico survey suggests that on the order of US$ half a billion is saved at home in Mexico City alone.
9 In particular, requirements of wage and employment verification, tax returns, commercial and personal references.
10 See Housing Programmatic Loan (Report 31756-BR, May 11, 2005)
11 In addition to meetings and incentives designed for banks, US regulators are negotiating with the organizations representing “check cashing outlets” and pawn shops as service providers for the unbanked encouraging them to lower costs and improve services.

About the Authors

This note was prepared by Tova Solo, Senior Urban Specialist in the Latin America and Caribbean region of the World Bank.

About “en breve”

Subscribe to “en breve” by sending an email to en_breve@worldbank.org