FINANCIAL INCLUSION IN ASIA

COUNTRY SURVEYS

ADBInstitute

Financial Inclusion in Asia

Country Surveys

© 2014 Asian Development Bank Institute

All rights reserved. Published 2014.
Printed in Japan.

Printed using vegetable oil-based inks on recycled paper;
manufactured through a totally chlorine-free process.

ISBN 978-4-89974-045-2 (Print)
ISBN 978-4-89974-046-9 (PDF)

The views in this publication do not necessarily reflect the views and policies of the Asian Development Bank Institute (ADBI), its Advisory Council, ADB's Board of Governors, or the governments of ADB members.

ADBI does not guarantee the accuracy of the data included in this publication and accepts no responsibility for any consequence of their use.

By making any designation of or reference to a particular territory or geographic area, or by using the term "country" or other geographical names in this publication, ADBI does not intend to make any judgments as to the legal or other status of any territory or area.

Users are restricted from reselling, redistributing, or creating derivative works without the express, written consent of ADBI.

Asian Development Bank Institute
Kasumigaseki Building 8F
3-2-5 Kasumigaseki, Chiyoda-ku
Tokyo 100-6008, Japan
www.adbi.org

Contents

Figures, Tables, and Boxes iv
Foreword vii
Abbreviations ix
Contributors xiii

1 Overview of Financial Inclusion in Asia **1**
Aladdin D. Rillo

2 Financial Inclusion in the People's Republic of China: Achievements and Challenges **7**
Runzhong Peng, Min Zhao, and Lei Wang

3 Financial Inclusion in Indonesia: A Poverty Alleviation Strategy **45**
Khan Kikkawa and Yuqing Xing

4 Innovations in India: From Agent Banking to Universal Identification **63**
Alan Myrold

5 Thailand's State-Led Approach to Financial Inclusion **89**
Yuka Terada and Paul Vandenberg

6 From Microfinance to Mobile Banking: Making Financial Inclusion Work in the Philippines **111**
Ami Fujimoto and Aladdin D. Rillo

Figures, Tables, and Boxes

Figures

2.1	Pyramid of Banking System and Real Economy in the People's Republic of China	13
2.2	Agro-loans, 2007–2012	19
3.1	Asset Composition of Financial Institutions in Indonesia, 2013	49
4.1	Banking Outlets in Villages	73
4.2	Basic Savings Bank Deposit Accounts	74
4.3	IT-based Accounts—Business Correspondents	75
4.4	Bank Credit to Micro, Small, and Medium-Sized Enterprises	82
5.1	Commercial Bank Branches per 1,000 km^2	92
5.2	ATMs per 1,000 km^2	93
5.3	Financial Access	95
5.4	Access to Deposit Accounts	97
5.5	Deposit and Loan Accounts	97
5.6	Loan Access	99
5.7	Remittance Transfer Access	100
5.8	Regional Profile of Those Sending Money	101
5.9	Interest Rates Charged by Village Funds	103
5.10	Involvement in Farming	104
5.11	Access to Bank Branches and ATMs	106
5.12	Access to Commercial Bank Services	107
6.1	Assets of the Philippine Financial System by Type of Institution, 1990–2013	116
6.2	ATM Network: Philippine Banking System	118
6.3	ATM Network: Rural and Cooperative Banks	118
6.4	Philippine Mobile Phone Subscriptions per 100 Inhabitants	125

Tables

2.1	Development of the Financial System in the People's Republic of China	9
2.2	Principal Providers of Financial Services in the People's Republic of China	13
2.3	Bank Cards—Number Issued and Access Points	16
2.4	Principal Agro-related Financial Institutions, end-2012	19
2.5	Development of Microcredit Companies, 2010–2013	21
2.6	Agricultural Bank of China's Major Agro-related Products	23

2.7 Classification Criteria of Micro, Small, and Medium-Sized Enterprises 25
2.8 Comparison of Loans Provided by Different Banks to Micro and Small Enterprises 26
2.9 Development of SME Board and ChiNext in Shenzhen Stock Exchange 28
2.10 Issuance of SMECN and SMECN-II 31
3.1 Characteristics of Targeted Group 47
4.1 Accounts at Formal Institutions and Use of Mobile Money, Selected Countries 67
4.2 Share of Adults Accessing Savings, Credit, and Insurance, Selected Countries 68
4.3 Scheduled Commercial Banks, March 2013 70
4.4 Access to and Use of Financial Services, 2012 71
4.5 Financial Inclusion and Access Progress 72
4.6 Interest Rates for Deposits (based on Mor Committee calculations, November 2013) 80
5.1 Financial Institutions in Thailand 91
5.2 Account at a Financial Institution, Selected Asian Countries 96
5.3 Default Rate on Village Funds 103
5.4 Share of Households with Debt 107
6.1 Level of Financial Inclusion for Individuals: Philippines versus Peers, 2011 114
6.2 Level of Financial Inclusion for Firms: Philippines versus Peers, 2011 115
6.3 Number of Banking Institutions in the Philippines, 2000–2014 117
6.4 Geographical Reach: Philippines versus Peers, 2012 119
6.5 Microfinance in the Philippines: Outreach 122
6.6 Selected BSP Regulations on Microfinance 123
6.7 Selected BSP Regulations on E-banking 127
6.8 E-money in the Philippines: Selected Indicators 128
6.9 Approaches to Mobile Banking: SMART and Globe 128

Box

4.1 Microfinance Crisis in Andhra Pradesh 77

Foreword

Inclusive growth has recently become one of the world's most important policy goals. Governments, development partners, and economists have given attention to inclusion in economic and social life, including wide or universal access to education, health care, social security, clean water and sanitation, and affordable transport and electricity. Financial inclusion is the most recent item to be added explicitly to the social inclusion agenda and promotes the need for access among all segments of society to a range of financial services at affordable cost.

While financial inclusion is a recent term, it is clear from the country case studies in this volume that for many years governments have recognized the need to extend access to financial services. They have sought measures to promote it through public sector banks, agriculture credit programs, and micro and small enterprise credit programs. At the same time, the microfinance revolution, pioneered by the Grameen Bank in Bangladesh in the 1970s, focused on the reality that the formal financial system has not been successful in reaching the poor. Using peer monitoring and group-based approaches, microfinance agencies have shown that the poor are bankable and that innovative models can allow finance to benefit the poor. The narrow focus on credit has given way to a broader approach that includes micro-savings, micro-insurance, and remittance and payment transfers.

The most recent innovations include the related models of e-banking, branchless banking, and agency or business correspondent banking to overcome the barriers of distance and the high cost of setting up traditional bank branches in remote areas. In recent years, governments have realized that specific financial programs and agencies can only flourish in an appropriate policy environment. The last few years have seen the development of national financial inclusion master plans and strategies in many countries, along with efforts to regulate microfinance agencies to better protect the users of their services.

This book provides a survey of progress on financial inclusion in five major Asian developing economies: the People's Republic of China (PRC), India, Indonesia, the Philippines, and Thailand. It is the most recent output of a fruitful collaboration between the Asian Development Bank Institute (ADBI) in Tokyo and the Asia–Pacific Finance and Development Center (AFDC), Ministry of Finance of the PRC, based in Shanghai. Since 2010, the two organizations have jointly organized annual seminars and forums on financial inclusion, focusing on strategies, policies, regulatory reforms, practices, and financial innovations of member economies of the Asia–Pacific Economic Cooperation (APEC).

Government officials, practitioners, and organizations involved in financial inclusion participated in these events to exchange ideas and review progress in the region.

At the 2014 APEC Financial Inclusion Forum, ADBI and AFDC agreed to publish a joint report summarizing the achievements and challenges of financial inclusion in selected APEC economies as well as India. The country chapters were written by staff members of the two organizations and drew on both the material presented at past events and other studies, databases, and information on the topic. The project was directed by Yuqing Xing, former director, Capacity Building and Training, ADBI, with support from colleagues Robert Davis, Aladdin D. Rillo, and Paul Vandenberg.

Jae-Ha Park
Deputy Dean
Asian Development Bank Institute
Tokyo, Japan

Li Kouqing
Director-General
Asia-Pacific Finance and Development Center
Ministry of Finance
Shanghai, People's Republic of China

Abbreviations

3G	third generation
3P	*Pastikan Manfaatnya* (Ensure benefits)*, Pahami Risikonya* (Understand the risks)*, Perhatikan Biayanya* (consider the costs)
ABC	Agricultural Bank of China
ADB	Asian Development Bank
ADBI	Asian Development Bank Institute
AFDC	Asia–Pacific Finance and Development Center
APEC	Asia–Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations
ATM	automated teller machine
B	baht
BAAC	Bank for Agriculture and Agricultural Cooperatives
BC	business correspondent
BDO	*Banco de Oro*
BFA	Bankable Frontier Associates
BKD	*Badan Kredit Desa* (village credit agency)
BMT	*Baittul Maal wa Tamwil* (microfinance institution based on Islamic principles)
BPR	*Bank Perkreditan Rakyat* (rural bank)
BRI	*Bank Rakyat Indonesia*
BSP	*Bangko Sentral ng Pilipinas*
CAM	China Association of Microcredit
CB	commercial bank
CBA	China Banking Association
CBRC	China Banking Regulatory Commission
CCB	City Commercial Bank
CGAP	Consultative Group to Assist the Poor
CIRC	China Insurance Regulatory Commission
CNY	yuan
CRC	Credit Reference Center
CRISIL	Credit Rating Information Services of India Limited
CSRC	China Securities Regulatory Commission
CUP	China Union Pay
DBT	direct benefit transfer
DOF	Department of Finance
EBRB	*Ewenki Baoshang* Rural Bank
EFLP	Economic and Financial Learning Program
EIU	Economist Intelligence Unit

Findex	Financial Inclusion Database
FIP	financial inclusion plan
FSDC	Fiscal Stability and Development Council
FSP	financial service provider
G2P	government to person
GCC	General Credit Card
GDP	gross domestic product
GoI	Government of India
GSMA	Groupe Speciale Mobile Association
GXI	G-Xchange
ICT	information and communication technology
IMF	International Monetary Fund
IPO	initial public offering
IT	information technology
ITU	International Telecommunication Union
KCC	*Kisan* Credit Card
Kshs	Kenyan shilling
KSP	*Kelompok Simpan Pinjam* (Cooperatives)
KUR	*Kredit Usaha Rakyat* (People's Business Credit Program)
KYC	Know Your Customer
LDKP	*Lembaga Dana Kredit Pedesaan* (Village Fund and Credit Institution)
MBO	micro-banking office
MCC	microcredit company
MFI	microfinance institution
MIIT	Ministry of Industry and Information Technology
MNO	mobile network operator
MSEs	micro and small enterprises
MTN	medium-term note
MSMEs	micro, small, and medium-sized enterprises
NAFMII	National Association for Financial Market Institutional Investors
NBFC	nonbanking financial company
NBFI	nonbank financial institution
NBS	National Bureau of Statistics
NCC	National Credit Commission
NDTL	non-deposit taking lender
NEDA	National Economic and Development Authority
NGO	nongovernment organization
NSSTS	National SME Share Transfer System
P	Philippine peso
P2P	peer-to-peer
PAM	poverty alleviation microfinance
PBC	People's Bank of China
POS	point-of-sale
PRC	People's Republic of China

PSBC	Postal Savings Bank of China
RBI	Reserve Bank of India
RCB	Rural Commercial Bank
RCC	rural credit cooperative
RCoB	Rural Cooperative Bank
RMCC	rural mutual credit cooperative
Rp	rupiah
Rs	Indian rupee
SAIC	State Administration of Industry and Commerce of China
SBU	small business unit
SFI	specialized financial institution
SIM	subscriber identity module
SMEs	small and medium-sized enterprises
SMECN	SME collective notes
SMECN-II	SME regional leader collective notes
SMS	short message service
SOE	state-owned enterprise
SSE	Shanghai Stock Exchange
SZSE	Shenzhen Stock Exchange
T-Cash	*Telkomsel* Cash
UID	unique identification
UNCDF–FT	United Nations Capital Development Fund and Finmark Trust
VTB	village and township banks

In this report, “$” refers to US dollars, unless otherwise stated.

Contributors

Ami Fujimoto is a Business Analyst at KPMG Consulting, Japan. She is a former Associate at the Asian Development Bank Institute, Tokyo.

Khan Kikkawa is Associate, Capacity Building and Training Department, Asian Development Bank Institute, Tokyo.

Alan Myrold is Associate, Capacity Building and Training Department, Asian Development Bank Institute, Tokyo.

Runzhong Peng is Director and Professor of the Asia–Pacific Finance and Development Center, Ministry of Finance of the People's Republic of China, Shanghai.

Aladdin D. Rillo is a Senior Capacity Building Economist in the Capacity Building and Training Department, Asian Development Bank Institute. He is former Director and Chief Economist of the ASEAN Integration Monitoring Office, Jakarta.

Yuka Terada is a former Associate, Capacity Building and Training Department, Asian Development Bank Institute, Tokyo.

Paul Vandenberg is a Senior Capacity Building Economist in the Capacity Building and Training Department, Asian Development Bank Institute, Tokyo. He is seconded from the Asian Development Bank, Manila.

Lei Wang is a Research Fellow and Senior Economist at the Asia–Pacific Finance and Development Center, Ministry of Finance of the People's Republic of China, Shanghai.

Yuqing Xing is Director of the Asian Economic Policy Program at the National Graduate Institute for Policy Studies, Tokyo. He is former Director of the Capacity Building and Training Department, Asian Development Bank Institute, Tokyo.

Min Zhao is Deputy Director and Associate Professor of the Asia–Pacific Finance and Development Center, Ministry of Finance of the People's Republic of China, Shanghai.

Overview of Financial Inclusion in Asia

Aladdin D. Rillo

Without doubt, financial inclusion is now a global agenda. In Asia, many countries are employing financial inclusion as an important part of their strategies to achieve inclusive growth. Regional discussions of the issue have also intensified. The Asia–Pacific Economic Cooperation (APEC) Finance Ministers' process has a dedicated forum looking at financial inclusion issues. The implementation of the Association of Southeast Asian Nations (ASEAN) Framework on Equitable Economic Development has been anchored on the promotion of financial literacy, among other initiatives. Development organizations have been responsive too. The Asian Development Bank has approved 121 projects (amounting to $2.59 billion as of 2012) to support microfinance in countries in Asia and the Pacific (ADB 2012).

This heightened interest in financial inclusion is not misplaced, as countries prioritize inclusive growth and development in their policy agendas. In general, inclusive finance is crucial to sustain economic and social development. It is also expected to lead to greater financial stability and growth. Perhaps because of these reasons many Asian countries have either implemented initiatives or set specific targets to promote financial inclusion.

This is evident in the five countries surveyed in this study—the People's Republic of China (PRC), India, Indonesia, the Philippines, and Thailand. Although approaches and priorities to pursue financial inclusion differ, what is clear is that progress has been achieved in the last 10 years.

In the PRC, financial reforms have played a critical role in the success of financial inclusion. Although efforts to promote financial inclusion started in the 1950s, it was only after deeper reforms in the rural financial system were implemented in 2005 that significant gains were achieved. Reforms allowed the rural banking system, once dominated by state-owned banks, to diversify and enabled new market players (such as agro-related banks, village township banks, and postal savings banks) to expand financial services to rural areas. The reforms also resulted in the creation of some innovative products and services for financial inclusion such as the SME Board and ChiNext (Growth Enterprise Board), two innovative funding markets for small and medium-sized enterprises (SME) that are unique to the PRC.

Indonesia's efforts to promote inclusive finance have been encouraging despite constraints posed by the country's geography and challenging regulatory environment. The success of its key programs such as *TabunganKu* (My Savings) and People's Business Credit, as well other initiatives on mobile banking and microfinance, attests to this. The practical projects implemented by Bank Rakyat Indonesia, a private bank, to reach thousands of unbanked individuals and firms also show the critical role that the private sector can play in financial inclusion.

Like in the PRC, India recognized since the 1950s the need to empower the poor segments of the population. But it was only in 2004, at the behest of the Reserve Bank of India and the Government of India, that a more focused, bank-centric strategy was seriously pursued. Since then some programs that are unique to India have been implemented, including the use of agent or business correspondent banking, to widen access to financial services. In addition, the first ever unique identification project, where identities are biometrically scanned, is enabling unbanked individuals to access credit and other banking services.

In the Philippines, a combination of good policy environment and strong market support has proved to be an effective approach to financial inclusion. As one of the pioneers of mobile banking, the Philippines shows how technological innovations, supported by good business models and government policies, can be harnessed to deliver low-cost and efficient financial services to the poor. The same market-oriented approach has led to the provision of better and more diversified microfinance services such as micro-deposits and micro-insurance.

Thailand's approach to financial inclusion is also unique in the sense that unlike other countries, the pursuit of inclusive finance is primarily driven by the government—and with significant results. The Village Fund is now recognized as one of the largest microfinance institutions in the world, providing subsidized credit to farm households and small firms in rural areas. It has also become a model for other countries to develop successful microfinance programs.

Despite these achievements, financial inclusion in Asia remains challenging. Large disparities in the use of financial services persist. The proportion of households with access to formal bank accounts varies widely across countries. In-country disparities can even be larger when access to financial services is examined within population segments and across income levels. For example, in Thailand, where formal account penetration is high, the poorest 40% of households are much less likely to have an account than the richest 60%. Similarly, in India, only 21% of adults from the poorest quintile have a formal account compared to 56% from the richest quintile. Evidence suggests that higher exclusion is associated with higher income inequality and with vulnerable groups (young, uneducated, unemployed, and the poor in rural areas). Hence, in countries where rising population and income inequality are still concerns (like in the PRC, India, and Indonesia), providing an environment that better enables access financial services can be challenging.

One reason perhaps for these disparities is the difference in financial sector development across countries. Although the existing evidence is not yet conclusive, so far it suggests that both financial depth and efficiency are positively related to financial inclusion (World Bank 2014). An efficient and deep financial sector has the ability to improve competition, thus allowing the supply of financial services to expand and to establish the necessary financial and lending infrastructure. In the PRC, for example, it was only after the banking reforms of 2005 that significant changes in improving access to finance were achieved. This stands in contrast to earlier periods in the PRC when the state-owned and monobanking system prevented greater financial inclusion. Indeed, efficiency in the financial system is critical if financial inclusion is to be realized. This is a problem in Indonesia where banking inefficiency (due to the concentration of wealth within a few banks) has slowed the ability of banks to respond favorably to the needs of the unbanked.

In particular, access to financial infrastructure is still a problem in Asia despite efforts to address it. This prevents inclusion from being realized. In India, financial infrastructure has been lagging. In fact one reason being given by the unbanked for limited usage of financial services is the absence of technological infrastructure to access bank accounts. The same situation is faced by micro and small enterprises in the country that are still constrained by the absence of functional infrastructure to operate competitively. Although progress has been achieved in Indonesia and the Philippines to increase the supply of financial infrastructure, the archipelagic nature of their economies still poses serious barriers to financial access.

Country-specific barriers to inclusion also matter. Much variation exists in the delivery models because of the existence of market and regulatory constraints as well as non-market barriers that prevent equitable access to financial services. Only a few countries are working to implement modern payment and credit information systems and lending technology to expand the supply of financial

services. The People's Bank of China established the Credit Reference Center in 2006 that has since become an important provider of credit information to individuals and enterprises. In the Philippines, efforts are underway to establish a comprehensive credit information system that will include information about clients from all types of financial institutions including microfinance institutions. Interestingly, regulatory issues still figure prominently among the many challenges faced by Asian countries in improving financial access. These include concerns related to regulatory hurdles for microfinance institutions (Thailand), the monitoring of performance by microfinance institutions (the Philippines), and identification regulations for the unbanked (Indonesia).

In terms of removing impediments to the demand for financial services, country actions also differ, as seen in the approaches taken to improve financial literacy and consumer protection across countries. In some countries, financial education is an integral part of the overall financial inclusion strategy adopted by central banks. The Reserve Bank of India formulated the National Strategy on Financial Education in 2012, along with other initiatives, to address supply and demand constraints affecting the effective delivery of financial education. In the Philippines, the Bangko Sentral ng Pilipinas became the first central bank in the world to establish within a bank a dedicated advocacy unit to address all financial inclusion initiatives including financial education and literacy.

In the end, the challenge is still to address all those constraints that are often driven by country conditions. This means that because financial inclusion has many aspects, identifying the right policies to target may not result in optimal results for all countries since conditions differ in each country. Thus, it is important that country-specific strategies are taken into account in cross-country comparisons of financial inclusion programs.

By looking at the five country cases, this study aims to identify which policies work, and which do not, and to highlight best practices that each country can offer (for example, mobile banking in the Philippines and the Village Fund program in Thailand), taking into account special circumstances and constraints. Furthermore, there are useful lessons that countries can learn from each other to design and implement effective, relevant, and successful financial inclusion programs.

Still, as seen in the country studies, for inclusion to be successful, more effort is needed to address gaps in the understanding of financial inclusion, particularly its results. Three areas are worth examining.

First is the quality of regulatory policies. While it is true that the countries surveyed in this study have been able to put in place key policies, the effects of those policies on financial inclusion are not clear. Evidence is limited on which policies work best. Ineffective policy measures, too much regulation, or the lack

of internal synergies to implement financial inclusion are familiar cautionary tales in all countries. These need to be verified to ensure that policies are indeed addressing the right problems of financial access in the country.

Second, it is also important to have a positive enabling environment for promoting financial inclusion. This means that policies that support financial inclusion have to be closely connected with the pursuit of macroeconomic stability. Financial access is impossible without increasing the capacity of individuals and firms to access higher income levels. It is also important that countries continue to address the impediments that hamper access to financial services, including legal, regulatory, and market barriers.

Finally, greater financial inclusion is only possible if undertaken responsibly. In as much as inclusion is about increasing the capability to use financial services, it is crucial that those who are directly affected are financially literate and capable.

These three issues are not trivial. All the country chapters have consistently identified these issues as key challenges affecting the outcome of financial inclusion initiatives in Asia. Understanding these issues is crucial and they must be seriously considered if the goal is to achieve a financially inclusive Asia in the years to come.

References

Asian Development Bank (ADB). 2012. *Technical Assistance Report*. *Improving Financial Inclusion in Asia and the Pacific.* Manila: Asian Development Bank.

World Bank. 2014. *2014 Global Financial Development Report: Financial Inclusion.* Washington, DC: World Bank.

2 Financial Inclusion in the People's Republic of China: Achievements and Challenges

Runzhong Peng, Min Zhao, and Lei Wang

2.1 Overview

As the world's largest developing country, the People's Republic of China (PRC) has a remarkable record of economic growth after initiating its reform and opening up in 1978. Today, the PRC is the second largest economy behind the United States, and the largest exporter and manufacturer in the world. However, the financial sector is still facing problems of insufficient financial supply, financing difficulties of micro and small enterprises (MSEs), and difficulties of farmers in getting loans. The financial sector, dominated by state-controlled commercial banks, has focused on providing financial services to state-owned enterprises (SOEs) and large private companies that has resulted in problems for the country's economic and social development.

Progress has been made on improving financial services for financially excluded segments of society, especially after early 2005 when the central government put forward the goal of building a harmonious society. Policy documents issued by the State Council and financial authorities required the financial sector to find ways to support social harmony by enhancing social and economic inclusion through increasing access to finance.

This chapter describes the financial inclusion landscape in the PRC, on the basis of available information and research conducted by the Shanghai-based Asia–Pacific Finance and Development Center (AFDC).

2.1.1 Background and Development of Financial Inclusion in the People's Republic of China

Background

The development of financial inclusion in the PRC has been occurring at the same time as the building of its market-oriented economic system and is closely linked to the reforms first launched in the rural areas in the late 1970s and gradually extended to cities in the 1990s.

With the implementation of the household contract responsibility system in the early 1980s, more than 200 million farmers were released from 26,000 people's communes and production brigades and became part of the rural economy again. This major reorientation of rural production required the building of an effective rural financial system. This system should meet the needs of a stable rural economy, reflect the special nature of rural finance, and facilitate the development of agriculture and the rural economy. However, for many reasons, the system faces practical problems resulting in unbanked and underserved farmers and MSEs (CBA 2011). Despite these faults in the system, rural reform has been successful and has contributed to the PRC's economic growth.

The practices of rural reform began to extend to the cities and townships from the early 1990s. The most significant aspect accompanying this reform was the emergence of a large number of laid-off workers from the former collective-owned enterprises and SOEs that were merged and/or privatized. In 1997, about 91% of the 11.5 million laid-off workers were from collective-owned enterprises and about 7 million from SOEs (NBS 1997). Since the reform of the financial sector lagged the reform of SOEs during this period, the banking sector was unable to provide services to the enterprises that could employ more workers and to individuals who planned to set up their own businesses.

With this background, an inclusive financial system to support economic transformation and development is needed. Key elements of an inclusive financial system include:

i. All families and enterprises should have access to financial services (such as deposits, short-term and long-term loans, mortgages, insurance, pensions, payments, and domestic and international remittances) at reasonable prices.
ii. Institutions should have reasonable management systems, industrial performance standards and market mechanisms, and prudential regulations.
iii. Financial viability is the key to providing long-term financial services.
iv. Diversified financial service providers (including individual informal providers, nongovernment organizations, and formal financial institutions) should provide profitable and variable financial services under accessible conditions (CGAP 2006).

Development of the financial system in the PRC

While the emergence of an inclusive financial system can be traced back to the 1950s, significant progress has been made since the early 1990s, and most progress has been made since 2005. A simplified historic evolution of the financial system is summarized in Table 2.1.

Table 2.1 illustrates that exclusion and inequality increased after 1993, but changes are in progress. The most important change in the financial system is that the state-led banking system dominated by the "big five" (Industrial and Commercial Bank of China, Bank of China, Agricultural Bank of China, China Construction Bank, and Bank of Communication) has become more diversified with the entry of joint stock commercial banks and the establishment of a number of small and medium-sized commercial banks. At the same time, state-controlled big commercial banks, especially the Agricultural Bank of China (ABC), are expanding lending to *sang nong* (*sang nong* refers to rural areas, agriculture, and farmers). Besides, other financial institutions, especially village and township banks (VTB), are focusing their business on micro, small, and medium-sized enterprises (MSMEs) and unbanked or underbanked individuals. The VTBs have played a core role in financial inclusion.

In parallel to the banking sector reform, some of the non-deposit taking lenders (NDTLs), including financial and non-financial institutions such as microcredit companies (MCCs) and pawnshops, have emerged or reemerged as financial providers. The role of NDTLs in financial inclusion is becoming more evident, but obstacles still exist.

Table 2.1 Development of the Financial System in the People's Republic of China

Economic inclusion but stagnation and poverty (1949–1978)	Inclusive growth but increasing inequality (1979–1993)	Slower growth but increasing exclusion (1993–2005)	Increasing economic and social inclusion (After 2005)
Centrally planned economy State-owned monobanking system State-controlled and managed resources allocation	Market-oriented economic system State-led multibanking system Directed and subsidized lending to priority sectors	Partial privatization of economy Market-oriented banking system Directed and subsidized lending to weak sectors	Deepening reform of economic system Building more effective financial system Directed more financial services to real economy, especially for MSMEs and farmers

MSMEs = micro, small, and medium-sized enterprises.

Source: Based on CGAP (2012).

Another trend in providing financial services is the development of branchless banking on the basis of the internet and information technology (IT). Branchless banking has greatly enlarged the coverage of financial services in rural and remote areas where conventional bank branches operate at high cost.

With these efforts, the PRC's inclusive financial system has undergone tremendous development since 2005. There are challenges in developing financial inclusion, as discussed in section 2.3.

2.1.2 Demand and Supply of Financial Services

Demand of groups with low financial access

The Consultative Group to Assist the Poor (CGAP) has identified four groups that have difficulty accessing banking services and are offered unattractive or inappropriate products (CGAP 2012).

The first and the largest group is rural households, in particular those of small-scale farmers, livestock raisers, and fishers; the second largest group is low-wage workers, especially migrant workers; the third group is MSMEs, particularly private enterprises; and the fourth group is the unemployed, particularly laid-off workers from SOEs and job seekers in urban areas. Each group has different financial needs and responds differently to financial institutions, branchless banking channels, and technology. Within these groups, the poorest households, the smallest enterprises, and migrant workers are almost fully excluded from accessing financial services.

According to the World Bank (World Bank database), 64% of adults (age 15+) in the PRC have a bank account provided by a diverse and rapidly growing array of financial service providers. They can use their accounts to save money, receive government payments, and get bank loans. However, 36% of adults are not yet financially included and consist primarily of poorer people living in rural and less-developed regions and migrant workers from those areas.

A State Administration for Industry and Commerce[1] survey report in March 2014 shows that there are approximately 57 million MSMEs. MSMEs represent 94% of total enterprises in the PRC and contribute about 60% of gross national product. Regional surveys suggest that more than 63% of MSEs in coastal regions (Yangtze Delta, Pearl River Delta, and Bohai Rim) need external financing. This figure is higher in the western and central regions, reaching 73% (Ali Research 2011). A total of 58% of MSEs surveyed in the Yangtze Delta region finance themselves

[1] This survey on MSMEs is the first of its kind in the PRC. MSMEs are classified according to the document released in 2011 by the Ministry of Industry and Information Technology (http://www.saic.gov.cn/zwgk/tjzl/zxtjzl/xxzx/201403/t20140331_143497.html) (in Chinese).

through informal sources and family members. In the western and central regions, this figure is 69%.

Factors affecting demand for financial services

With 1.36 billion people in 2013, there is a huge potential market for expanding financial services. Four key factors affect the demand for financial services: migration, the income gap, an aging population, and technology.

Migration. In 2011, the urban population surpassed that of the rural areas for the first time in the history of the PRC. However, urban people can be divided into two kinds, people with local residential registration (*hukou*) and those without. According to the National Bureau of Statistics, in 2013 there were about 269 million "floating workers" from rural areas (NBS 2014). This migration has resulted in the emergence of a new segment with new financial service needs, typically, the need to protect salaries paid in cash and to remit money home through reliable channels. Migrants are often excluded from basic services and the strict residential registration system prevents rural migrants from settling in cities and accessing services.[2] The current evolution in urbanization also changed the nature of employment such that the share of workers in the tertiary sector has increased quickly. Providing financial services to these segments will have cost implications for financial providers and different challenges in terms of client needs and the adoption of technology.

Income gap. The divide between urban and rural people and between the rich and poor may result in social unrest and falling into the middle-income trap. Since the 1980s, the PRC's double-digit growth in gross domestic product (GDP) has lifted more than 500 million out of poverty. Still, in 2013 there were more than 82 million people in rural areas living below the national poverty line, most of them living in the western and central regions. The fact that poor people are more dispersed in poor villages and mountainous areas makes it more challenging for policymakers and financial providers to further reduce poverty and provide inclusive services. Income disparity requires different kinds of financial inclusion solutions for poor segments.

Aging population. Since the mid-2000s, the age composition and dependency ratio have been changing dramatically. The old age dependency ratio reached 12.7% in 2012, compared to 9.9% in 2000. As of end-2013, the percentage of people aged 65 and over was 9.7%, a 2.7 percentage points increase from 2000. This change will affect the economy and the demand for financial services.

---

[2] According to the National Plan for New-type Urbanization (1914–2020) released in 2014, the *hukou* system will be reformed to encourage people to settle in cities and townships, but settling in large cities such as Beijing and Shanghai, is still strictly controlled.

Technology. The use of technology, such as mobile phones and the internet, is changing the nature of the demand for financial services, including in rural areas. According to the National Bureau of Statistics (NBS 2014), as of end-2013, there were 1.23 billion mobile phone subscribers, this means the overall mobile phone penetration stood at 90%, just at the global average. About one-third of the PRC's mobile subscribers have third generation (3G) connections and the smartphone penetration in the biggest cities is higher than that of many developed markets. Besides, about half of mobile phone subscribers live in rural areas. Also in 2013, internet penetration reached 45.8% and has increased more than five-fold over the past ten years. With the increase of mobile phone subscribers, mobile phone-based and internet-based payment systems have grown rapidly—a five-fold increase from 2012 to 2013 (Xinhuanet 2013). It is also noteworthy that the share of the population shopping and trading online is growing quickly and this virtual marketplace may become a driving force for nonconventional banking. It is believed that the large volume of online and offline trade and payments will help financial providers in tailoring their products and segmenting their client base.

However, while technology-driven financial services are growing significantly, many people, especially in rural areas, are still concerned about the security of their money when using digital trade and payment mechanisms. The further development of technology-based financial services will depend on how providers adapt their products and services to their clients' needs. At the same time, financial literacy is needed for poor clients with low financial access.

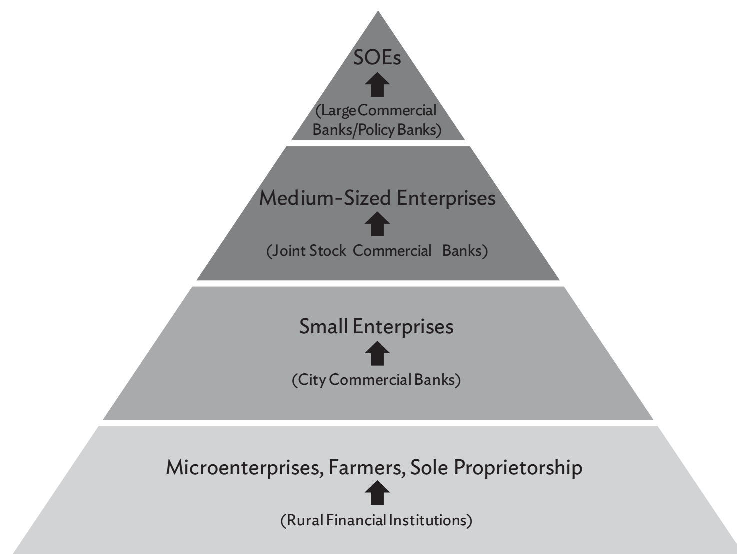
Major providers in financial inclusion

The banking sector, comprised of large state-controlled commercial banks, policy banks, joint stock commercial banks, and other small and medium-sized commercial banks, plays a dominant role in providing financial services to the real economy. According to the China Banking Regulatory Commission (CBRC), the number of banking financial institutions reached 3,747 as of end-2012 (CBRC 2012). These financial institutions have set up a corresponding pyramid to the real economy served by them (Figure 2.1).

As seen in Figure 2.1, the segments at the bottom of the pyramid are the most financially excluded. This structure reflects the philosophy of the PRC for the whole banking sector in the process of building an inclusive financial system. The system is aimed at supporting the real economy, to forge a multi-level, wide coverage and differentiated financial system, and to allow all individuals and enterprises with financial needs to enjoy high quality financial services so as to boost the continuous growth of the real economy (AFDC 2014).

Aside from banking institutions, nonbank institutions have emerged recently (including credit-only institutions such as microcredit companies and peer-to-peer [P2P] platforms) and are playing a more important role in providing financial services. The major providers in financial inclusion are summarized in Table 2.2.

Figure 2.1 Pyramid of Banking System and Real Economy in the People's Republic of China



SOE = state-owned enterprise.

Source: AFDC (2014).

Table 2.2 Principal Providers of Financial Services in the People's Republic of China

Regulated/ Unregulated	Type	Description	No. of outlets or institutions	Estimated year
Banks and RCCs	RCC	Small rural-based providers of multiple financial services including savings, loans and money transfer services; gradually transforming into rural commercial banks through reform process.	2,646	2011
	ABC	One of the country's original five large commercial banks; formerly state-owned and now partly privatized. ABC has a history of failed subsidized programming. New sustainable programming directives launched in 2007 resulted in significant turnaround. ABC has 320 million retail customers and nearly 24,000 branches. As of 2010 it had provided 96 million Kins Farmer Benefit Cards.	46,502	2012

continued on next page

Table 2.2 *continued*

Regulated/ Unregulated	Type	Description	No. of outlets or institutions	Estimated year
	PSBC	State-owned commercial bank, formed originally from the postal savings and remittances bureau, now also offering credit and insurance products, with significant agent banking pilots underway in rural areas. Still planning to expand by tapping 70,000 additional post office branches.	39,000	2013
	CCB	Small urban-based providers of multiple financial services, including innovators such as Harbin Bank.	147	2010
	VTB	One of the three new-type small rural financial institutions, initiated by commercial banks, offering a wide range of banking products. Only one VTB is permitted per county, creating a more predictable competitive environment. This has drawn the involvement of some of the larger commercial banks, foreign banks, and city commercial banks that are keen to expand beyond their city borders such as ANZ, HSBC, Minsheng Bank, and Standard Chartered.	726	2011
	RMCC	One of the three new-type small rural financial institutions, initiated by rural cooperatives, offering savings and credit services for members only, designed to work as true cooperatives but as fully licensed financial institutions.	50	2011
Nonbanks	PAM	Credit-only institutions that are mostly registered as social welfare organizations originally numbering 300. As unregulated bodies, they have lower costs, but are not able to mobilize deposits and most cannot attract new capital. Many have converted to MCCs.	100	2011
	MCC	One of the three new-type small credit-only institutions that are registered as private companies. Experiencing very strong growth in portfolio and numbers, but typically with low social performance. Can only borrow up to 50% of equity, which constrains growth.	7,086	2013
	P2P	Financial advisers that link individual investors with individual borrowers. In 2010 it was estimated that 30 P2Ps existed, with significant growth through 2012.	200	2012

Note: ABC = Agricultural Bank of China; CCB = city commercial bank; MCC = microcredit company; P2P = peer-to-peer platform manager; PAM = poverty alleviation microfinance; PSBC = Postal Savings Bank of China; RCC = rural credit cooperative; RMCC = rural mutual credit cooperative; VTB = village and township bank.

Source: Shrader and Duflos (2014).

2.2 Achievements and Progress of Financial Inclusion

Efforts to increase financial inclusion have intensified since early 2005 when the PRC placed "building a harmonious society" as a priority in its work agenda. Subsequent policies released by the State Council and financial authorities[3] required financial institutions to find ways to support the building of social harmony by enhancing economic and social inclusion through increasing access to finance. Since then, efforts in financial inclusion are mainly focused on three areas: expansion of financial services coverage, support of *sang nong*, and promotion of MSMEs.

2.2.1 Improving Financial Services Coverage

To improve financial services coverage, the government has adopted many policies to provide unbanked or underserved people in western and central, rural, and remote areas with basic banking services.

Expansion of physical outlets

Since 2005, financial authorities have taken action to develop financial inclusion by launching policies to expand the coverage of financial services by: (i) pushing the banking sector to ensure the availability of minimal financial services in all towns and villages by increasing the number of branches and exploring innovative alternatives to physical facilities; (ii) lowering the requirements for setting up rural financial institutions by encouraging the establishment of three new-type rural financial institutions;[4] (iii) consolidating rural credit cooperatives (RCCs) by transforming viable RCCs into rural commercial banks and rural cooperative banks; and (iv) promoting the ownership and use of bank accounts and bank cards by requiring bank accounts for government-to-person (G2P) transfers and recommending the use of bank cards for person-to-government payments.

Promoted and guided by these policies, the accessibility of financial services in rural areas where unbanked people are concentrated, has improved significantly. As of end-2011, the number of unbanked township and villages nationwide declined to 1696 from 2945 in October 2009, with 616 unbanked areas eliminated in 2011 (CBRC 2011).

---

[3] The institutions governing financial sector supervision and regulation include the People's Bank of China (PBC), China Banking Regulatory Commission (CBRC), China Securities Regulatory Commission (CSRC), and China Insurance Regulatory Commission (CIRC). This is the so-called "one central bank plus three regulatory commissions" framework .

[4] The three new-type rural financial institutions are village and township banks (VTB), rural mutual credit cooperatives (RMCC), and loan companies.

Promotion of branchless banking

Along with the expansion of physical outlets, branchless banking has grown dramatically. Many VTBs and other providers of financial services in remote and mountainous regions have found cost-effective ways of creating branchless access points by setting up mobile units or banks-on-wheels, automated teller machines (ATMs), and placing point-of-sale devices with retailers and other nonbanking institutions. The presence of physical outlets and branchless points facilitates the coverage of financial services and increases the convenience of access to basic banking services.

The fast development of branchless banking is attributed to the significant improvement of financial infrastructure. The expansion of bank card issuance and acceptance is a good example on the basis of the most recent data available (Table 2.3). The development of branchless banking in other forms, such as third-party payment, will be discussed later in this section.

2.2.2 Financial Inclusion in Rural Areas

In 2003, the State Council issued the *Notice about a Pilot Program to Deepen the Reform of Rural Credit Cooperatives*, officially initiating the third rural financial reform. Since then, the PBC and CBRC have required and encouraged the financial sector to enhance financial services to *sang nong*.

Overview of key policies promoting development of rural financial services

Following the announcement by the State Council in 2003, the CBRC promulgated several policies to promote the development of rural financial inclusion by encouraging the entry of new types of rural financial institutions and institutionalizing their governance.

Table 2.3 Bank Cards—Number Issued and Access Points

	2011	2013	Growth (year-on-year, %)
Cumulative issuance (billion)	29.49	42.14	19.54
Networked merchants (million)	3.18	7.63	54.90
POS (million)	4.82	10.63	48.51
ATM (million)	0.33	0.52	25.53

ATM = automated teller machine; POS = point-of-sale.

Sources: Based on PBC (2013a, 2014b).

On 20 December 2006, the CBRC issued the *Guidelines on Adjusting the Market-entry Threshold for the Banking Institutions in Rural Area*, which is regarded as a milestone of rural financial reform since 2003. While the entry threshold was reduced, supervision and regulation were enhanced to avoid potential risk. In the same year, the CBRC approved the Postal Savings Bank of China to open for business.

In 2007, the CBRC issued several documents about the governance of VTBs, RMCCs, and lending companies to strengthen the regulation of new-type rural financial institutions and safeguard the legitimate interests of members and creditors. On 1 March, the Sichuan-based Yilong Huimin Village Bank, the first of its kind in the PRC, commenced business. On 9 March, the Baixin Rural Mutual Credit Cooperative in Yanjia village, Jin Province, commenced business as the first RMCC in the PRC. On 1 July, CBRC launched the PRC Banking Services Distribution Map on its website. The map contains detailed information about banking service coverage and competition status in rural areas and serves as a reference when licensing new-type rural financial institutions. On 6 August, the *Guidelines on Developing Rural Microcredit Business by Banking Institutions* provided programmatic requirements on banking institutions' endeavors to actively develop rural microcredit business. Two months later, the pilot program of lowering the market entry threshold for setting up rural banking institutions, first initiated in 2006, was expanded.

In the following years, more policy documents have been released to support the development of the rural financial system. In 2008, the PBC and CBRC jointly issued two documents related to three new-type rural financial institutions which clarified the requirements on their required deposit reserve management, interest rate management, and payment and settlement management. Aside from setting up three new-type rural financial institutions, banks are encouraged to establish special agencies that are run like subsidiaries or independent legal entities to better serve small enterprises in rural and urban areas. As one of the "big five" state-controlled commercial banks, the Agricultural Bank of China (ABC) started its reform on the basis of the *Guidelines on Reform and Supervision of Agriculture Related Strategic Business Unit of the Agricultural Bank of China*, urging the ABC to serve the needs of *sang nong*. To promote the healthy and sustainable development of lending companies, the CBRC issued the *Provisional Rules Governing Transformation of Lending Companies into Village and Township Banks*, specifying the requirements on restructuring activities. In 2012, the CBRC issued the *Notice on Issues Concerning the Establishment of Village and Township Banks by Banking Institutions,* laying out the qualifications for the initialing banks and approved procedures for relevant issues. A milestone in the reform of the PRC's financial system was the opening of the banking sector to private capital in 2012 after the CBRC announced the *Implementation Guidelines on Encouraging and Introducing Private Capital into the Banking Sect*or. This policy gives private capital the same entry standards to the banking industry as other types of capital,

improves conditions for private capital to enter the banking sector, and promotes the sound operation of private banks. According to the CBRC, in 2014, ten private capital institutions, including Alibaba and Tencent, among others, will be included in the first five pilot private-owned banks to be located in Tianjing, Shanghai, Zhejiang, and Guangdong.

Policy-led measures after 2003 improved rural and urban financial inclusion significantly, in terms of coverage, providers, and products of financial services.

Improvement in rural financial inclusion

The situation of financial inclusion, particularly in rural areas, has improved significantly although more time is needed to fully evaluate the effectiveness of recent changes. More diversified financial providers and products have promoted the development of rural financial inclusion.

Significant increase of financial institutions in rural financial services

In the past ten years, the significant increase in the number and diversity of banking institutions involved in rural areas has dramatically improved rural financial services, measured in terms of agro-related banking institutions and outstanding agro-loans (Table 2.4 and Figure 2.2).

The ABC, one of the PRC's "big five" state-controlled commercial banks, has branches and sub-branches in every province and provides a wide range of services, including savings, loans, and money transfer services through its more than 19,000 outlets nationwide. In accordance with the requirements of reform endorsed by the State Council, the ABC has been assigned to focus its operation on agro-related business and make innovations in products and business models. The ABC reports that it has served more than 7 million rural households in 16,000 administrative villages (ABC website), in collaboration with the China Foundation for Poverty Alleviation. The ABC 2013 annual report indicates that cumulative outstanding loans for micro and small enterprises amounted to CNY813.3 billion. Of these loans, loans to central, western, and northeastern regions, where most of the weak segments are located, has reached CNY2.8 trillion, or about 38% of total loans in 2013. What is noteworthy is that loans to the western region amounted to 22% of its loans in 2013, which contributed greatly to the economic development of this region.

Table 2.4 Principal Agro-related Financial Institutions, end-2012[a]

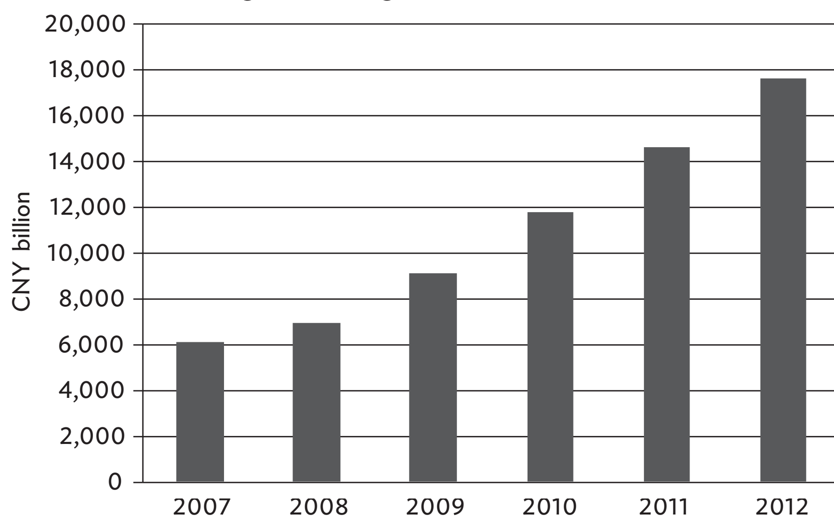
Institutions	No. of institutions	No. of outlets	Staff
Agricultural Bank of China (ABC)	1	23,472	478,980
Postal Savings Bank of China (PSBC)	1	39,087	169,729
Rural credit cooperatives (RCCs)	1,927	49,034	502,829
Rural commercial banks (RCBs)	337	19,910	220042
Rural cooperative banks (RCoBs)	147	5,463	55,822
Village or township banks (VTBs)	800[b]	1,426	30,508
Lending companies	14	14	111
Rural mutual credit cooperatives (RMCCs)	49	49	421
Total	3,276	138,455	1,458,442

Notes:

[a] Figures for ABC and PSBC are from 2013 Yearbook of Financial Statistics.
[b] As of end-2013, this figure increased to 987 (PBC 2013c).

Source: PBC (2013c).

Figure 2.2 Agro-loans, 2007–2012



Sources: PBC (2013b).

With the endorsement of the State Council, the CBRC officially approved the Postal Savings Bank of China (PSBC) to open its business on 31 December 2006. The China Post Group is the sole shareholder of the PSBC. The establishment of the PSBC aims to provide comprehensive financial services to clients by taking advantage of postal outlets that previously provided only savings and remittance services. As of end-2012, the PSBC had about 39,000 outlets, two-thirds of which were at the county level or below. Most of the PSBC's clients are students, self-employed entrepreneurs, migrant workers, and pension receivers. In recent years, the PSBC enhanced its financial services in rural areas, especially services to farmers and micro and small enterprises. From 2007 to the end of 2013, the PBSC had provided CNY1.7 billion in loans to 12 million MSEs and rural households. It was probably the largest single provider of microcredit and small loans in terms of numbers of clients.

Small and medium-sized rural financial institutions play an important role in rural financial inclusion. According to the CBRC, they comprise two kinds of financial institutions: (i) rural cooperative financial institutions and (ii) new-type rural financial institutions.

Rural cooperative financial institutions consist of a large and diverse number of small-scale, locally based rural financial institutions, comprising 1,927 rural credit cooperatives (RCCs), 337 rural commercial banks, and 147 rural cooperative banks (CBRC 2013). These 2,411 rural cooperative financial institutions provide a variety of financial services, including savings, loans, and money transfers, and their clients constitute a significant proportion of the unbanked population in less developed regions of the PRC.

New-type rural financial institutions, based on the CBRC's classification and terminology, include village or township banks (VTB), lending/loan[5] companies, and rural mutual credit cooperatives (RMCC).[6] New-type rural financial institutions were established to address the issues of short supply and insufficient competition in rural areas. According to the CBRC's policies and guidelines, all kinds of new-type rural financial institutions were encouraged to be established on an economic basis, with priority given to the western region and underdeveloped counties in the central region. As of end-2012, there were 863 new-type rural financial institutions, including 800 VTBs (excluding 76 under

[5] In literature, the term of lending company is sometimes confused with microcredit company (MCC). In the PRC, a loan company is a type of nonbank financial institution (NBFI) that should be established by domestic commercial banks or rural credit cooperatives to provide specialized lending services in rural areas to farmers, agriculture, and for rural development. Loan companies must be approved by the CBRC. An MCC is not a financial institution and is designed to focus on providing credit services to rural borrowers and MSMEs, and adhering to a small and diversified business model. An MCC is approved by the local financial affairs office.

[6] RMCCs are community-based, member-owned banking financial institutions. Like VTBs, they must be established within the scope of a town or village in poor, rural areas. However, unlike VTBs they can offer only deposit, loan, and settlement services, and their business is restricted to members. In general, a minimum of 10 farmers or rural entrepreneurs is needed to establish an RMCC.

establishment), 14 lending companies, and 49 RMCCs. In recent years, most of the new VTBs were located in the central and western regions. For instance, in 2012, about 61.2% of the new VTBs were located in underdeveloped central and western regions. VTBs have gradually become the new driving force in serving the development of the rural economy and MSEs. As of end-2012, the loan balance of VTBs reached CNY233 billion, with rural households and MSEs loans taking up 84% (CBRC 2013). Meanwhile, the CBRC required village and township banks to remain committed to serving *sang nong* and follow the principle of "granting small loans to diversified small borrowers."

Microcredit companies (MCCs) have emerged as another type of provider related to financial inclusion.[7] As one of the major non-deposit taking lenders (NDTLs) in the PRC in terms of number of established institutions, MCCs have experienced fast growth since their start in 2007, playing an increasingly important role in expanding access at the base of the pyramid (Figure 2.1). MCC data became available on the PBC website in 2010, while the PBC initiated the pilot program of MCCs in 2005. Key information about MCCs is summarized in Table 2.5. MCCs can be invested in and established by natural persons, companies, or social organizations. MCCs can take the form of a limited liability company or a joint stock company. The difficulty in funding MCCs limits their role in financial inclusion and the trend of MCCs in further financial reform is to upgrade into VTBs (and become deposit-taking institutions).

Emergence of innovative products by providers

Guided by the PBC and CBRC, financial institutions have strengthened their efforts to provide financial services to unbanked or underserved populations in rural regions. As shown in Figure 2.2, the annual growth rate of agro-related loans granted by rural financial institutions was 24.3% from 2007 to 2012. A variety of financial products have been created and applied to meet the different demands of clients.

Table 2.5 Development of Microcredit Companies, 2010–2013

Year	No. of institutions	Outstanding loans (CNY100 million)
2010	2,674	1,975
2011	4,282	3,915
2012	6,080	5,921
2013	7,839	8,191

Source: PBC (2013a).

7 Microcredit company is a small, privately funded, credit-only institution and supervised by local financial affairs offices.

Large commercial banks such as the ABC and the PSBC have made efforts in developing commercially viable and client-oriented loan products for farmers, MSEs, and rural entrepreneurs. The ABC's business is more focused on agro-related financial products and services. To meet the needs of rural clients, the ABC has tailored a series of financial products for rural clients, including Kins Farmer's Benefit products and *sang nong* oriented products. These products have been applied to loans relevant to rural urbanization, agricultural infrastructure, households, and farmers. According to the PBC (2013b), 359 financial products based on the Kins Farmer's Benefit have been developed, covering a wide range of needs for farmers, households, and MSMEs in rural areas. Table 2.6 summarizes the agro-related products developed by the ABC. As of end-2012, agro-related loans granted by the ABC had amounted to CNY1.97 trillion, a 1.3 trillion increase compared to 2007 when the ABC initiated its reform, requiring it to focus on agro-related services.

As a newcomer among financial institutions, the PSBC has designed its products based on commercial viability and the good practices of other financial institutions. A variety of innovative products have been developed for personal and corporate business, including microcredit and group lending for farm households and group lending for merchants. Besides, the PSBC has extended the range of collaterals, such as the ownership of forestry and land use rights. Factoring has also become available in recent years.[8]

Rural cooperative financial institutions offer innovative products in line with best practices and specific demands of their clients. It is difficult to make a summary of featured products developed by rural cooperative financial institutions due to their variety. Nonetheless, an important philosophy followed in their design is ensuring they meet the needs and demands of clients. The Zhejiang-based Taizhou Bank is a good example. Located in the Yangtze Delta, Taizhou Bank has developed four local MSE-specific products. First, there is *xiao ben dai kuan* (small loan for micro and small business) for MSEs and farm households. This is a localized product developed from a European microfinance product provided by IPC GmbH. The average loan for this product ranges from CNY2,000 to CNY1 million. The second product is the energy efficiency loan for MSEs. This product was modified in 2011 from a product offered only to large enterprises. The third product is the *xing nong* card (*xing nong* refers to promoting farmers and agriculture) for village-based loans. This is a collateral-free loan exclusively for farm households. The target village has a credit line with the bank and farm households can apply for loans from CNY50,000 to CNY300,000. Fourth, the mutual guarantee fund is a product that finances a group of MSMEs in the same industrial chain.

[8] Factoring is a financial transaction in which a company sells its accounts receivable to a third party at a discount.

Table 2.6 Agricultural Bank of China's Major Agro-related Products

	Products	Description
Personal products	Kins Farmer's Benefit Card	Union Pay standard debit card issued to farmer households. Kins Card also provides holders with functions such as carrier of microfinance to farmer households and financial subsidy agents, as well as certain preferential financial service charges.
	Farmer's Benefit Credit Card	A specific debit-credit-in-one card issued for county-level and rural high-end customers. The card can be used for payment, settlement, savings, and wealth management. After credit extension, more personalized functions are available.
	Personal Business Loan for Farmers	This product refers to the large-amount credit granted to individual members of farmer households to meet their fund demands for scale production and operation.
	Microfinance to Farmer Households	A loan granted to individual members of farmer households according to the requirements of universal preferences, broad coverage, and commercialization. For each farmer household, only one family member can apply for this service.
	Loan for House Construction of Farmers in Earthquake-stricken Areas	This product is for special earthquake-affected farmer households. Loan applicants must meet requirements set by the governments.
Corporate products	Rural Infrastructure Construction Loan	A loan for rural infrastructure construction projects, with full-amount principal and interest repaid by the public finance.
	Off-Season Fertilizers Reserve Loan	A short-term working capital loan for customers for their development of commercial reserves of chemical fertilizers during off-seasons.
	Revolving Line of Credit	Line of bank credit approved to be used by customers under the credit line that includes the revolving credit line and the international trade finance line.
	Rural Urbanization Loan	A loan for construction and development of various infrastructure, which is extended by ABC to customers within a county scope for improving county-level production, living conditions, and economic bearing function.
	Commodity Circulation Market Construction Loan	A fixed assets loan for the project owners for county-level commodity circulation market construction.
	Working Capital Loan	A loan granted to satisfy the borrower's need for temporary working capital during normal production and operation.

Source: Based on information from ABC website http://www.abchina.com/en/agro-related-business/ (accessed 10 May 2014).

Each member of the fund contributes 15%–20% of its own loan to the fund and the fund provides guarantees for members when applying for loans (AFDC 2014). A member's joint liability is limited to his or her contribution to the fund. As of end-2013, Taizhou Bank has supported nine projects guaranteed by the mutual guarantee fund and granted CNY200 million to more than 300 MSEs. Rural cooperative financial institutions have innovated a large number of similar but more customized products since 2005.

New-type rural financial institutions have also developed tailored products for their clients. The products are more location specific because the operation of this kind of financial institution, such as VTBs, is restricted to a limited geographical area. VTBs are the most important component of new-type rural financial institutions. This paragraph takes the Inner Mongolian-based VTB, *Ewenki Baoshang* Rural Bank (EBRB), as an example to discuss the characteristics of VTB's financial products. EBRB's philosophy in designing financial products transformed from clients with more fixed assets to farmers and herders. In early 2011, EBRB launched a series of loan products branded "Three Auspicious Treasures" for farmers and herders, corresponding to animal husbandry, herders, and the economic cooperation organization of herders. These loan products effectively supported the development of a "three animal husbandry" related economy. As of February 2014, the value and number of loan balances with this brand reached CNY126 million and 1,879, respectively, with an average single loan size of CNY94,300. Another loan product is "Tala microcredit" launched in 2012, a collateral-free loan specially designed for local MSEs. By the end of February 2014, the value of loan balances of Tala microcredit reached CNY96.2 million and the number reached 759, with an average loan size of CNY175,800. To facilitate female employment, a special loan product called "Tala Beauty Loan" was derived from the Tala loan. This product empowers women's rights with respect to participation, voice, and decision making in their families.

Lending companies included in new-type rural financial institutions only provide loans to clients but the size is small, compared to other banking financial institutions. As of end-2013, the loan balance of 14 lending companies, located in eight provinces and municipalities, was CNY1.6 billion, including loans from four new lending companies.

Although MCCs are providers of financial services, they are not financial institutions and they mainly provide loans to a limited number of clients. In the loan portfolio of MCCs in 2013, personal loans reached CNY507 billion, or about 62% of the total loan balance (CAM 2013). The constraints in financing limit the development of MCCs and different views exist on their future development.

2.2.3 Financing for Micro, Small, and Medium-sized Enterprises

Micro, small, and medium-sized enterprises (MSMEs) have experienced continuous development since 1978 and played a crucial role in boosting the economy, increasing employment, and creating industries. With the development of the financial market and financial products, the financial environment for MSMEs has improved significantly.

Overview of MSMEs

In June 2011, the Ministry of Industry and Information Technology issued *Regulations on Classification Criteria of Small and Medium-Sized Enterprises*. All MSMEs, except those in the construction, real estate, and lease and business services sectors, are classified based on the number of employees and annual sales (Table 2.7).

Table 2.7 Classification Criteria of Micro, Small, and Medium-Sized Enterprises (no. of employees, sales and assets, CNY million)

	Medium-sized enterprises		Small enterprises		Microenterprises	
Sectors	No. of employees	Sales or assets	No. of employees	Sales or assets	No. of employees	Sales or assets
Agri./Forestry/ Fishing		5≤S<200		0.5≤S<5		S<0.5
Manufacturing	300≤N<1,000	20≤S<400	20≤N<300	3≤S<20	N<20	S<3
Construction		60≤S<800 50≤A<800		3≤S<60 3≤A<50		S<3 A<3
Wholesale	20≤N<200	50≤S<400	5≤N<20	10≤S<50	N<5	S<10
Retail	50≤N<300	5≤S<200	10≤N<50	1≤S<5	N<10	S<1
Transportation	300≤N<1,000	30≤S<300	20≤N<300	2≤S<30	N<20	S<2
Storehouses	100≤N<200	10≤S<300	20≤N<100	1≤S<10	N<20	S<1
Postal services	300≤N<1,000	20≤S<300	20≤N<300	1≤S<20	N<20	S<1
Hotels	100≤N<300	20≤S<100	10≤N<300	10≤N<300	N<10	S<1
Catering	100≤N<300	20≤S<100	10≤N<100	1≤S<20	N<10	S<1
Information Services	100≤N<2,000	10≤S<1,000	10≤N<100	1≤S<10	N<10	S<1
Software and IT services	100≤N<300	10≤S<100	10≤N<100	0.5≤S<10	N<10	S<0.5
Real estate		10≤S<2,000 50≤A<100		1≤S<10 20≤A<50		S<1 A<20
Property management	300≤N<1,000	10≤S<50	100≤N<300	5≤S<10	N<100	S<5
Lease/ Business services	100≤N<300	80≤A<1200	10≤N<100	1≤S<80	N<10	S<1
Others	100≤N<300		10≤N<100		N<10	

A = total assets; Agri = agriculture; IT = information technology; N = total number of employees; S = annual sales.

Source: Ministry of Industry and Information Technology. http://www.miit.gov.cn/n11293472/n11293832/n11293907/n11368223/13912671.html

In early 2014, the State Administration of Industry and Commerce (SAIC) released the first survey report on MSMEs. According to SAIC, there are 57 million of these enterprises (including industrial enterprises, privately or individually owned business, and farmers' economic cooperatives). They contributed to 60% of gross domestic product (GDP) and 50% of tax revenue and provided 80% of urban job opportunities, introduced more than 80% of new products, and accounted for 65% of patents and inventions.

The most serious problem faced by MSMEs is difficulty in financing. According to a survey on MSE financing in 2011, about 47% of surveyed MSEs received finance from family members and relatives and 23% from informal lending organizations. The shares of MSEs financed by banks and rural credit cooperatives were 35% and 26%, respectively.[9] The findings came from a survey on MSEs in the Yangtze Delta, the most developed region in the PRC. Similar results were also observed for other coastal regions.

MSME bank credit

MSMEs' access to bank loans has improved significantly with the development of diversified banking and nonbanking financial institutions. Small and medium-sized banking financial institutions played a crucial role in providing financial services to MSEs, while the big commercial banks established small business units (SBUs) to serve MSEs, as shown in Table 2.8. According to the PBC (2013c), loans outstanding to MSEs reached CNY13.5 billion by the end of 2013, about 18% of all loans outstanding.

Table 2.8 Comparison of Loans Provided by Different Banks to Micro and Small Enterprises

Bank Type	Average assets (CNY100 million)	Ratio of MSEs loan to all loans (%)	Ratio of MSEs loans to assets (%)
Large commercial bank	115,880	19.90	6.84
Joint stock commercial banks	19,533	22.10	6.98
City commercial banks	858	39.72	12.91
VTBs	4	87.88	32.87

MSEs = micro and small enterprises; VTB = village and township bank.

Source: Everbright Bank (2013).

[9] Multi-selection questions were used in the questionnaires.

Additional support to MSE financing comes from nonbank enterprises such as MCCs, pawn enterprises, and SME credit guarantee funds. Since 2005, the number of these enterprises has increased quickly and they provide additional support to MSME borrowing. According to the most recent data available, the number of pawn enterprises and SME credit guarantee funds had risen to 5,237 in 2012 and 816 in the second half of 2013, respectively.

MSME financing through capital markets

Direct financing through equity markets and bond markets for MSMEs has experienced fast growth since the 2000s. The SME Board, the first equity market for SMEs, was launched under the Shenzhen Stock Exchange (SZSE) in May 2004. This board originally acted as a pilot venture market, but now has become a market for growing SMEs to raise funds. In September 2004, another market, ChiNext (Growth Enterprise Board), was established under the SZSE for innovative SMEs.

Equity markets

The SME Board and ChiNext expanded the funding channels for growing and innovative SMEs and will play a more important role in realizing the goal of building multi-level capital markets proposed by the central government in the *Decision on Some Major Issues Concerning Comprehensively Deepening the Reform,* released in 2013.

As of end-2013, the SME Board had 701 listed companies with a total market capitalization of CNY3,716 billion, while the ChiNext had 355 listed companies with total market capitalization of CNY1,509 billion (Table 2.9). Manufacturing companies dominate the two boards, followed by IT-related companies. However, the listed companies in the SME Board are geared to traditional industry, while the majority of the listed companies in ChiNext belong to strategic emerging industry. There was no increase in new listed companies in 2013, since the China Securities Regulatory Commission (CSRC) suspended all initial public offerings (IPO) approvals in the SZSE and Shanghai Stock Exchange (SSE) in October 2012.

The SME Board adopted almost the same listing rules as the main board of the SZSE, including profitability in the last 3 consecutive years with net profits of not less than CNY30 million in aggregate. The ChiNext offers less stringent listing rules and shorter operational history, and primarily caters to innovative enterprises and other growing start-ups. Among the listing requirements are profitability in the last 2 consecutive years, with aggregate net profits of not less than CNY10 million.

Table 2.9 Development of SME Board and ChiNext in Shenzhen Stock Exchange (no., CNY billion)

Market Data		2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
SME Board	Listed companies	38	50	102	202	273	327	531	646	701	701
	Market capitalization	41	48	202	1,065	627	1,687	3,537	2,743	2,880	3,716
ChiNext	Listed companies						36	153	281	355	355
	Market capitalization						161	737	743	873	1,509

Source: Shenzhen Stock Exchange website. http://www.szse.cn/ (accessed 25 May 2014).

To effectively promote financing of unlisted SMEs, a new national platform named the National SME Share Transfer System (NSSTS) was established. This system is operated by the National Equities Exchange and Quotations Company. In September 2012, the CSRC released a document for regulation of unlisted public companies and the NSSTS was put into operation in January 2013. The NSSTS is an over-the-counter market. As of end-May 2014, 762 SMEs had listed on the NSSTS (National Equities Exchange and Quotations website).

Together with the development of the NSSTS, regional markets have been and will be established as supplements to national markets. These markets will act as a platform for the transfer of shares and credit assignments of local privately-owned enterprises including SMEs. Markets have already been established in Tianjing, Shanghai, Shenzhen, and other major cities. It is expected that 31 regional markets will be established and about 8,000 companies will be listed.

Interbank bond market

The interbank bond market is the largest bond market among the PRC's three bond markets and has become an important market for SME debt financing since 2007.[10] Institutional investors are the main participants in the interbank bond market, while the exchange bond market allows for participation of individual participants. Key bonds issued and traded in the interbank bond market include government bonds issued by the Ministry of Finance; central bank notes issued by the PBC; financial bonds issued by financial institutions including policy bank bonds, commercial bank bonds, security company bonds and other bonds of financial institutions; and non-financial corporate bonds issued by a wide variety of enterprises, including SOEs and SMEs.

[10] Three bond markets in the PRC are interbank bond market, exchange market, and over-the-counter market. The interbank bond market is the largest one in terms of trading volume.

Two innovative bonds issued and traded in the interbank market are SME collective notes (SMECN) and SME regional leader collective notes (SMECN-II). These two bonds were first issued in 2009 and 2011 respectively, after the National Association for Financial Market Institutional Investors (NAFMII)[11] released the *Interbank Bond Market Small and Medium Sized Non-financial Enterprise Collective Bills Guidelines* in 2009.

SMECN and SMECN-II belong to medium-term notes (MTNs). According to the guidelines released by the NAFMII, MTNs are defined as debt finance instruments that are issued in tranches, and are paid back within a certain maturity.

SME collective notes

An SMECN is a fixed maturity debt instrument that can be collectively issued by 2 to 10 legally operating small and medium-sized non-financial enterprises. SMECN is a standard product, sharing a common credit rating, and issued on the interbank bond market after collective registration.

According to NAFMII rules, issuers of SMECNs are subject to the following key conditions:

i. Must issue collective notes according to the guidelines by registering at the NAFMII. Registration should be done for each single issuance.
ii. Must abide by national regulations and laws. Any single SMECN to be repaid cannot exceed 40% of net assets. Furthermore, the funds raised by any single SME cannot exceed CNY200 million, whereas the collective note itself cannot be more than CNY1 billion.
iii. Will raise capital for business production purposes in line with national regulations and laws. Furthermore, issuance documents must clearly disclose the use of capital, and any change in the use of capital will be disclosed. The product structure of an SMECN cannot violate relevant laws and regulations. The legal relationship between the different participating enterprises, as well as the payment responsibilities of each enterprise, should be defined clearly.
iv. Should set debt repayment protection measures, and clearly disclose in issuance documents updated credit information, a capital repayment plan, and debt repayment protection measures.
v. Should disclose their facility credit rating, the credit rating of each participating enterprise, and the collective credit rating performed by a qualified credit rating agency.
vi. Should arrange in their issuance documents outlining investor protection mechanisms, including measures in the scenario of a downgrade in the credit

[11] NAFMII was established in 2007 and is supervised by the PBC. NAFMII is the approval and registration body for issuance of MTNs.

rating, measures to be taken in the event of the deterioration in the financial situation of the enterprise, and measures to be taken in the event of a breach of contract.

vii. Should disclose relevant information on the interbank bond market according to the guidelines.
viii. Must use qualified agents for SMECN issuance. This will help solve the problem of individual small-sized enterprises unable to independently issue bonds. By pooling resources, it lowers the bar for individual enterprises to access the bond market. However, because many SMEs are in different regions and industries, the time and resources required to organize an SME collective is relatively high, thus accounting for a low volume of issuance and slower growth.

As of the end of 2013, 77 SMECNs had been issued (Table 2.10).

SME regional leader collective notes

SME regional leader collective notes (SMECN-II) are an innovative instrument based on the SMECN. This joint financing tool supports non-financial SMEs in a specific region with core technology and/or products with strong market potential, while benefiting from the support of government guarantee measures. This model of collective notes has been a joint initiative of local government offices, the PBC's local offices, and the NAFMII, while also having the cooperation of commercial banks, credit enhancement agencies, and local guarantee companies, in order to design a more tailored bond financing product suitable for small scale non-financial enterprises. Five SMECN-IIs were issued in 2011, with the funds raised reaching CNY1.39 billion.

The key characteristic of the SMECN-II is the participation of local governments. Within this model, the key role of the government can be summarized as follows: (i) relevant government agencies will take care of the initial filtering, and recommend SMEs in industries supported by relevant policies; (ii) the government will directly inject capital into a risk guarantee fund, with contributions also required from SMEs participating in the scheme. In the case that the enterprise is unable to meet its commitments, the risk guarantee fund will be drawn upon. The government may also provide related tax or financial subsidies; and (iii) relevant government agencies will recommend credit enhancement agencies to the issuing enterprises to achieve a suitable credit rating. Due to the strong involvement of the government, SMECN-IIs expanded quickly since first issued in 2011 (Table 2.10).

In 2013, a new kind of bond, the supporting bond for MSEs or credit-enhanced collective bonds for MSEs, began to issue in the interbank bond market. This bond is issued by an SOE or a government-supported company. The funds raised

Table 2.10 Issuance of SMECN and SMECN-II

Type		2009	2010	2011	2012	2013
SMECN	No. issued	4	19	17	34	3
	Raised funds (CNY billion)	1.27	4.66	5.23	7.09	0.52
SMECN-II	No. issued			5	11	28
	Raised funds (CNY billion)			1.39	2.92	6.12

SMEs = small and medium-sized enterprises; SMECN = SME collective notes; SMECN-II = SME regional leader collective notes.

Source: Compiled by authors.

through the issuance of this kind of bond can be provided to MSEs in a limited jurisdiction in the form of trusted loans through a commercial bank. In 2013, four companies in Tianjing and Jiangsu provinces had issued this bond with a maturity of three years.

2.2.4 IT-based Financial Services in Financial Inclusion

With the development of information technology, more new models have emerged to expand financial services to the unbanked population. Although there are debates on the safety of IT-based financial instruments, they have created many innovations in expanding financial services in rural and urban areas.

Peer-to-peer lending platforms

Peer-to-peer (P2P) lending platforms have been a fast-growing phenomenon since 2006 and are an important provider of financial services. According to CreditEase (2013), there are more than 200 P2P platforms nationwide. P2P lending platforms bring lenders and borrowers in rural and urban areas into contact via the internet, with individuals wanting to lend and those wanting to borrow self-matching online. In the transaction procedure, the borrowers pay interest to the lenders via the platforms and the platforms charge transaction fees. Well-known examples of the P2P model are CreditEase, Renrendai, 51Qian, and Tuandai. These platforms target the rural unbanked segments as part of their client portfolio. No exact data on the number of clients and average loan sizes are available, but it is assumed that the number of clients are significant and growing, and a proportion of the loans provided are small or microloans.

A new trend in P2P platforms is that a growing number have been operating their businesses offline and online; they seek investors online and lend to

borrowers offline. For lending to borrowers, the platforms operate like small loan companies.

The fact that investors in P2P platforms can earn higher returns has attracted many speculators into the market. In the past few years, P2P platforms have been growing at an annual rate of 300%. As a result, regulators have paid increasing attention to P2P platforms.

Third-party payment services

The third-party payment provider service is one of the major innovations in the development of financial inclusion in the PRC. As of end-2012, more than 200 third-party payment licenses had been approved (Butani 2012). The volume of online transactions provided by these providers was estimated to be CNY3.8 trillion in 2012, triple their turnover for 2011 (Wang 2013).

In terms of market share, Alibaba is at the top with 48.9% share of the market, followed by Tenpay with 20.2%, Unipay, 99bill, and ChinaPnR (Chen 2013). There are two kinds of development models used by the PRC's third-party payment enterprises. Alipay and TenPay focus largely on the needs of individual users in business development and product innovation. 99Bill, ChinaPnR, YeePay, iPS and others treat corporate users as the focus of business development, providing integrated solutions to enterprises (Research in China 2013).

Third-party payment enterprises provide low-income, rural populations with access to a broader range of goods and services at lower prices and have helped create more than a million jobs directly through business growth, as well as indirect jobs through their collaboration with logistics companies and other partners.

Branchless banking

With the development of information technology, a number of branchless banking initiatives have emerged. According to CGAP, branchless banking refers to the delivery of financial services outside conventional bank branches, using agents or other third-party intermediaries as the principal interface with customers, and relying on technologies such as card-reading point-of-sale terminals and mobile phones to transmit the transaction details (CGAP 2011). Although the term "banking" is used, branchless banking is not limited to bank services; it includes a broad array of financial services often provided by nonbanks.

Mobile banking

As mentioned earlier, the PRC had 1.23 billion mobile phone subscribers at the end of 2013. The number of mobile banking users reached 150 million in 2012, accounting for more than 40% of mobile banking users worldwide. In the same

year, the number of mobile banking users increased 100%, and the value of transactions via mobile phones increased 300%. (Zhang 2013).

All commercial banks already offer mobile banking services, although with differing levels of sophistication. To meet the fast-growing needs of mobile subscribers for financial services, banks have been developing innovative products for different enterprises and clients. For example, a Shanghai-based bank, Shanghai Pudong Development Bank, has developed an innovative "account-to-cell" remittance product and mobile enterprise solutions tailored for small business.

In terms of financial inclusion, mobile banking has proven to be more additive than transformational in the PRC, serving clients who are already banked, rather than using these innovations to reach unbanked and underserved markets. While this is common worldwide, it misses the opportunity of using low-cost and accessible mobile channels to drive financial inclusion.

SIM overlay technology for small financial institutions

Combining the subscriber identity module (SIM) overlay technology with mobile banking is an innovation provided by Shanghai-based F-Road.[12] F-Road, working with smaller financial institutions, provides a mobile platform that enables end-clients to access basic banking services via nearly any type of mobile phone.

F-Road's established partnerships with small financial institutions include rural financial institutions such as rural commercial banks, rural credit cooperatives, and VTBs. These institutions serve millions of low-income and poor clients. F-Road serves nearly 650 financial institutions across the country and reaches 4 million active users.

Mini branch self-service points

Self-service banking models can be considered as a PRC innovation in financial inclusion (Shrader and Duflos 2014). It is hard to conclude who first created this model but the Bank of Huzhou could be taken as a good example. It has developed a relatively low-cost "mini branch" model that includes a suite of five self-service machines for very small villages with no bank branches. The machines were custom designed and built in the PRC, and can open accounts and issue bank cards in real time, taking advantage of the PRC's universal identification card and easy account opening standards. Another machine uses a high-resolution scanner to process checks for deposits. The mini-branch suite of self-service machines can perform 95% of all branch functions, with no bank staff, allowing the bank to open mini-branches without heavy regulatory

[12] For more information about F-Road, see http://www.f-road.com.cn/froadcom/IndexPage.do?lang=V100212

requirements and cost. Community volunteers manage the mini-branch to help new clients use services.

Television banking

Chongqing-based Three Gorges Bank has worked with its area cable operator to deliver banking services via television. Bank clients with a television and a standard cable service can elect to add this channel and manage their accounts using the basic television remote to maneuver through banking operations, including making payments, enquiries, and transfers. While this is a new service launched in early 2013 and reached only 2,000 clients in its initial months of implementation, the bank believes it will provide greater accessibility and more intuitive interfaces than personal computer banking, particularly for older urban clients. Costs of operation and setup for this service are low, and more banks, such as the ABC and Bank of China, are offering this type of service, trying to tap this ubiquitous digital channel.

Mobile payment pilots

Three mobile network operators (MNOs) are innovating in the area of near-field communication technology, which is largely focused on urban commercial pilot projects for financial institutions, mobile operators, and other companies. In 2012, the PBC launched pilot projects for mobile payment services in select rural areas. To use the service, rural residents must apply for a credit card, along with a SIM card linked to their bank account. The mobile service allows users to process taxes, make remittances, and withdraw small amounts of cash. The ABC, PSBC, China Union Pay, and three telecommunications operators are among the first batch of companies participating in the pilot projects (Shrader and Duflos 2014). China Union Pay is conducting training programs for some agricultural product dealers to promote mobile payment services in rural areas.

2.2.5 Agricultural Insurance

Development of agricultural insurance

Agricultural insurance can be traced to 1950, but was suspended in the 1980s. In 2004, agricultural insurance restarted with the launch of several pilot programs. From 2007, agricultural insurance entered a fast-growing stage after several preferential policies were put into effect. In 2012, the *Rule of Agricultural Insurance*, the first of its kind in the PRC, was released. Since then more relevant policies such as *Administrative Rules on Agricultural Insurance Risk Reserve* have been released to promote the development of agricultural insurance.

As of end-2013, there are 23 agricultural insurance providers with 400,000 staff in rural grassroots areas, including 23,000 outlets at county level and 280,000 outlets at township and village level (He 2014).

Major policies and products in agricultural insurance

In 2013, the *Rule of Agricultural Insurance* came into effect. The national policies to support agricultural insurance included two categories: premium subsidies and tax preference. In addition, regulation fees were exempted by regulatory bodies.

The operation of agricultural insurance can be characterized as a government guided, market-oriented operation, with voluntary and concerted efforts. Several models have been developed nationwide for agricultural insurance, depending on the methods of risk sharing and premium sharing. Fiscal subsidies have played an important role in agricultural insurance in the PRC. However, more effort is needed to let market mechanisms work more efficiently.

As of end-2013, the number of insured varieties in agricultural insurance reached over 90, including food crops, cash crops, livestock products, and forestry products.

2.3 Challenges and Opportunities

The last decade has witnessed the rapid development of financial inclusion in the PRC. New policies, regulations, and measures put into practice have significantly improved financial inclusiveness by increasing access to financial services. There is a huge potential in the construction of an inclusive financial system. The final goals of developing financial inclusion are to allocate funds more effectively and promote the sustainable development of the real economy.

2.3.1 Opportunities

Financial inclusion has benefitted the real economy in the past ten years and more opportunities will emerge in the process of realizing the long-term goals to double GDP and per capita GDP between 2010 and 2020. To realize these goals, the financial system will play a more crucial role in serving the real economy, the low-income population, and MSMEs. Besides, the PRC still shows great potential for economic development in the coming decades.

The development of diverse types of institutions with varying ownership is one of the crucial factors in broadening financial inclusion. The financial system, previously dominated by state-owned banks, fails to meet the highly diversified demands of enterprises and individuals. The findings from research and surveys

indicate that the groups having difficulty accessing financial services rely largely on small banks and nonbank providers. Small banks and nonbank providers have a deeper reach than most large and medium-sized banks. Unfortunately, the outreach of small banks and nonbank institutions, including pawn enterprises and guarantee companies, is limited. New financial reforms that allow private capital to enter the banking sector will promote the building of a more effective financial system comprised of more diversified banking and nonbanking financial institutions that can meet the different demands for financial services.

A well-developed inclusive financial system includes an array of innovative financial products. In the past ten years, banking financial institutions have developed, on the basis of providing commercially sustainable, innovative products for rural people, MSEs and other privately owned enterprises. Since 2006, the CBRC has guided banks to be firmly committed to serving the real economy, improving rural financial services, and enhancing financial services for SMEs. In this context, financial institutions supervised by the CBRC have incentives to develop more featured products in line with the requirement of the CBRC's prudential supervision.

With the rapid increase of mobile phone subscribers and internet users, there is considerable potential for increasing the commercial provision of mobile- and internet-based financial services to the excluded. The small and medium-sized financial institutions have been developing an array of featured products and services through mobile and internet platforms. At the same time, some enterprises provide tailored financial solutions to micro and small financial institutions serving millions of low-income people. The Shanghai-based F-Road and CardPay Financial consulting companies are good examples.

The continual improvement of financial infrastructure offers opportunities for developing branchless banking. The PRC's comprehensive identification system, first established in the 1980s and modified in the 2000s, helps bank and nonbank financial institutions to meet the "Know Your Customer" requirements and to recover loans. It also provides third-party platforms and e-commerce enterprises such as Alibaba and Taobao the possibility of using data to analyze the consumption behavior of their clients and to manage the risks in granting micro loans. The excellent mobile phone infrastructure and wide network of branchless access points offer opportunities for reaching a large number of clients at low cost. The improvement in financial infrastructure, including deposit insurance, credit information systems, and payment systems, has started to contribute to the expansion of opportunities (IMF 2012).

Understanding the demands of different market segments is important in the promotion of financial inclusion. The classification criteria of SMEs released by the Ministry of Industry and Information Technology (MIIT) in 2011 has been used in surveys of access to formal and informal finance and in setting MSME policies.

For example, in accordance with the new criteria, the CBRC has approved a series of policies to improve financial services to MSMEs. Research findings, such as those provided by Everbright (2013), can help bank and nonbank financial institutions to understand the difficulties of rural people and MSEs accessing financial services and to develop more featured products for these segments.

2.3.2 Challenges

The PRC's new round of economic reform offers opportunities for promoting financial inclusion, while there are challenges to be addressed in achieving future progress.

Financial infrastructure

The central government and financial authorities have released documents, policies, and regulations to promote an inclusive financial system to improve financial services to rural people and MSEs. The macro environment is right for accelerating the development of financial inclusion but more differentiated policies and regulations are needed for different financial institutions.

Rural financial institutions have a deeper reach than most banks. The VTBs, as major actors of new-type rural financial institutions, may need more preferential policies to expand their services and to become commercially viable. According to AFDC, the factors constraining the VTBs' growth include control by a single large shareholder, deviation of market position, difficulties in mobilizing savings, and a lack of financial innovation. Therefore, more preferential policies are needed to support the development of VTBs. The entry of private capital into the banking sector helps to improve efficiency of the VTBs (AFDC 2014). According to the CBRC, the initiating institution of a VTB must be a banking financial institution and its stake shall not be less than 20%, although this figure had decreased to 15% in 2012 in line with the CBRC's *Implementation Opinions on Encouraging and Guiding Private Capital into the Banking Industry* (CBRC 2007). However, the provision of requiring a banking institution as initiator of a VTB has not loosened. This provision may limit the innovation of VTBs and the injection of new vitality. In addition, the current requirement of legal deposit reserve ratios of VTBs is 15%, the same as for rural credit cooperatives, which places a huge burden on VTBs. Since VTBs are crucial providers of financial services in financial inclusion, preferential tax policies are needed. According to current practice, the VTBs pay 5% business tax, compared to 3% for RCCs. As for income tax, RCCs can be exempted or levied at half the regular rate, while VTBs have to pay the full amount.

Nonbank providers, including MCCs and P2P platforms, are also important actors in financial inclusion, in particular the microcredit companies. One key challenge

faced by microcredit companies is the source of funds. As non-deposit taking lenders, MCCs are mainly financed from their own funds. The external financing sources include borrowing from other banking institutions. In the financing portfolio of MCCs, self-financing amounted to 93% of total new financing in 2013 (CAM 2013). Policies are needed to expand the sources of refinancing so MCCs can provide financial services to rural and low-income people. It is reasonable to consider the possibility of MCCs raising funds in the bond market, like other non-financial enterprises. More in-depth research is needed to start a pilot program.

Credit information services can contribute significantly to improving the banking and payment ecosystem. The shortage of reliable and sufficient credit information makes it difficult for financial service providers to manage the risks relevant to their clients. The enhancement of credit information services is crucial for financial inclusion. The Credit Reference Center (CRC), established by the PBC in 2006, provides limited credit information services to individuals and enterprises. Credit information included in this system is provided to financial and other institutions for references in proving financial services. Apart from the CRC, there are many privately owned credit information service providers that supply limited credit information about local residents. In January 2013, the State Council released the *China Credit Reporting Industry Regulation,* but more effort is needed to effectively share credit information and make financial inclusion in the PRC more efficient.

It is important to coordinate the rules relevant to branchless banking. Branchless banking has benefitted from the tremendous growth of mobile phone and internet users since 2005. The development of branchless banking encompasses regulators and services providers. The PBC and CBRC are responsible for supervising and regulating branchless banking, and the MIIT is responsible for regulating mobile network operators, the internet, software companies, and the production of electronic and information goods used in branchless banking. Regulators have released regulations related to branchless banking, electronic banking, anti-money laundering, and consumer protection, which played an important role in promoting branchless banking, but increased the need to enforce implementation. In addition, more effort is needed in financial standardization to allow broad interoperability and interconnection in financial transactions.

Lack of financial innovation

Lower innovative capacity in financial products and services is a constraint to financial inclusion in the PRC, in particular for the small institutions such as VTBs and small rural commercial banks. The policies need to support capacity building in financial innovation for rural and small financial institutions. Policymakers, practitioners, and academic institutions can conduct a joint analysis of actual demand and the difficulties in accessing financial services by underserved people. Support also should be given to providers such as F-Road and Cardpay

that provide professional solutions to rural and small institutions. VTBs should foster their capacity in creating financial products according to the characteristics of rural credit, such as the issuance of microcredit, the promotion of group guarantees and group lending among farmers and MSEs, and the development of financial products to satisfy seasonal needs (AFDC 2014). However, governments and regulators need to guide and support capacity enhancement in providing innovative financial services.

Financial literacy

The PRC's financially-excluded segments encompass populations living in underdeveloped regions and migrant workers in urban areas. The lack of financial knowledge makes these segments unable to use financial services. Fostering greater financial understanding through financial education to financially-excluded segments can help to promote financial inclusion as well as poverty reduction. As a regulator of the financial sector, the CBRC established a website for public financial education and requested financial institutions to provide their clients and the public with basic financial knowledge. Core contents of financial literacy for the public include a basic knowledge of financial products and services, and financial regulation. Financial scams, fraud, and illegal deposit mobilization require the public to pay more attention to financial literacy.

2.4 Conclusions and the Way Forward

2.4.1 Conclusions

Based on the analysis above, the conclusions are summarized as follows.

The economic and financial environment for financial inclusion has been improving. The beginning of the 21st century represents a watershed in developing financial inclusion in the PRC. The policies that favored large state-owned enterprises in urban areas and on the coast at the expense of rural households, SMEs, and social equality, have changed to benefit all economic entities and all segments of the population. New policies introduced in the past ten years have had an important impact on the economic and financial landscape of the PRC. As a result, the macroeconomic environment for economic and financial development has improved dramatically. SMEs and other privately owned enterprises are encouraged to play a greater role in economic development as many industrial sectors previously monopolized by SOEs have opened to private capital including the banking sector.

Significant progress has been achieved in financial inclusion. Driven by new policies, financial inclusion has witnessed a profound change. There has been an

increase in the number of financial institutions with a mandate to provide financial services to the previously excluded—in particular rural people and MSMEs. The financial system, previously dominated by the "big five" commercial banks, has changed with the entry of a large number of banking financial institutions, nonbanking financial institutions, and non-deposit taking lenders. Financial institutions' networks cover all towns and villages. The traditional business of banks is more commercially viable. Financial service providers are experimenting with branchless banking by applying the latest technologies and developing financial products and services based on internet and mobile phone technology.

Financial inclusion is not sufficient and needs to be improved. While financial inclusion has been promoted, efforts need to be made so the weakest can access basic financial services. About 36% of adults do not have a bank account and most of them live in rural and remote areas. The financial product and service requirements of MSEs and households are far from satisfied, despite a significant increase in the number of such products and services available. In addition, very few financial institutions serve the poorest with financial services they urgently need, such as microcredit. In the field of agricultural insurance, more services are needed.

2.4.2 The Way Forward

Financial inclusion in the PRC has made remarkable progress but will face additional challenges in the future. Based on analysis and practices in the past ten years, more work remains to be done to promote financial inclusion.

Enhancing financial services by different providers

MSMEs and rural people are the major targets of financial inclusion. Medium and small financial institutions and new-type rural financial institutions are the key providers in serving MSEs and rural households.

Financial institutions have been enhancing their services for MSEs. Policies need to play a greater role in guiding different financial institutions to enhance the services available to different types of MSMEs in urban and rural areas in line with the principle of comparative advantage.

The VTBs are becoming a crucial driving force in serving rural MSMEs and farmers but face additional challenges in expanding their services for clients. Policies can focus more on fostering the capacity to innovate and building a more favorable environment for development, such as preferential financial and tax policies. The VTBs are encouraged to develop more products and services for their clients in line with their specific demands.

As one of the non-deposit taking lenders, MCCs are becoming an important supplement to the mainstream financial system, providing much-needed funding support to MSMEs and farmers. Two considerations in policymaking are: (i) conducting differentiated regulation to gradually relax the leverage restrictions on MCCs; and (ii) creating the possibility of raising funds through bond markets. For this purpose, MCCs need to improve their operating performance and information disclosure to meet the requirements of issuing bonds in the bond market. A possible way is to take the practices in issuing the SMECN-II as a reference, that is, to introduce a government additional guarantee for issuing bonds. More research is needed.

Developing SME facilities in capital markets

Equity markets have expanded the financing channels for SMEs but more effort is needed to benefit more SMEs. The newly established NSSTS provides unlisted SMEs with a chance to raise funds via this system; the development of this market will speed up in the coming years by creating more products and services.

The interbank bond market has developed several innovative products for SMEs since 2005, such as the SMECN and SMECN-II. The role of an interbank bond market in supporting SMEs could be enhanced by creating more innovative products. These include:

i. Supporting commercial banks could issue special financial bonds. In 2013, the CBRC approved 30 commercial banks (normally, the medium-sized ones) to issue special financial bonds to expand the size of loans to SMEs.[13] This practice will be extended to more commercial banks. In addition, the financial authorities are considering allowing commercial banks to issue special financial bonds used for granting agro-related loans.

ii. Supporting SOEs could issue credit-enhanced collective bonds for MSEs. Like special financial bonds, this kind of bond can be issued by SOEs or government-supported enterprises to finance MSEs in a specified region through trusted loans, in collaboration with commercial banks.

Enhancing credit information services

The development of branchless banking and digital payment need the support of a well-functioning credit information system. Currently, many institutions involved in financial inclusion have failed to have credit information of their clients. Building a comprehensive credit information system will promote information sharing among financial regulators, financial institutions, and organizations

[13] In 2013, the size of special financial bonds amounted to CNY4,000 billion.

providing public services. The CRC could play a key role in credit information services.

Development of agricultural insurance

Agricultural insurance (first started in the 1950s and suspended in the 1980s) restarted in 2004. As farmers are badly affected by natural disasters, agricultural insurance is very important for financial inclusion.

The core orientation of policies on agricultural insurance is to improve the market mechanism and to minimize government intervention. Efforts will focus on:

i. Developing models to draw up insurance rates on the basis of data analysis. Policies will guide and support insurance service providers to establish scientific ways to figure out approximate insurance rates for farmers and agricultural products in different regions.

ii. Developing more innovative insurance products for agricultural products. It is important to foster the capacity of innovation in agro-related insurance. There are more than 600 agro-related insurance products covering 90 crop varieties but this is not sufficient.

iii. Promoting the application of new technology to agricultural insurance. Policies will promote the application of new scientific innovation to agricultural insurance, such as satellite remote sensing, drone remote sensing, and ground surveys. The application of new scientific innovation can help insurance providers in developing new agro-related insurance products.

References

Agricultural Bank of China (ABC) website. http://www.abchina.com/en/about-us/about-abc/Overview/

Asia–Pacific Finance and Development Center (AFDC). 2014. *2014 Asia–Pacific Financial Inclusion Forum: China's Cases*. Unpublished.

Ali Research. 2011. *A Survey Report of Micro and Small Enterprises in Three Coastal Regions in China* (in Chinese). http://www.aliresearch.com/?m-cms-q-list-cid-7-ccid-123.html

Butani, D. 2012. Mobile Subscriber Base in China Crosses 1.104 Billion with Revenues Over $116.26 Billion in 2012. *Fonearena*. 25 December. http://www.fonearena.com/blog/59613/moblie-subscriber-base-in-china-cross-1-104-billion-with-revenues-over-116-26-billion-in-2012.html.

China Association of Microcredit (CAM). 2013. *Microcredit Bulletin.* 6: 37–40 (in Chinese).

China Banking Association (CBA). 2011. *Research on the Development of Village and Township Banks (VTBs) in China.* Beijing: China Banking Association.

China Banking Regulatory Commission (CBRC). 2007. *The Interim Provisions of Village and Township Banks Administration.* Beijing: China Banking Regulatory Commission.

———. 2011. *2011 Annual Report of China Banking Regulatory Commission.* Beijing: China Banking Regulatory Commission.

———. 2013. *2012 Annual Report of China Banking Regulatory Commission*. Beijing: China Banking Regulatory Commission.

Consultative Group to Assist the Poor (CGAP). 2006. *Access for All: Building Inclusive Financial Systems.* Washington, DC: World Bank.

———. 2011. *Global Standard-Setting Bodies and Financial Inclusion for the Poor: Toward Proportionate Standards and Guidance*. Washington, DC: World Bank.

———. 2012. *Financial Inclusion in the People's Republic of China*. Washington, DC: World Bank.

Chen, A. 2013. *2012–2013 China Third-Party Payment Report.* Beijing: iResearch Reports.

CreditEase. 2013. China's First P2P Industry White Paper Released, Indicating Fast Development of Internet Finance. http://english.creditease.cn/pressroom/PressRelease/2013/0719/84/ht

Everbright Bank. 2013. *Report on Small and Micro Business Financing: Chinese Experience and Asian Paths* (in Chinese). Unpublished.

He, H. 2014. The Development and Regulation of China's Agricultural Insurance. Presented at the APEC Seminar on Improving Financial Services for Regional Real Economy.

International Monetary Fund (IMF). 2012. Financial Access Survey, Mainland China Report. http://elibrary-data.imf.org/public/FrameReport.aspx?v=3&c=20573689&pars=Country,924 (accessed 30 May 2014).

National Bureau of Statistics (NBS). 1997. *A Survey of Laid-off Workers* (in Chinese). Beijing: National Bureau of Statistics.

———. 2014. *2013 Statistical Bulletin of National Economic and Social Development* (in Chinese). Beijing: National Bureau of Statistics. http://www.stats.gov.cn/tjsj/zxfb/201402/t20140224_514970.html

National Equities Exchange and Quotations website. http://www.neeq.com.cn/html/listing.html (accessed 30 May 2014).

People's Bank of China (PBC). 2013a. *2012 Report of China Payment System* (in Chinese). Beijing: People's Bank of China.

———. 2013b. *China Rural Finance Service Report* (in Chinese). Beijing: People's Bank of China.

———. 2013c. *China Financial Stability Report* (in Chinese). Beijing: People's Bank of China.

———. 2014a. *Statistics of Microcredit Companies* (in Chinese). Beijing: People's Bank of China. http://www.pbc.gov.cn/publish/diaochatongjisi/3172/ 2014/2014 0422154234421754813/20140422154234421754813_.html

———. 2014b. *2013 Report of China Payment System* (in Chinese). Beijing: People's Bank of China.

Research in China. 2013. *China Third-Party Payment Industry Report, 2013–2016*. Beijing: Research in China.

Shrader, L. and E. Duflos. 2014. *China: A New Paradigm in Branchless Banking?* Washington, DC: Consultative Group to Assist the Poor.

Wang, F. 2013. New Payment Rules from PBC. *Global Times*. 12 June. http://www.globaltimes.cn/content/788360.shtml#.Uybq6_mSwuc.

World Bank Database. http://datatopics.worldbank.org/financialinclusion/country/china. (accessed 10 May 2014).

Xinhuanet. 2013. China Drafting Regulation for Mobile Payment. http://news.xinhuanet.com/english/china/2013-12/11/c_132959171.html

Zhang, H. 2013. Mobile Banking Trends in China. *Celent*. http://www.celent.com/reports/mobile-banking-trends-china.

3 Financial Inclusion in Indonesia: A Poverty Alleviation Strategy

Khan Kikkawa and Yuqing Xing

3.1 Introduction

In 2010, President Susilo Bambang Yudhoyono[1] announced at the Global Policy Forum that Indonesia has adopted financial inclusion as an essential pillar of the national strategy for reducing the rising income disparity between rural and urban areas, due to the excessive concentration of industrialization under Suharto's New Order regime from 1965 to 1998. The Indonesian government has implemented a variety of programs to improve access to financial services for micro, small, and medium-sized enterprises (MSME) and impoverished households through financial deregulation, education, no-frills bank accounts, financial identity programs, and small business loan programs backed by the government. No-frills savings accounts and financial education initiatives have promoted saving and improved MSME access to finance. Bank Rakyat Indonesia, the second largest bank, has proven that it is a win-win strategy by engaging in microfinance. In addition, the government has encouraged commercial banks to enhance their infrastructure by building bank branches and installing automated teller machines (ATMs) to reach populations with limited access to financial services, and reformed financial regulations to accommodate the operation of mobile money and the entry of telecommunication companies into financial services.

Having easy access to various financial services by poor, vulnerable, and less privileged people is the essential objective of financial inclusion. Indonesia is a

[1] Susilo Bambang Yudhoyono completed his term of office as president in 2014.

country with more than 270 million people living in more than 17,000 islands. The geographic diversity and mass population pose natural obstacles to financial inclusion. The remote location of small islands and the limited banking potential of their inhabitants discourage banks from reaching out and providing financial services. Hence, improved financial inclusion through increased banking infrastructure such as new bank branches and ATMs are less successful than expected as these branches are mainly located in urban areas and not reaching unbanked citizens in rural areas in Indonesia's many small islands. The mobile banking initiative has been equally constrained by strict financial regulations that impose high transaction costs for individuals to open bank accounts. Some of the existing financial regulations even clash with the goal of financial inclusion.

This chapter provides an overview of financial inclusion activities in Indonesia. It focuses on the status of financial access by low-income households and micro and small-sized enterprises and major initiatives of public and private institutions for promoting financial inclusion.

3.2 Objectives and Targets of Financial Inclusion in Indonesia

Bank Indonesia is one of the major public agencies responsible for designing and implementing strategies for promoting financial inclusion. It defines financial inclusion as:

> The right of every individual to have access to a full range of quality financial services in a timely, convenient, informed manner and at affordable cost in full respect to his/her personal dignity. Financial services are provided to all segments of the society, with a particular attention to low-income poor, productive poor, migrant workers and people living in remote areas (Bank Indonesia, 2014a, p. 1).

The recent Household Balance Sheet Survey revealed that 52.4% of Indonesians do not have any savings or savings accounts with banks or nonbank financial institutions (Bank Indonesia, 2014a). People with limited or no access to financial services are classified into three groups: low-income poor, working poor, and near poor. Bank Indonesia's financial inclusion programs target these three groups. Table 3.1 outlines the major characteristics of each group.

Four major factors that affect the demand of the targeted groups for financial services are: geographic location, migration, low marginal propensity to save, and education level.

Geographic location. Rural residents accounted for 48% of Indonesia's population in 2013 (World Bank 2014). Although poverty rates were close

Table 3.1 Characteristics of Targeted Group

Target / Financial capacity	Low-income poor	Working poor/ productive poor	Near poor
Ability to save	Do not have any savings ability/have very low ability without access to savings service	Have ability to save some of their income in informal manner	Have savings ability and access to formal banks
Access to credit	Unable to repay	Have access to informal credit. Able to repay credit, but do not have collateral which can be accepted by bank	Have access to some formal and informal sources. Able to pay credit and have collateral
Insurance needs	Vulnerable to personal and public (economic) turbulence	Have some support, but can be highly influenced by turbulence	Have various instruments to face risks
Remittance needs	Receive remittance from family members working as migrant workers	Need for remittance as well as possibility to remit money through mobile devices	Possibly need to remit through banks, pay bills, etc.
Financial literacy	None	Medium	Medium
Financial identity	None	Limited	Limited

Source: (Bank Indonesia, 2014a).

to equal in both rural and urban regions in 1980 (29% in urban versus 28.4% in rural), poverty rates in urban areas declined rapidly with rates close to half of those in rural areas as of March 2013 (8.39% in urban areas, 14.32% in rural areas) (Statistics Indonesia 2014b). Poverty is one reason why a substantial portion of rural residents has no access to financial services. Besides, rural resident populations are less likely to gain access to financial services due to their distance from urban centers. Under current banking regulations, bank accounts can only be opened in bank branches, most of which are located in urban areas. Thus, only 16.23% of Indonesian adults in rural areas have an account with a formal financial institution compared to 28.93% of adults living in urban areas as of 2012 (Demirguc-Kunt and Klapper 2012). Without access to the physical financial infrastructure, unbanked individuals cannot open accounts and thus cannot utilize financial services needed for their development.

Migration. Indonesia is the third largest remittance recipient in the Asia and Pacific region, with 80% of migrant workers being women and 85% working in the informal sector. Migrant workers generally come from poor farmer households in rural areas with low incomes and have limited access to formal financial products

or services. Remittances contribute significantly to Indonesia's economy. In 2012, Indonesia received $7.2 billion in remittances from 6.5 million migrant workers, excluding remittances imported through unofficial channels such as cash. Combining total official and unofficial remittances, Indonesian migrant workers are estimated to bring close to Rp120 trillion ($12.36 billion) (Anjaiah 2013). Providing secure and efficient remittance services at low cost will improve financial inclusion.

Low marginal propensity to save. Poverty is one of the major reasons that low-income groups have no or limited access to financial services. 68.1% of the Indonesian population saves with 47.6% of the entire population possessing a savings account at a formal institution. Out of the 31.9% who do not save, 79% responded "no money" as the main reason for the lack of a savings account, while 9% responded "no job" as their main reason (Srinivas et al. 2010). Bank Indonesia defines these two individual groups as the low-income poor and the working poor. Low-income poor refers to an "extremely poor group of people who may receive social assistance and are the lower segment of poor category as part of community empowerment program" (Bank Indonesia, 2014a). The working poor is defined as "poor people having their own jobs, including small and marginal farmers, fishermen, artists and craftsmen, small traders, and micro businesspeople in the informal sector in urban and rural areas" (Bank Indonesia, 2014a).

Education level. Indonesia has made significant progress in providing universal primary and secondary education. 31.55% of the population aged 15 years and over have attained a secondary education and at least 80.66% have a primary school education in 2013 (Statistics Indonesia 2014a). Unfortunately, Indonesia's education system does not adequately cover financial education. According to Indonesia's financial literacy survey, 46.57% of respondents who finished primary school and 59.57% of respondents who finished secondary school possessed moderate to high levels of basic financial literacy and only 1.3% of primary school and 3.19% of secondary school graduates possessed moderate to high knowledge of advanced financial literacy (DEFINIT 2013).[2] People with limited or no financial knowledge tend not to use financial institutions to manage their income. As a result, only 10.19% of adults with a primary education or lower held an account with a formal financial institution, compared to 29.38% of adults with a secondary or higher education level in 2012 (Demirguc-Kunt and Klapper 2012).

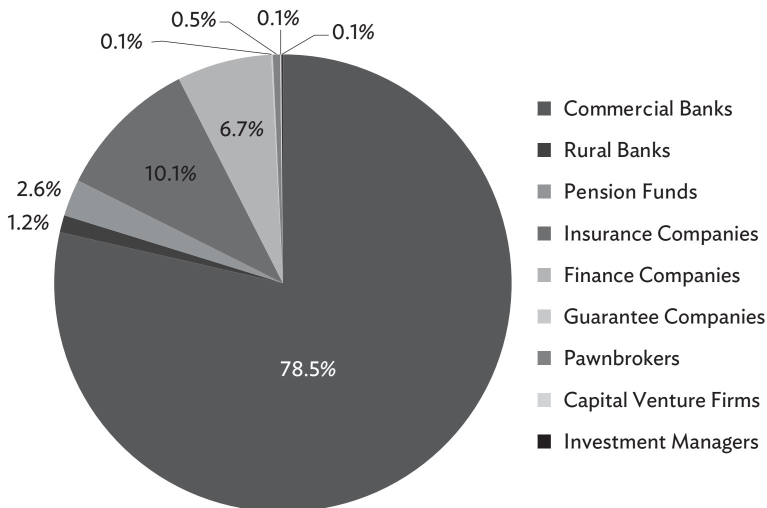
[2] Basic financial literacy is defined as possessing an understanding of inflation, simple and compound interest, and deposit guaranteed by government. Advanced financial literacy is defined as possessing knowledge of advanced financial instruments such as the stock market, risk on bonds and stock, and other investment schemes.

3.3 Financial Institutions and Agencies Involved in Microfinance

Indonesia's microfinance institutions (MFIs) consist of banks and nonbank institutions. Bank MFIs include rural banks, micro-units of commercial banks and village credit agencies.[3] Commercial banks usually offer a fully range of banking products, while rural banks specialize in serving microenterprises in rural and urban areas (Sembiring 2008). The number of branch offices of commercial and rural banks has risen substantially despite a decrease in the total number of banks. There were 119 commercial and 1,634 rural banks as of June 2014, a decrease from 130 commercial and 1,880 rural banks in 2006. Total assets have also increased significantly from Rp1,694 trillion to Rp5,198 trillion for commercial banks and from Rp23,045 billion to Rp80,329 billion for rural banks in the same time period (Indonesia Financial Services Authority 2014).

Nonbank MFIs can be divided into formal and informal institutions. Formal nonbank MFIs consist of cooperatives, pawnshops, and village fund and credit

Figure 3.1 Asset Composition of Financial Institutions in Indonesia, 2013



Note: Percentages may not add up to 100% due to rounding.

Source: Bank Indonesia. 2014b. *Financial Stability Review.* Jakarta: Bank Indonesia. No. 22, March 2014, p. 17.

[3] Examples of these institutions include: *Bank Perkreditan Rakyat (BPR),* a rural bank; *Bank Rakyat Indonesia (BRI),* a commercial bank with a micro-units branch; and *Badan Kredit Desa (BKD),* a village credit agency.

institutions.[4] As of April 2012, there were 36,485 cooperatives, 4,933 pawnshop branches and offices, and 1,351 village fund and credit institutions. As of April 2012, savings and loans cooperatives had total assets of Rp25.59 trillion. Non-formal, nonbank institutions consist of nongovernment organizations, self-help groups, and microfinance based on Islamic principles. Although there are a variety of microfinance institutions, the financial market is dominated by commercial banks. As seen in Figure 3.1, commercial banks possessed 78.5% of financial assets as of 2013, while microfinance institutions consisted of only 2% of financial assets due to the small average value of savings and loans (Bank Indonesia, 2014b).

3.4 Effective Initiatives and Programs of Financial Inclusion

3.4.1 Developing New and Innovative Financial Infrastructure for Individuals

The wealth of Indonesian households rose on average 14% and their disposable income increased 12.9% from 2010 to 2011. However, as of 2011, 51.9% of Indonesian households did not have savings accounts at financial institutions and 54.9% of households are financially excluded in terms of bank borrowing (Samboh 2012). Increasing financial infrastructure such as branch offices of banks is one strategy to enhance financial inclusion. The number of branches has increased significantly with the number of commercial bank branches increasing from 9,110 to 19,004 and the number of rural bank branches rising from 3,173 to 4,765 from 2006 to June 2014 (Indonesia Financial Services Authority 2014). However, the effectiveness of the improved financial infrastructure on financial inclusion is undermined by the concentration of these new branches in urban areas, where the rate of poverty is low. In fact, areas such as Java and Bali where the percentage of the poor in the population is low (3.7%), are identified as overbanked while more impoverished regions such as Gorontalo (14.3%) and Papua (31.5%) are significantly underbanked (Panggabean 2014).

E-money was introduced to overcome the physical constraint of conventional financial institutions in serving poor people living in remote areas. E-money and its corresponding services is a public-private partnership between a bank and a mobile network operator (MNO). The MNO first establishes a partnership with a bank to offer the service. The MNO then selects and recruits agents for the

[4] Examples of these institutions include: *Kelompok Simpan Pinjam (KSP),* a cooperative; *Lembaga Dana Kredit Pedesaan (LDKP),* pawnshops; and *Baittul Maal wa Tamwil (BMT),* a microfinance institution based on Islamic principles.

e-money network. These agents go to the partner bank to exchange cash for e-money. The agents then exchange e-money with subscribers to the program who convert their cash into e-money (cash-in). Mobile phone subscribers with e-money gain the ability to perform financial transactions such as sending money to other subscribers and paying bills (McGrath 2013). The mobile subscribers receiving e-money can also withdraw cash by exchanging e-money with the agents (cash-out).

The Indonesian telecommunications sector has been effective in selling low cost handsets, prepaid accounts, and a variety of small increment airtime purchase options to make mobile phones affordable to the majority of Indonesians. As a result, the number of individual subscribers tops 100 million. The mobile phone industry also has significant coverage of the population, covering over 90% of the population in Java and Bali and 70% of the population on the larger islands (USAID 2012). As of 2011, there were estimated to be over 160 million unique mobile phone subscribers in Indonesia, but only 60 million individuals with a savings account at a bank, rural bank, or savings cooperative (USAID 2011). Given the significant overlap of mobile phone subscribers and unbanked individuals, e-money could provide an ideal initiative to promote financial inclusion.

Telkomsel Cash (T-Cash) is Indonesia's e-wallet service from Telkomsel, Indonesia's largest mobile phone operator company with 44% of Indonesia's mobile phone market, followed by Indosat and XL Axiata (Chen 2014). Established in 2007, T-Cash reached over 8 million users in 2013. Telkomsel subscribers can register to the service by sending a text message to opt into the program. T-Cash users must then deposit cash to one of several T-Cash merchants for electronic tokens that can then be used to purchase vouchers for their mobile phones, pay phones, cable and water utility bills; purchase goods and services from participating merchants; and transfer cash of up to Rp5 million to other users (Jakarta Post 2011). As of 2013, total e-money transactions amounted to Rp2 trillion per year, a significant increase from Rp3.9 billion in 2012. The trend is expected to increase based on Bank Indonesia's relaxed regulations that will allow customers to withdraw cash from their e-wallets without a funds transfer license and an initiative by Indonesia's three largest e-money programs (Telkomsel's T-Cash, Indosat's Dompetku, and XL Axiata's XL Tunai) to allow subscribers to send money to subscribers in other networks (Lukman 2013). The initiative proposes to be a highly profitable sector for telecommunications just as microfinance was for BRI, and the increased market share will improve mobile money's use. However, Indonesia faces significant challenges utilizing mobile money as a means of promoting financial inclusion.

The success of Indonesia's mobile money market has been limited. By May 2011, there were an estimated 5.4 million T-money users, corresponding to 3.8% of total mobile phone subscribers, although not all registered users are active customers. In terms of the number of transactions, T-money only accounts

for 1.19% of volume and 2.17% in terms of value (Hidayati 2011). This is low compared to other mobile money markets. Kenya's mobile money initiative, M-PESA, was launched in the same year as Indonesia, but has been adopted by 13.3 million customers. The service reaches 70% of Kenyan households and 50% of all unbanked households (Hidayati 2011).[5] As of 2014, Safaricom, the MNO running M-PESA, reported a record total revenue of Kshs144.67 billion of which Kshs26.56 billion (18.36%) is derived from M-PESA revenue (Safaricom 2014).

There are several reasons for the slow progress of the e-money market in Indonesia. The rigid financial regulations hinder the further expansion of e-money users. The financial regulations require e-money agents to be formally registered businesses and obtain official agent licenses. To combat money laundering and financing of terrorism, Bank Indonesia must adhere to Know Your Customer (KYC) requirements that are essential for obtaining licenses for money remittance. The restrictions following KYC have resulted in an extremely low number of e-money agents. Insufficient infrastructure also limits the development of mobile money. Neither banks nor MNOs have actively invested in mobile money. Despite enabling banks to serve a customer at one-fiftieth the cost through mobile phones, banks have not capitalized on this advantage by moving down-market and approaching previously unbanked customers (USAID 2012). Although MNOs in Indonesia have established 500,000 airtime dealers located in almost every province, it only has 5,000 outlets to convert mobile money into cash and most outlets are located in the big cities. The ratio of outlets to users is low, about one outlet for 1,000 mobile users (Hidayati 2011). The limited number of agents to extract cash from the system is due to Bank Indonesia's strict regulations. If e-money issuers want to develop agents who offer cash-out services, the agents must be licensed as money remitters by Bank Indonesia as part of its KYC regulations.

3.4.2 Promoting Financial Services for Micro, Small, and Medium-Sized Enterprises

The vast majority of micro, small, and medium-sized enterprises (MSMEs) operating in Indonesia are self-financed or financed through informal institutions. According to a 2010 survey by Machmud and Huda (2011), 55.9% of surveyed small and medium-sized enterprises (SMEs) had access to finance from formal financial institutions, of which 39.1% relied solely on internal finance to run their business while 42.9% depended on the combination of internal and

[5] Safaricom controls 80% of the mobile market that will increase the utility of M-PESA compared to T-Cash with the greater number of subscribers. M-PESA has also adopted financial services such as the ability to take loans and gain interest on savings that T-Cash is unable to provide. Mobile phones have also penetrated a greater share of the Kenyan population with 47% of the population, or 83% of the population 15 years or older, having access to mobile phone technology (Buku and Meredith 2013).

external financing from formal institutions.[6] When starting up a business, only 6.6% of surveyed SMEs borrowed from formal financial institutions, while 45.6% relied on internal financing (45.6%). It would be reasonable for SMEs to rely on internal sources for starting a business due to a lack of experience and credit history. Due to their smaller size and assets, micro-sized enterprises are likely to encounter even greater barriers than SMEs to finance from formal financial institutions. A 2005 Bank Indonesia survey revealed that "access to finance becomes increasingly problematic as the scale of the business decreases" (Mourougane 2012, p. 17). The limited borrowing from banks, however, may not be voluntary. The Coordinating Ministry for People's Welfare reported that MSMEs face challenges due to their limited access to physical and institutional infrastructure of financial institutions, inadequate awareness and knowledge of financial services, poor saving habits, and various cultural traditions. The most common reason micro and small enterprises gave for not borrowing from banks was "no collateral" (20.69% and 28.55%), followed by "no knowledge about the procedure" by small enterprises (14.5%), and "procedure is too complex" by micro-enterprises (24.31%) (Tambunan 2014). On a list of key constraints common to MSMEs in Asian developing countries, one of the constraints in Indonesia is the lack of capital. According to Statistics Indonesia, a lack of capital was considered the main constraint to accessing finance by 37.8% of MSMEs in 2010 (Statistics Indonesia 2011).

Although there is a significant number of MFIs to assist MSMEs in financing, the challenges for MSMEs are their limited credit history and capital, and their geographic location that discourage them from obtaining financial services from formal financial institutions. The Indonesian government has implemented several programs to promote financial inclusion targeting MSMEs. The most notable program is the people's business credit program (KUR) that addresses the issue of insufficient collateral for bank loans by MSMEs. Under the program, the Ministry of Finance provides insurance for 70% of loans issued by banks to MSMEs while the risk of the remaining 30% is borne by the banks (Sembiring and Purwanti 2012). Six national banks and 26 regional banks have joined the KUR program to issue loans to MSMEs. The interest rate on KUR loans is 14% for retail business and 24% for microenterprises, which are affordable compared with loans from informal financial sources. To control the risk and the potential liability of the government, Rp5 million was set as the ceiling a microenterprise could borrow. In 2012, the government raised the ceiling to Rp20 million and cut interest rates to 13% for retail businesses and 22% for microenterprises (Ahmad and Syukro 2012).

---

[6] Surveyed enterprises came from three industries: clothing and garment, automotive parts and components, electronic parts and components. Small enterprises are defined as enterprises with assets more than Rp50 million to Rp500 million excluding land or with total annual sales from Rp300 million to Rp2.5 billion. Medium-sized enterprises have assets from Rp500 million to Rp10 billion, excluding land, or have total annual sales from Rp2.5 billion to Rp50 billion (Machmud and Huda 2011).

The program has been successful in assisting MSMEs with financial access. In 2011, KUR distributed Rp29,003 billion ($3,099 million) to 1,909,914 recipients (Sembiring and Purwanti 2012). Encouraged by the success, the government plans to increase the amount of money disbursed through the program by 23.3%; the loans are expected to grow to Rp37 trillion ($2.9 billion) in 2013 (Ahmad and Syukro 2012). As of July 2014, KUR's six participating banks provided Rp146.33 trillion to 11,309,283 recipients (KUR 2014). Despite the success, there are concerns and risks associated with the KUR program. Some applicants fail to meet criteria necessary for paying back the loans; although the KUR loans are aimed at providing business financing, many loan recipients actually use the loans for consumption purposes. In addition, it is a common practice that banks demand additional collateral from applicants for the 30% of the loan that is not insured by the government. There is also evidence of sectoral bias, with the majority of loans granted to enterprises in the trade services sector (Machmud and Huda 2011). While 53% of MSMEs belong to the agriculture sector, only 20.14% of total bank credits in 2013 were allocated to the sector. On the other hand, trade services represent 28% of MSMEs but received 57.59% of bank credit in the same year (Ciptowidarto 2014).[7]

3.4.3 Financial Education

Bank Indonesia has established multiple programs to improve financial education for youth. Bank Indonesia established *Ke Bank* (Let's go to the Bank) in 2008, a program to introduce financial products and services to youth. The program outlines the benefits, risks, and charges of products and services, as well as the rights and obligations of customers. Bank Indonesia followed this program with the program *Perhatikan 3P Seblum Beli Produk Perbankan* (Whatever the Product, Remember the 3Ps: Ensure Benefits, Understand the Risks, Consider Costs) in 2009.[8] The 3Ps program was to further educate people on the benefits, risks, fees, rights, and obligations they have before deciding to use a bank product to eliminate asymmetric information between customers and banks (Wibowo 2012).

Indonesia's most recent education program is the Indonesia Savings Movement launched in 2010. The program intends to increase the marginal propensity to save, increase domestic funding to support national economic development, and foster a savings culture in Indonesia. The program is focused on middle to low-income populations, defined as individuals who are bankable but do not have access to a bank, and has established a new savings initiative called *TabunganKu*

---

[7] Although it is possible that MSMEs engaged in agriculture are not in as much need of bank credit as MSMEs engaged in trade or industry, scholars have noted that banks in Indonesia have favored firms in the industry and trade sectors.

[8] The 3Ps are *Pastikan Manfaatnya* (ensure benefits), *Pahami Risikonya* (understand the risks), and *Perhatikan Biayanya* (consider the costs) (Senin 2009).

to promoting savings. Prior to this account, almost all financial institutions in Indonesia charged the same monthly administrative fee regardless of the existing balance but put different yields for different balances, resulting in the erosion of low balance accounts and disincentives for low-income people to save. *TabunganKu* is a no-frills savings account with no monthly administration fees and a low initial deposit requirement of Rp20,000 for commercial banks and Rp10,000 for rural banks. As of June 2013, the number of *TabunganKu* accounts reached 12.3 million, an increase of more than 1.7 million since December 2013. This represents about 25% to 30% of the targeted population (Bank Indonesia 2014c).

3.4.4 Commercial Microfinance—Bank Rakyat Indonesia

Indonesia's private sector has also focused on promoting financial inclusion. Bank Rakyat Indonesia (BRI) is the oldest and the second largest bank in Indonesia. As of 2013, microloans had increased 23.72% to Rp132.1 trillion with the number of microloan borrowers increasing to 6.5 million, and the migration of KUR loan borrowers to commercial micro loan borrowers increasing to 842,000 (Bank Rakyat Indonesia 2014). BRI is an example of successful commercial microfinance that highlights the profitability of improving financial access to the community and working with MSMEs.

BRI was initially a state-owned bank with limited focus on microfinance. Originally, the bank relied on government subsidies as its main source of financing to support small rural businesses. Unfortunately, the government's implicit guarantee of loans eroded farmers' incentives to repay and BRI was unable to enforce credit discipline, resulting in a loss ratio of 17.5%. However, following the decline in oil prices in 1982, the government withdrew its subsidies that allowed BRI to transform its commercial micro banking units. Under the new system, the units were supervised by branches and audited by regional offices with substantial profit-sharing incentives and penalties for each unit. If loan arrears exceeded 5%, units would lose their authority to lend, incentivizing units to move from rice planting to business centers, and providing credit to any creditworthy person for any income-generating activity rather than focus on commodities. Although BRI also suffered from the 1997–1998 Asian financial crisis, the number of borrowers in the microfinance sector stood at a constant level and the crisis had little effect on loan repayments. On the contrary, BRI's microfinance units allowed the bank to remain solvent during the crisis, resulting in BRI drastically reducing lending to the corporate sector and increasing its lending to MSMEs to 80% of its portfolio. BRI maintains its position as the largest bank financing MSMEs, serving 29.5% of that market. BRI experienced significant economic success as a commercial microfinance institution. By 2007, BRI's total assets grew by 92.3% from $11.2 billion to $21.6 billion and its gross loans outstanding grew by 113.9%. BRI's net profit grew by 14.27% to Rp21.16 trillion from 2012 to 2013. BRI highlights the

importance of involving the private sector in financial inclusion and the potential economic growth that can result (Seibel and Ozaki 2009).

3.5 Challenges to Financial Inclusion

3.5.1 Competition and Regulatory Reforms

The crippling effects of the Asian financial crisis persist in Indonesia. Although Indonesia has been able to recover economically from the crisis, structural effects persist. The re-regulation of banks following the crisis has resulted in a concentration of wealth and bred inefficiency within the banks. To remain profitable, Indonesia's banks impose high interest rates that cripple the performance and competitiveness of Indonesia's MSMEs.

The Asian financial crisis was a traumatic experience for Indonesia. The crisis destroyed Indonesia's banking system and required 70% of Indonesia's 1999 gross domestic product (GDP) to recapitalize the banks (Rosengard 2002). As a result, Bank Indonesia focused on consolidating the banking sector in the belief that a smaller number of large, full-service commercial banks would be more stable. This resulted in a significant decrease in the number of banks, resulting in a "medium concentrated oligopoly" in Indonesia with half of the banking system's total assets held by the five largest banks.

The concentration of wealth within a few banks has resulted in Indonesia possessing the most inefficient and most profitable banks in the Association of Southeast Asian Nations (ASEAN) region. Banks in Indonesia possess an operating ratio of 82% and net interest margin of 6%, much higher than banks in neighboring countries that have operating ratios from 33% to 73% (Rosengard and Prasetyantoko 2011). Due to the oligopoly of the five largest banks, the difference between lending rates to borrowers and interest paid to depositors is unusually high with the average margin for the country's big banks being 7 percentage points (Vallikappen and Moestafa 2013). This imposes a significant deterrent to borrowers, in particular MSMEs. Improving competition in the banking sector is important for mitigating the costs of loans and increasing the accessibility of financial services to MSMEs and poor households.

3.5.2 The Regulations of "Know Your Customer"

Bank Indonesia has adopted Know Your Customer policies (KYC) to prevent banks from inadvertently facilitating money laundering or assisting in the financing of terrorism. Under KYC regulations "before executing a business contact with a customer, rural banks must inquire information regarding the identity of the customer, the intention and objective of the customer for initiating a business,

other information that enables the bank to inquire the profile of the potential customer, and the other party's identity if the potential customer acts for and on behalf of another" (Bank Indonesia 2003, pp. 3–4). The customer's identification must provide the name, address, place and date of birth, nationality, occupation, signature, and information on the source and objective of the fund's use to allow the customer to open a bank account (Bank Indonesia 2003). The requirements become obstacles for many low-income individuals to open bank accounts.

In addition, KYC policies impose limits that undermine the role of branchless banking to incorporate the unbanked. Under the policies, rural banks "that have used electronic media in their banking service must initiate a meeting in person with the potential customer at least during the opening of the account" (Bank Indonesia 2003, p. 4). This defeats the advantage of branchless banking which is to reach unbanked potential customers who are unable to open accounts due to their remote geographic location. A substantial portion of unbanked Indonesians lives on remote islands and so the requirement for a meeting in person hinders the development of mobile money among the unbanked population. Mobile money is designed to overcome the barriers of financial infrastructure and geographic remoteness. However, the KYC policy has become a new regulatory barrier to the adoption of mobile money among the unbanked population.

To address the identification barrier, Bank Indonesia, with support from the Alliance for Financial Inclusion, has completed a baseline survey of 400,000 partially banked individuals and collected data from a sample of 600 households as part of Indonesia's financial identity project (Alliance for Financial Inclusion 2013). The information helped establish a new identification system of unbanked people in which 130,000 respondents were to receive financial identification numbers with basic information to fulfill KYC requirements. By providing a financial history, the numbers (and the issuance of cards with the numbers) allow financial institutions to access a customer's financial history thereby reducing the barriers to obtaining credit (Hadad 2011). Moreover, some regulatory reforms have been introduced to modify the restrictions on mobile money and branchless banking. In December 2012, a new regulation on funds transfer was passed. It allows full encashment of person-to-person transfers on electronic wallets and enables customers to withdraw cash from cash payment points without requiring individual agents to have a money transfer license. In May 2013, Bank Indonesia released guidelines for a new pilot project which would allow banks to provide financial services through agents. Although KYC requirements were not relaxed, key provisions in the new guidelines required banks to implement their pilot mobile banking projects in rural areas and encouraged bank-led, MNO-led, and hybrid products to be provided to unbanked individuals (Shrader 2013).

3.6 Concluding Remarks

Indonesia has made significant progress toward financial inclusion. Based on a vision to provide all Indonesians with access to financial services, Indonesia has adopted many programs to reach unbanked people who had previously been denied access due to their isolation from financial institutions. Due to Indonesia's large rural population spread over many islands, financial inclusion through physical infrastructure alone would be financially prohibitive. Banks are unwilling to build branches to reach marginalized customers due to the limited financial gain they would generate. Thus, branchless banking through mechanisms such as mobile money is essential to promote financial inclusion. Not only are the infrastructure costs low compared to building additional branches, the benefits of expanding mobile technology throughout Indonesia will yield additional benefits beyond financial inclusion. As additional infrastructure will result in greater penetration of mobile phones, Indonesia can fund the expansion of cellular infrastructure through public-private partnerships with MNOs.

Financial inclusion initiatives such as Bank Indonesia's *TabunganKu* and KUR loan programs have been successful. These programs have addressed the key issues of unbanked populations by providing financial services that increase the marginal propensity to save and provide financing for MSMEs, and also promote economic growth that meets Indonesia's overall goal of addressing poverty. Financial inclusion initiatives such as Safaricom's M-PESA in Kenya and Bank Rakyat Indonesia's microfinance operations show that such initiatives can be highly profitable for the private sector as well.

However, as seen with T-Cash, Indonesia has faced significant barriers in promoting financial inclusion through mobile money due to the legal difficulties in establishing an account under existing regulations. Due to strict KYC regulations, unbanked populations are unable to open accounts and are thus unable to use T-Cash to create a bank account without access to a bank branch. Due to the fact that the majority of the unbanked reside in rural areas, the inability to create an account without bank access restricts T-Cash's use to the unbanked. In addition to improved mobile phone infrastructure, Bank Indonesia will need to reassess its regulations to allow mobile money to become a useful and attractive alternative to currency.

References

Alliance for Financial Inclusion. 2013. *Putting Financial Inclusion on the Global Map: The 2013 Maya Declaration Progress Report.* Bangkok: Alliance for Financial Inclusion.

Ahmad, N. and R. Syukro. 2012. Government to Expand KUR Loan Program for Small Business. *Jakarta Globe.* 24 December. www.thejakartaglobe.com/archive/govt-to-expand-kur-loan-program-for-small-business/

Anjaiah, V. 2013. RI Ranks Third on SE Asia Remittance List. *Jakarta Post*. 29 April. www.thejakartapost.com/news/2013/04/29/ri-ranks-third-se-asia-remittance-list.html

Bank Indonesia. 2003. Regulation No 5/23/PBI/2003 on The Implementation of Know Your Customer Principles for Rural Banks. Jakarta: Bank Indonesia.

Bank Indonesia. 2014a. *Financial Inclusion*. Jakarta: Bank Indonesia, Financial Access and SME Development Department.

Bank Indonesia. 2014b. *Financial Stability Review*. Jakarta: Bank Indonesia. No. 22, March 2014.

Bank Indonesia. 2014c. *Inclusive Finance*. Bank Indonesia. http://www.bi.go.id/id/perbankan/keuanganinklusif/program/gimtab/Contents/Default.aspx (accessed September 2014).

Bank Rakyat Indonesia. 2014. *Annual Report 2013.* Jakarta: Bank Rakyat Indonesia.

Buku, M. W. and M. W. Meredith. 2013. Safaricom and M-PESA in Kenya: Financial Inclusion and Financial Integrity. *Washington Journal of Law, Technology & Arts. 8* (3). 375–400.

Chen. Y. 2014. Indonesia's Booming Mobile Money Market. *Amcham Indonesia.* 12 March. www.amcham.or.id/nf/features/4510-indonesia-s-booming-mobile-money-market

Ciptowidarto, P. 2014. Country Presentation: Indonesia. Presented at 2014 Asia–Pacific Forum on Financial Inclusion–Realizing Financial Inclusion in Asia: Achievements and Challenges. Shanghai, People's Republic of China. 19–20 March.

DEFINIT. 2013. Developing an Indonesian Financial Literacy Index. SEADI Discussion Paper No. 11.

Demirguc-Kunt, A. and L. Klapper. 2012. Financial Inclusion Data: Indonesia. World Bank: The Global Findex Database. http://datatopics.worldbank.org/financialinclusion/country/indonesia (accessed 28 August 2014).

Hadad, M. 2011. Financial Inclusion: Using Financial Education to Reach Out to Undeserved Groups and the Informal Sector. Presented at OECD–FSB of South Africa International Conference on Financial Literacy. Cape Town, South Africa. 27–28 October.

Hidayati, S. 2011. Cash in and Cash Out Agents for Mobile Money in Indonesia. Presented in the Fletcher School Leadership Program for Financial Inclusion. Jakarta. 6 September.

Indonesia Financial Services Authority. 2014. *Indonesian Banking Statistics*. Jakarta: Indonesia Financial Services Authority. June, 12 (7).

Jakarta Post. 2011. T-Cash, A New Payment Method in the Mobile Era. 2 February. www.thejakartapost.com/news/2011/02/02/tcash-a-new-payment-method-mobile-era.html

Komite Kredit Usaha Rakyat. 2014. Business Credit Distribution of the Period November 2007–July 2014. *Komite Kredit Usaha Rakyat*. http://komite-kur.com/article-99-sebaran-penyaluran-kredit-usaha-rakyat-periode-november-2007-juli-2014.asp

Lukman. E. 2013. Indonesia's E-money Adoption has Bright Future. *Tech in Asia*. 12 November. www.techinasia.com/indonesias-emoney-adoption-bright-future/

Machmud, Z. and A. Huda. 2011. SME's Access to Finance: An Indonesia Case Study. In *ERIA Research Project Report 2010-14*, pp. 261–290.

McGrath, F. 2013. *Mobile Money for the Unbanked 101: A Guide to Commercial Best Practice.* GSMA Mobile Money for the Unbanked.

Mourougane, A. 2012. Promoting SME Development in Indonesia. OECD Economics Department Working Papers No. 995. Paris: Organisation for Economic Co-operation and Development.

Panggabean, E. V. 2014. Financial Inclusion in Indonesia: Achievements and Challenges. Presented at 2014 Asia–Pacific Forum on Financial Inclusion–Realizing Financial Inclusion in Asia: Achievements and Challenges. Shanghai, People's Republic of China. 19–20 March.

Rosengard, J. K. 2002. Reforming the Financial Sectors of Thailand and Indonesia: Myth Perceptions of Ramakien and Ramayana Capitalists. Presented at Harvard University Conference on Financial Sector Reform Across Asia: Facts, Analyses, Solutions. 10 December.

Rosengard, J. K. and A. Prasetyantoko. 2011. If the Banks are Doing So Well, Why Can't I Get a Loan? Regulatory Constraints to Financial Inclusion in Indonesia. *Asian Economic Policy Review.* 6 (2). 273–296.

Safaricom. 2014. *Annual Report 2014*. Nairobi: Safaricom Limited.

Samboh, E. 2012. RI Middle-class Households Grow Richer: BI Survey. *Jakarta Post.* 23 July. www.thejakartapost.com/news/2012/07/23/ri-middle-class-households-grow-richer-bi-survey.html

Seibel, H. D. and M. Ozaki. 2009. *Restructuring of State-Owned Financial Institutions: Lessons from Bank Rakyat Indonesia.* Manila: Asian Development Bank.

Sembiring, M. 2008. SMEs Growth and Development in Indonesia. Presented at ADBI Regional Workshop on SME Development and Regional Economic Integration. Tokyo. 22–26 September.

Sembiring, M. and W. Purwanti. 2012. Indonesia's Experiences on Micro Finance Institution and Small Scale Cross Border Transaction. Presented at ADBI–AFDC–ABAC Asia-Pacific Forum on Financial Inclusion: Approaches, Regulations and Cross-Border Issues. Shanghai, People's Republic of China. 25–27 June.

Senin. 2009. BI: Perhatikan 3P Sebelum Beli Produk Perbankan. *Ekonomi*. 27 April. (in Bahasa Indonesia). www.yiela.com/view/405462/bi-perhatikan-3-p-sebelum-beli-produk-perbankan

Shrader, L. 2013. *Latest on Branchless Banking from Indonesia*. Consultative Group to Assist the Poor. 12 July. www.cgap.org/blog/latest-branchless-banking-indonesia

Srinivas, P. S., Y. Doi, C. C. Kusharto, B. H. Zia, I. G. P. Arsana, D. Sitorus, N. L. L. Kenward, C. Buchori, and F. Fitrani. 2010. *Improving Access to Financial Services in Indonesia.* Washington DC: World Bank.

Statistics Indonesia. 2011. *Profil Industri Mikro dan Kecil 2010* (Profile of Micro and Small Industry). (in Bahasa Indonesia). Badan Pusat Statistik.

———. 2014a. *Education Indicators*. Badan Pusat Statistik. http://www.bps.go.id/eng/tab_sub/view.php/excel.php?id_subyek=28%20¬ab=1 (accessed 8 August 2014).

———. 2014b. Number of Poor People, Percentage of Poor People, and the Poverty Line, 1970-2013. Badan Pusat Statistik. http://www.bps.go.id/eng/tab_sub/view.php?kat=1&tabel=1&daftar=1&id_subyek=23¬ab=7 (accessed 8 August 2014).

Tambunan, T. 2014. Financial Inclusion, Financial Education, and Financial Regulation: A Story from Indonesia. Presented at ADBI Conference on Financial Inclusion, Regulation, and Education. Tokyo. 23 April.

USAID. 2011. *Accelerating Mobile Money in Indonesia: Opportunity Assessment*. Washington, DC: United States Agency for International Development.

———. 2012. *Mobile Money and Financial Inclusion: Sector Assessment*. Washington, DC: Nathan Associates Inc.

Vallikappen, S. and B. Moestafa. 2013. World's Most Profitable Banks in Indonesia Double U.S. Returns. *Bloomberg*. 5 February. www.bloomberg.com/news/2013-02-04/world-s-most-profitable-banks-in-indonesia-double-u-s-returns.html

Wibowo, P. P. 2012. Financial Education in Indonesia: Experiences & Evaluation. Presented at OECD Asian Seminar on Financial Literacy and Inclusion. Cebu, Philippines. 11–12 September.

World Bank. 2014. Urban Population (% of total). World Bank Database. http://data.worldbank.org/indicator/ (accessed July 2014).

4 Innovations in India: From Agent Banking to Universal Identification

Alan Myrold

4.1 Overview

India has been proactive in pursuing a strategy of equitable development through the efforts of the Government of India (GoI) and the Reserve Bank of India (RBI) to broaden financial inclusion. With over 1.2 billion citizens and a rapidly developing country, India has put financial inclusion at the forefront of the political and socio-economic agenda. Since the 1950s, major strides have been taken from developing commercial banking networks and co-operative associations, to the establishment of business correspondents and no frill accounts.

As the world's second-largest developing country, India has focused on poverty reduction as a central goal of development policy since independence in 1947. Long before financial inclusion became popular, India recognized the need for proper financial access and a reduction in financial exclusion. India has recorded medium to high growth since 1993 but the trickle-down effects are overshadowed by the scale of financial need. Therefore, the past decade has seen a flurry of activity from policymakers and the RBI to pursue financial inclusion. The RBI Governor, Raghuram Rajan, on taking office in 2013, stated the urgent need for broad-based and diversified growth to combat poverty. He also recognized financial inclusion as the most important pillar for equitable and sustainable growth and expanding access to micro, small, and medium-sized enterprises (MSMEs), the poor, and the remote and underserved areas of the country. Addressing capital and financial infrastructure needs of both households and businesses is an important part of the RBI's goals (Rajan 2013).

This chapter provides the current financial inclusion landscape of India, bringing together available information and research conducted by the Asian Development Bank Institute (ADBI) on *Promoting Financial Inclusion through Innovative Policies* (ADBI 2010) and the 2014 Asia–Pacific Forum on Financial Inclusion.

4.1.1 Assessing Financial Inclusion

In 2009, the Asia–Pacific Economic Cooperation (APEC) Business Advisory Council, ADBI, the Alliance for Financial Inclusion, and the Advisory Group on APEC Financial System Capacity Building organized a workshop on financial inclusion that resulted in a report incorporating the major findings (ADBI 2010). Specifically, the report identified six key areas as crucial for financial inclusion: agent banking, mobile phone banking, diversifying providers, reforming public banks, financial identity regulations, and consumer protection.

Additionally, the RBI authorized a Committee on Comprehensive Financial Services for Small Businesses and Low Income Households, chaired by Nachiket Mor, to produce a countrywide analysis of financial services and financial inclusion in India. In December 2013, the committee presented its findings. The report provided recommendations that the RBI is currently considering along with six visions as being the most vital components for delivering financial inclusion by January 2016. The visions comprise universal access at reasonable rates to bank accounts, payment services, deposit and investment products, and insurance and risk management products, along with wide access to credit and a right to suitability (that is, that services meet the needs of a range of clients).

The results of the 2009 workshop and the 2013 report have similarities and provide initiatives for broadening financial inclusion in India. These 12 points provide the framework of this chapter in assessing progress of financial inclusion, and support a number of recommendations.

4.2 Background of Financial Inclusion in India

4.2.1 Definition of Financial Inclusion

The RBI has defined financial inclusion as “the process of ensuring access to appropriate financial products and services needed by all sections of the society in general and vulnerable groups such as weaker sections and low income groups in particular at an affordable cost in a fair and transparent manner by mainstream institutional players” (Joshi 2014). Financial inclusion also encompasses the broadening of financial services to those people who do not have access, the deepening of financial services for people who have minimal access, and greater

financial literacy and consumer protection so that those who are offered the products can make appropriate choices (Rajan 2014).

4.2.2 Progress from 1947 to 2004

The examination of financial access began with the All-India Rural Credit Survey in the early 1950s. The survey indicated that farmers borrowed Rs7.5 billion in 1951–1952, with moneylenders accounting for 70% of that total, and commercial banks providing less than 1% (Pradhan 2013). The distribution of bank branches was highly concentrated in urban areas, a trend that continued until the 2000s when the RBI adopted a financial inclusion growth model. The urban concentration of bank branches corresponded with a higher portion of bank credit going to urban areas while the share of private business credit grew from 44% in 1957–1961 to over 60% in 1970 (Pradhan 2013).

The government and RBI have adopted some innovative strategies and actions over the years to increase inclusion. These include:

- Nationalization of banks (1969–1980)
- Priority sector lending requirements
- Lead bank scheme
- Establishment of regional rural banks (1975–1976)
- Service area approach (1989)
- Self-help group—bank linkage program (1989–1990)

The 1990s financial sector reforms focused on competitiveness, strengthening institutions, access, efficiency, and consumer satisfaction. Liberalization had a positive impact and resulted in improvement in rural areas, but reforms lacked a cohesive approach that resulted in regional disparities of financial access and inclusion.

4.2.3 Post-2004

In 2004, the RBI formally adopted financial stability as a policy objective that encompassed inclusive growth (Khan 2011). Financial inclusion has been pursued with a regulated bank-led model. In addition, nonbanking financial companies (NBFCs) engaged in financial inclusion promotion were regulated along with microfinance institutions (MFIs) after the 2010 Andhra Pradesh crisis.[1] The Financial Stability and Development Council (FSDC) is the inter-institutional body for financial inclusion and is active in policy implementation.

[1] As of 2 June 2014 Andhra Pradesh has been split into two new states: Telengana and Seemandhra. This chapter refers to Andhra Pradesh rather than the new states, as all financial inclusion data is delineated in Andhra Pradesh terms.

2005 saw the birth of no frills accounts with low or zero minimum balance to empower the poor and excluded. The RBI followed with relaxing Know Your Customer (KYC) requirements to ensure that people without documentary proof of identity are not excluded from banking services. To help with the process of identification, in 2009 the Unique Identification Authority of India organized the Aadhaar project (known as UID) to provide clear proof of identity for all Indian residents. This allows previously excluded citizens into the formal banking system.

Recommendations of the 2006 Khan Committee that were endorsed by the RBI, established branchless banking in India through the business correspondent/ business facilitator model (Khan 2011).[2] The committee encouraged the model in recognition of the difficulty in providing bank branches in over 600,000 villages.

While initially excluded, nonbanking and non-financial entities have since been allowed to help banks in offering financial services such as remittances. The 2007 Payment and Settlement Systems Act regulated services operated by these entities under the guidance of the RBI. This approach allows the entities to provide fee-based services while protecting access to customer funds.

More recent initiatives include the 2011 Malegam Committee report that sought to address emerging problems in the microfinance industry including excessive interest rates, over-borrowing, ghost borrowers, and coercive recovery practices. The government and the RBI implemented the committee's recommendations through new regulations to ensure that microfinance providers continue to play an enabling role in achieving financial inclusion (Malegam 2011).

The RBI has recognized that comprehensive financial literacy programs are vital to equip the unbanked and unaware on how to use financial services. Meanwhile, the banking ombudsman system presents an arena where grievances can be addressed. The platinum jubilee celebrations in 2009–2010 was an outreach program by the RBI to help educate low-income groups across India to increase demand and was also directed at banks to supply financial services.

The most important initiative of the RBI is the creation of financial inclusion plans (FIP) that banks are asked to develop and integrate into their operations. The first FIP ran in 2010–2013 and the second in 2013–2016. The 2013 Mor Committee report on financial inclusion, surveyed the successes and challenges of policy implementation and drew on the first FIP. Financial inclusion reports by the Word Bank (Global Financial Inclusion Database, Findex) and Credit Rating Information Services of India Limited (CRISIL) were also released in 2013.

---

[2] Business facilitator is used exclusively in documents; most sources on branchless banking in India elect to use business correspondents as the only or default terminology.

4.3 Demand and Supply of Finances in India

4.3.1 Demand of Groups with Low Financial Access

India's varied demographic and economic characteristics present a challenging environment for promoting financial inclusion. The four main target groups are urban and rural households, and urban and rural micro, small, and medium-sized enterprises.

Most rural households are engaged in agriculture and related activities. Migrant and seasonal workers shift between farm and urban work while MSMEs are also important rural players. In urban areas, people from low-income households, including migrants, are engaged as low-wage workers and in running MSMEs. Regardless of location or group type, there are large gender disparities in India in the job market and the MSME sector.

Results from the World Bank's Global Findex Database indicate that only 35% of adults in India have an account at a formal financial institution—a bank, credit union, cooperative, post office, or microfinance institution (Table 4.1). Account penetration varies by age, income level, and education. Only 21% of adults from the poorest quintile have a formal account, while 56% of those in the richest quintile have an account. A total of 31% of adults with a primary education or less have a formal account, rising to 76% of those with a tertiary education. Just 4% of adults used a mobile phone to pay bills or to send or receive money.

The Global Findex Database also revealed that only 12% of adults save in a formal account. This is lower than in other major Asian developing countries, including the PRC where 32% of adults save in this manner (Table 4.2). Formal borrowing

Table 4.1 Accounts at Formal Institutions and Use of Mobile Money, Selected Countries

	Share of adults (%) with account at a formal financial institution			Share of adults (%) using mobile money in the past year
	All adults	Poorest quintile	Women	All adults
India	35	21	26	4
Indonesia	20	8	19	1
Philippines	27	4	34	15
PRC	64	39	60	2
Thailand	73	64	73	3

PRC = People's Republic of China.

Source: Demirguc-Kunt, Klapper, and Randall (2013).

in India is also low with only 8% of adults having obtained a new loan from a formal financial institution over the previous 12 months. Households are much more likely to borrow from family and friends—20% use that method. This is lower than in the PRC, Indonesia, or the Philippines (Table 4.2).

The CRISIL report (2013) identified three critical parameters of basic banking services: branch penetration, deposit penetration, and credit penetration. The report found that while the overall level of inclusion is low, it rose from 35 to 40 (on a scale of 100) in 2009–2011.

The 2014 Financial Inclusion Insights survey (Financial Inclusion Insights 2014b) looked at digital account use and mobile phone access across India. It found that the financial system is highly reliant on cash, especially in rural areas, while direct deposits are more common in urban areas. 90% of those who receive remittances get them in cash. Friends, family, and informal sources supply most credit. Trust plays a large role in financial services with 72% of respondents fully trusting state-owned banks compared to only 3% trusting business correspondents.

The Ministry of Micro, Small, and Medium Enterprises recently presented 10 programs being implemented to support smaller enterprises. The first on the list is "adequate flow of credit from financial institutions/banks" (GoI 2013). MSMEs are an important part of the Indian economy, contributing 8% of gross domestic product (GDP), 45% of manufacturing output, and 40% of exports. These enterprises employ an estimated 60 million people spread over 26 million enterprises, according to data from 2006–2007 (Chakrabarty 2011). They represent a vibrant part of the economy vital for economic growth and innovation and require finance to make that contribution.

Table 4.2 Share of Adults Accessing Savings, Credit, and Insurance, Selected Countries (%)

	Saving in the past year		Originating a new loan in the past year		Use of credit card	Outstanding mortgage	Paying personally for health insurance
	Formal account	Community based method	Formal financial institution	Family or friends			
India	12	3	8	20	2	2	7
Indonesia	15	14	9	42	0	1	1
Philippines	15	7	11	39	3	4	5
PRC	32	2	7	25	8	5	47
Thailand	43	5	19	8	5	5	24

PRC = People's Republic of China.

Source: Demirguc-Kunt, Klapper, and Randall (2013).

4.3.2 Analysis of Factors Affecting Demand for Financial Inclusion

India has a high and growing demand for financial services. Five key factors affecting the demand for financial services are demographics, migration, urban–rural divide, technology, and gender.

Demographics. India has a population of 1.2 billion that grew at an annual rate of 1.3% in 2008–2013 (ADB 2014; GoI 2014). The fertility rate is 2.5 births per woman, which is expected to make India the world's most populous country by 2025. Continued population growth will increase the demand for financial access. In addition, 65% of the population is under the age of 35, and 50% is under 25. This demographic can provide an economic dividend but also requires financial inclusion to be properly utilized. India's youth is more technologically proficient and the electorate is more vocal, which will require more transparent, effective, and efficient responses from banks and policymakers to address the current environment of financial exclusion.

Migration. India has one of the largest diaspora networks in the world. Less well known is the internal migration of workers. Internal remittances are often the largest and only source of income for the rural poor (Jones and Thorat 2011). A large number of India's 100 million domestic migrant workers are excluded from formal finance. Migrants are often from low-income households who leave in search of economic opportunity, but they face challenges in sending money home and are forced to rely on moneylenders or correspondents charging high fees. These domestic migrants account for roughly 10% of GDP and the remittances they send can account for 80% of the income for rural residents in some states (Jones and Thorat 2011). Providing accessible and low-cost remittance services can increase financial inclusion.

Urban–rural divide. Financial access differs between rural and urban areas but both areas are underserviced. Financial inclusion nationwide is 36%, with urban residents slightly higher at 45% and rural residents at 32% (RBI 2013; CRISIL 2013).[3] Thus, the majority of urban residents are also excluded and as urban areas continue to expand, it will be important to build access in these areas. The approach of financial inclusion since 2004 has been to focus on rural areas and a more equitable strategy is needed.

Technology. India has 30 million fixed line telephone subscribers and 870 million mobile phone subscribers, with 350 million in rural areas (RBI 2013). The rural mobile penetration rate is about 40% while urban mobile penetration is 138%. The Internet and Mobile Association of India, an industry body, projects the internet user base to reach 243 million by the end of 2014 (The Hindu 2014).

[3] Inclusion is based on having at least one bank account.

The rapid acceptance of mobile phone and internet technology will result in an increased demand for internet based and mobile banking solutions.

Gender. A large gender gap is found in the ownership of formal accounts in India. 44% of men have an account, but only 26% of women do (Demirguc-Kunt, Klapper, and Randall 2013). The most commonly reported reason for not having a formal account is lack of money—a barrier reported by 63% of unbanked adults. But 41% of unbanked respondents (46% of females) indicated they didn't have an account because a family member did. This suggests that indirect account use is widespread among women, which may be a concern for it undermines female empowerment and self-employment opportunities. The Financial Inclusion Insights (2014b) survey found that 32% of men have active digital accounts compared to only 18% of women. At the rural level, 26% of men and 15% of women have active digital accounts. Gender plays a role in mobile phone access, with 68% of men owning their own phone, compared to 31% of women. Across the financial spectrum from basic accounts to more advanced mobile phone access, women in India are more excluded than men.

4.3.3 Major Providers of Financial Inclusion

The RBI promotes financial inclusion through a range of financial institutions: public and private sector banks, foreign banks, regional rural banks, self-help groups, and microfinance institutions. The four types of banks, noted above, are classified as scheduled commercial banks. The public sector banks account for 70% of the commercial bank network, underlying the important role that the public sector plays in the financial sector (Table 4.3).

Financial services are also provided through automated teller machines (ATMs), networks of business correspondents in rural locations, as well as nonbank financial companies, and more recent and innovative solutions such as mobile money and the postal network. India's postal network is the largest in the world with over 155,000 offices of which 90% are located in the rural areas (India Post website).

Table 4.3 Scheduled Commercial Banks, March 2013 (no. of branches)

Bank Type	Rural	Semi-urban	Urban	Metropolitan	Total
Public sector	23,286	18,854	14,649	13,632	70,421
Private sector	1,937	5,128	3,722	3,797	14,584
Foreign	8	9	65	249	331
Regional rural	12,722	3,228	891	166	17,007
Total	37,953	27,219	19,327	17,844	102,343

Source: Compiled by author based on data from the RBI.

Table 4.4 Access to and Use of Financial Services, 2012

Commercial bank branches per 1,000 km^2	33.17	Commercial bank branches per 100,000 adults	11.38
ATMs per 1,000 km^2	32.67	ATMs per 100,000 adults	11.21
Outstanding deposits with commercial banks (% of GDP)	68.64	Outstanding loans from commercial banks (% of GDP)	54.24
Deposit accounts with commercial banks per 1,000 adults	1,042.48	Loan accounts with commercial banks per 1,000 adults	151.06
Household deposit accounts with commercial banks per 1,000 adults	892.49	Household loan accounts with commercial banks per 1,000 adults	23.54

ATM = automated teller machine; GDP = gross domestic product; km^2 = square kilometer.

Source: International Monetary Fund. Financial Access Survey Database. http://fas.imf.org/ (accessed 22 July 2014)

About 40% of a postmaster's time is currently spent delivering payments based on the unique identification number (UID) (Banerjee 2014). If the postal network can be properly connected to the banking system, the number of access points available in rural areas would increase by 400%.

Lending by microfinance institutions increased 30% in 2013, with bank funding returning to the industry (EIU 2013). The growth of MFI lending is due to rising demand but also to the relaxation of RBI rules such as the 26% interest rate cap in 2012, the margin cap space for NBFC MFIs set at 12% in 2013, and allowing large NBFCs to apply for banking licenses in 2013.

Financial supply can also be seen in the IMF Financial Access Survey (Table 4.4). The most recent data for India is for 2012 and reveals the bank branch penetration per adult and per 1,000 square kilometers. The penetration level of ATMs is also given.

4.4 Achievements and Progress of Financial Inclusion in India

The formal adoption in 2004 of financial inclusion as a government objective combined with RBI guidance has resulted in the expansion of products and services. Banks have been encouraged to adopt a structured approach to broaden financial inclusion, through FIPs that they adopt based on targets negotiated and agreed with the RBI. The results achieved under the first set of FIPs in 2010–2013 and the first year of the new FIP 2013–2016 are summarized in Table 4.5 with the key points as follows (Joshi 2014a; 2014b):

- Banking outlets in villages increased from 67,694 to nearly 384,000 (Figure 4.1).
- 12,700 rural branches were opened (in contrast to the closure of 1,300 rural branches in the previous two decades).
- 60 million basic savings bank deposit accounts were opened, bringing the total to 243 million; the proportion of IT-based accounts increased from 25% in 2010 to 45% in 2013.
- 6.2 million new farm sector households gained access to small-scale entrepreneurial credit, bringing the total to 40 million households.
- 3.8 million new non-farm households accessed small-scale entrepreneurial loans, bringing the total to 7.4 million households.
- Business correspondents processed 328 million IT-based account transactions in March 2013–2014, compared to 250 million during 2012–2013.

Table 4.5 Financial Inclusion and Access Progress

No. of Scheduled Commercial Banks				Basic Savings Bank Deposit Accounts Opened			
Mar 2006		Mar 2013		Mar 2010	Mar 2013	Mar 2014	
68,681		102,343		73.45	182.06	242.96	million
No. of Rural Branches				Expansion of the ATM Network			
Mar 2006	Mar 2010	Mar 2013	Mar 2014	Mar 2010		Mar 2013	
30,572	33,378	40,837	46,126	60,153		114,014	
No. of Villages Covered				Rural ATMs			
Mar 2010	Mar 2013	Mar 2014	Population	Mar 2010		Mar 2013	
27,353	74,414	n/a	>2,000	5,196		11,564	
26,905	65,234	183,993	<2,000				
Total Bank Outlets				Kisan Credit Cards Issued*			
Mar 2010	Mar 2013	Mar 2014		Mar 2010	Mar 2013	Mar 2014	
67,964	268,454	383,804		24.31	33.79	39.94	million
Bank Outlets by Business Correspondents (BC)				General Credit Cards Issued			
Mar 2010	Mar 2013	Mar 2014		Mar 2010	Mar 2013	Mar 2014	
34,316	227,617	337,678		1.39	3.63	7.43	million

ATM = automated teller machine.

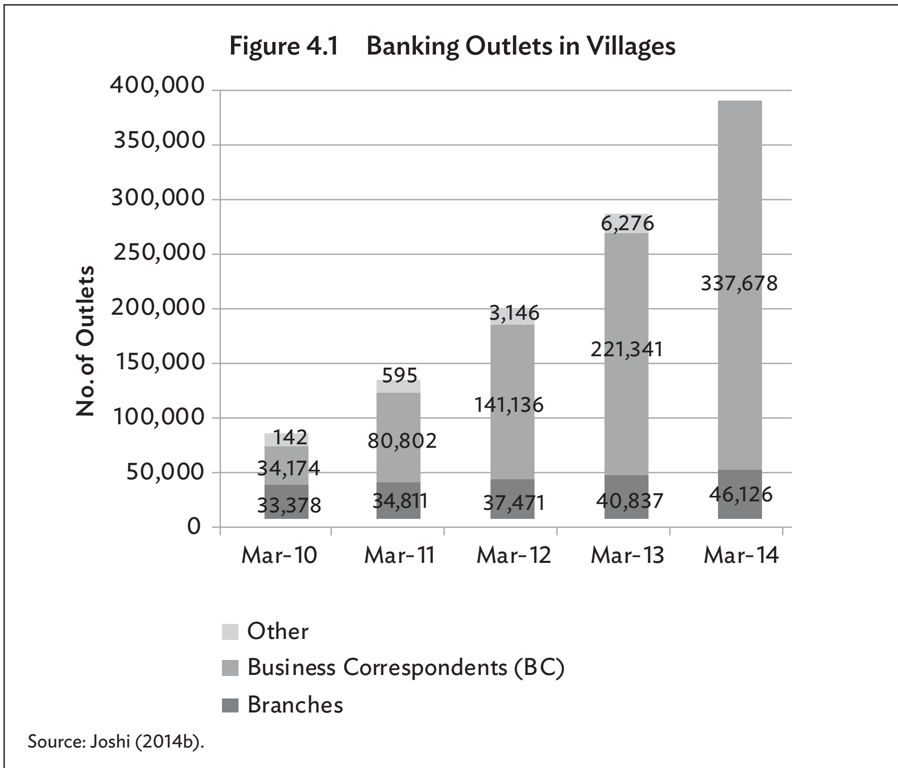
*for small farmer credit requirements

Source: Compiled by author based on Joshi (2014a, 2014b).

The RBI's approach to financial inclusion has been a "structured, planned and integrated approach" focusing on supply side constraints as presented during a speech by RBI Executive Director Joshi (2014a):

- bank-led model for financial inclusion
- encourage banks to pursue financial inclusion as a commercial activity, not as a social service or charity
- leverage technology to expand financial services while minimizing costs

Figure 4.1 Banking Outlets in Villages



Source: Joshi (2014b).

- banks to adopt innovative business models and delivery channels
- new products and delivery models developed and customized to the needs of the financially excluded rural and urban populations
- boost financial literacy as a necessary feature for financial inclusion, consumer protection, and financial stability
- improve the regulatory environment and institutional support to banks for financial inclusion initiatives
- encourage banks to determine their own strategies, goals, and targets for financial inclusion through financial inclusion plans (FIP).

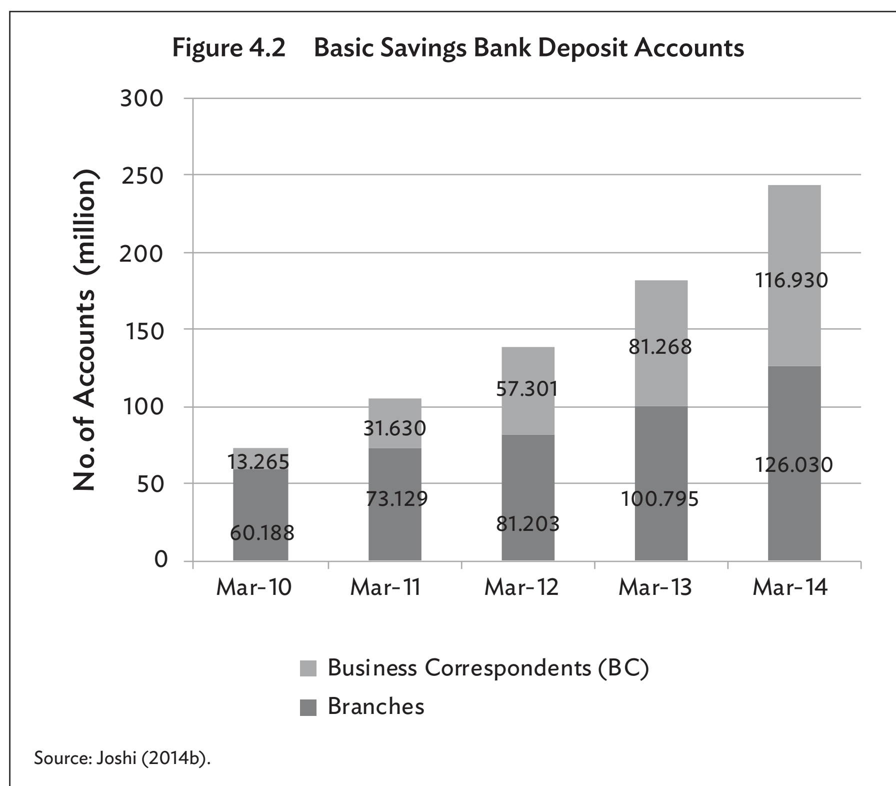
4.5 ADBI's Six Key Areas for Financial Inclusion

Progress on financial inclusion can be assessed against ADBI's six key areas (this section) and the RBI's six visions (following section).

4.5.1 Agent Banking (Business Correspondents)

Agent banking is the use of business correspondents to reach customers in rural and remote areas. Correspondents include retail stores, lottery kiosks,

Figure 4.2 Basic Savings Bank Deposit Accounts



Source: Joshi (2014b).

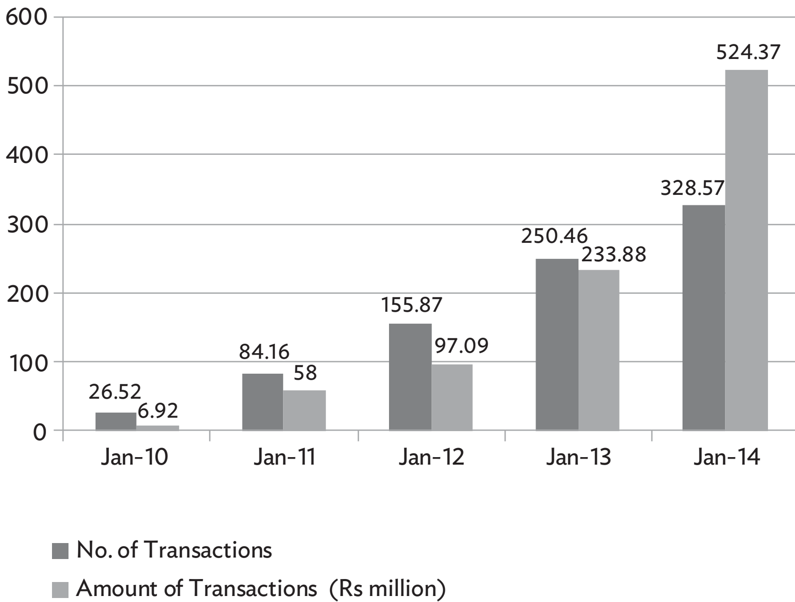
pharmacies, and post offices that establish partnerships with banks to provide distribution outlets for financial services.

The RBI has allowed banks to use business correspondents since 2006 as part of an effort to broaden financial access (RBI 2013). The banks gain doorstep delivery of services, notably deposits and withdrawals to address the "last mile" problem; that is, reaching the final client. In some cases, physical branches and business correspondents are combined to extend services to remote areas. In 2014, banks deployed over 338,000 correspondents (Joshi 2014b). In 2010 banks were permitted to use nonbank finance companies as correspondents. The networks of business correspondents are vital to the expansion of basic savings bank deposit accounts as shown in Figure 4.2.

Information technology-based accounts

The RBI has also encouraged banks to use information technology (IT) to deliver services directly to villages working through business correspondents (Figure 4.3). This approach allows connection to the core banking system and

Figure 4.3 IT-based Accounts—Business Correspondents



IT = information technology.

Source: Bhaskar (2013); Joshi (2014b).

provides all banking services including deposit and withdrawal of money in remote regions. The number of IT-based business correspondent transactions rose from 27 million to 329 million in 2010–2014, while the total transaction amount increased from Rs6.9 billion to Rs524 billion.

4.5.2 Mobile Phone Banking

Mobile phone banking is seen as an enabling agent for financial inclusion, with Kenya's M-PESA model being particularly potent. In India, mobile phone accounts are lacking, restricted, or non-existent. The RBI reported that in 2014 India had over 870 million mobile phone subscribers with 350 million in rural areas, ample opportunity for mobile services. But World Bank findings show only 4% of adults used mobile money in the past year (Demirguc-Kunt, Klapper, and Randall 2013). The 2014 *Financial Services Use and Emerging Digital Pathways* report found that those holding an active digital account (bank account or a mobile money account) was 25%, but only 0.7% report holding an active bank or mobile account. Further, only 0.3% had an active mobile money only account (Financial Inclusion Insights 2014b).

Mobile technology is key to providing cheap and universal payments, remittances, fund transfers between bank accounts and mobile wallets, and the cashing out of mobile wallets. The Mor Committee report (2013) suggested the creation of payment banks to help facilitate mobile transactions and services, and the use of IT enabled business correspondents in remote locations. The RBI has noted that while the vast majority of mobile subscribers do not yet use smartphones, the proportion is rising fast. Ironically, the bank-led model initially ignored the bottom-up approach of mobile services for financial inclusion that occurred in Kenya and elsewhere. The greater emphasis on mobile technology will allow India to switch to mobile financial inclusion and move up the financial inclusion ladder.

4.5.3 Diversifying Providers

The RBI led the development of financial inclusion by lowering barriers, simplifying Know Your Customer (KYC) norms, and diversifying the providers and available products on offer. *Access* is one of the RBI four pillars[4] of financial inclusion and relaxing KYC norms for small basic savings accounts was one of the innovative steps taken. These accounts can be opened with self-certification and the RBI has allowed the UID as an eligible document for meeting the KYC requirement. Banks can also provide e-KYC services through the UID platform. *Products* is another pillar: the RBI has recommended that a bouquet of financial services be provided. This bouquet comprises (i) a savings and overdraft account; (ii) a pure savings account, ideally a recurring or variable recurring deposit account; (iii) a remittance product to facilitate direct benefit transfers and other remittances; and, (iv) entrepreneurial credit products, like credit cards (Joshi 2014a).

Microfinance institutions (MFIs) are major suppliers of finance outside the banking system. In the 1990s, economic reforms in India allowed the private sector to play a larger role in the banking system. The reforms presented an opportunity for MFIs to emerge and originally operated as non-profit organizations, but soon transferred operations to for-profit nonbank finance companies (NBFCs). MFIs grew to an apex in 2010 with 30 operating as NBFCs and often reporting impressive growth projections. The MFI model developed in India was via group-based loan products common in South Asia and the publicly sponsored self-help group programs. MFIs reached 27 million low-income borrowers in 2010 (GoI 2013).

NBFC MFIs had been supported by both government policies and direct investment. The state-owned Small Industries Development Bank of India had steadily increased its lending to MFIs as a part of its mission to support small

[4] The four pillars are reach, access, products, and transactions (direct benefit transfers).

Box 4.1 Microfinance Crisis in Andhra Pradesh

The microfinance sector in the Indian state of Andhra Pradesh went into crisis in October 2010. The roots of the crisis were found in the liberalization of India's economy in the early 1990s that changed how lending occurred. Credit provided by MFIs and NBFCs skyrocketed and the increase in credit by self-help groups was also a factor. The growth and profitability of MFIs was based on low-income clients borrowing from multiple sources. There were three main reasons behind the crisis. First, India lacked the institutional infrastructure to oversee the rapid growth of the MFI sector. No reliable credit reporting systems had been established to monitor indebted or multi-borrowing clients and the crisis was exacerbated by the absence of personal bankruptcy laws to help low income clients.

Second, state government programs subsidized credit to low-income clients that created competition with MFIs, along with moral hazard issues. Third, the sector was affected by political interventions in the market. The state government instructed low-income clients to not pay their MFI loans as part of a plot to gain re-election. The crisis illustrates how rapid growth in lending, poor regulation and documentation of clients, combined with a problematic political environment can combine to cause problems.

A lesson from the crisis is the need for appropriate consumer protection regulation, viable credit market infrastructure, and personal bankruptcy facilities to help deal with financial risk. Reducing the need for credit market interventions by policymakers to avoid distortions is also ideal, but requires a transparent and functioning government.

Source: World Bank (2014).

enterprises. India's MFIs were promoted as the solution for India's financial inclusion problem until the Andhra Pradesh crisis in 2010 (Box 4.1). Following the crash, MFI lending has once again improved by 30% since 2012 and in September 2013 the RBI approved 30 MFIs with total assets of Rs190 billion.

4.5.4 Reforming Public Banks

There has been little reform in the past five years of public sector banks but reforms have occurred in the private bank sphere. Prior to becoming RBI governor, Raghuram Rajan wrote a report where he outlined the next generation of reforms for India's financial system (Rajan 2008). The report laid the groundwork for regulatory changes to the financial system to promote growth and social inclusion. The report highlighted the need for competition to spread finance, such as the licensing of new banks including foreign ones. Now as governor, Raghuram Rajan has been speeding up the process of financial sector reform by reducing bank rules on purchasing government debt. Most notable is the 2013 Licensing of New Banks in the Private Sector (RBI 2013c). As a result, in April 2014, the RBI approved licenses for two new small banks. This is the first time in over a decade that new banks have been allowed to enter the banking system.

The bank-led model has also reformed the way banks pursue and promote financial inclusion. Through the *Reach* pillar, the RBI has refocused the banks to:

i. simplify branch authorization to address the uneven spread of bank branches and allow branches in areas of less than 100,000;
ii. use FIPs to expand the branch network and encourage the use and sustainability of accounts with small balances; and
iii. expand into unbanked rural areas with the RBI mandating that 25% of new branches be in unbanked rural areas and that small intermediary structures be opened between the base branch and the unbanked villages (Joshi 2014a).

The RBI roadmap for banks was to provide banking services in every village with a population over 2,000 by March 2013 and the target of reaching 74,414 previously unbanked villages was achieved. The second phase will cover villages with a population less than 2,000 by March 2016. About 490,000 such unbanked villages have been identified and allotted to banks.

4.5.5 Financial Identity Regulation

Documentation remains one of the largest barriers to financial access and India has proposed a unique and ambitious endeavor to enhance inclusion. 650 million Indians have already been biometrically scanned, entered into the system, and given a card with an identification number (much like a social insurance number in other countries). The remainder of the population is expected to be covered by 2016. The UID will be used to help create bank accounts for the financially excluded, thereby removing one of the key barriers to financial access, namely the lack of identification needed to open an account. The accounts will be used to allow the government to transfer social benefits to the population.

The government began routing social security payments to recipients through this system in 2012. Starting in January 2013, seven welfare schemes in 20 districts over 16 states began a pilot process for what are known as direct benefit transfers (DBT). The scheme was extended to an additional 78 districts from July 2013. A study in April 2014 found that: (i) beneficiaries[5] see the advantage of using DBT, (ii) the process of switching to DBT can be confusing; (iii) payments are small and do not encourage greater digital use although beneficiaries show interest in learning more; and (iv) received payments are still cashed out as digital and electronic payment infrastructure for purchases does not often exist (Financial Inclusion Insights 2014a). Overall, the UID and DBT systems help people feel included. Because the UID system is biometric, lost cards can be returned and fraudulent use is reduced.

[5] Beneficiaries fall into three government schemes: pensions, scholarships, and the National Rural Employment Guarantee Scheme.

4.5.6 Consumer Protection

Consumer protection and transparency has been a mainstay of RBI policy. In 2013, RBI Deputy Governor Chakrabarty, in a presentation Regulation for Financial Consumer Protection: Present Status and Future Directions, noted that low financial inclusion is related to the low level of literacy. He also discussed the scale of information asymmetry, product proliferation due to technological advances, and limited competition because of stiff entry barriers. The RBI encourages banks to treat customers fairly through simple and fair product design, accurate marketing and advertising, after sales service, and dispute resolution mechanisms addressing grievances. He noted that fair treatment was not ingrained in the ethics and culture of financial institutions in India and that needed to change (Chakrabarty 2013b).

4.6 RBI's Six Visions of India

The Mor Committee report (2013) gave India a view of the constraints of the bank-led model and the restrictions it places on the future. The report highlighted some potential avenues for inclusive expansion. The committee's six visions to assess progress are universal bank account, access to payment services and deposit products, access to affordable formal credit, reasonable investment products, insurance and risk management products, and the right to suitability.

4.6.1 Universal Bank Account

The Mor Committee noted that bank account access stood at 36% and that the aspiration of universal access appears to be a long way off. One of the suggested strategies—to use the UID to ease the opening of banks accounts has been adopted.

4.6.2 Access to Payment Services and Deposit Products

The goal of full service access points within a fifteen minute walking distance implies a density of one access point per square kilometer (400 people) across the country. The current status is that the urban density is already 89% in locations such as Delhi, but in rural areas the density level can fall to 3%. Access points are defined as bank branches, business correspondent locations, and ATMs. The Mor Committee report notes that utilizing new small retailers, the postal network, and expanding mobile operators could enhance financial access and inclusion capabilities.

Charges, specifically remittance charges, often act as a barrier for inclusion for low-income customers. Remittance fees range from 5% for India Post money orders, 2% for business correspondents, and from 0.5%–3% for Airtel Money. Furthermore, the Mor Committee found that interest rates offered by banks in India are not competitive and offer a negative rate of return thereby discouraging customers from saving (Table 4.6).

4.6.3 Access to Affordable Formal Credit

The goal is to increase the credit-to-GDP ratio to 10% by 2016 and 50% by 2020. This is for credit in every district and for the main sectors of agriculture, manufacturing, services, and MSMEs. The growth of credit will allow for greater inclusion. Also, the goal is to provide one full-range credit access point per 10,000 people and lower interest rates by 2016.

For the credit-to-GDP ratio of 10%, 94% of urban and 30% of rural districts already meet the goal. The target of 50% is met by only 18% of urban districts and 2% of rural districts. The Mor Committee found that current credit ratios exceed 10% for agriculture, manufacturing and services, but not for MSMEs. At the 50% level only the manufacturing industry has reached the target. Credit access is high with 99% of urban districts covered and 92% of rural districts. Finally, as for affordable credit rates, the estimated risk-free rate ranges from 3% for a personal loan to 56% for credit from a money lender.

4.6.4 Deposit and Investment Products at Reasonable Charges

The next goal proposed by the committee is to increase the deposit and investment opportunities for low-income households and small businesses by providing them with convenient access, suitable products, and at a reasonable cost. This means a deposit and investment-to-GDP ratio of 15% by 2016 and

Table 4.6 Interest Rates for Deposits (based on Mor Committee calculations, November 2013)

Maturity	Nominal rate (%)	Inflation expectation (%)	Real rate (%)
Savings deposit rate	4.00	11.24	–7.24
Term deposit rate >1 year	9.05	11.24	–2.19
Fixed deposit rate for 360 days	7.50	11.24	–3.74
Fixed deposit rate for 720 days	9.00	11.24	–2.24

Source: Mor Committee (2013).

65% by 2020. The 15% goal has already been achieved in 99% of urban areas, but only in 36% of rural areas. The 2020 goal of 65% is currently only achieved in 35% for urban and 4% for rural districts.

4.6.5 Access to Insurance and Risk Management Products

The Mor Committee proposed the goal of a life insurance-to-GDP ratio of 30% by 2016 and 80% by 2020. As appropriate data was not available, premiums comparison was used to compare Indian schemes to those of other nations. Indian premiums as of 2011 for life insurance was 3%, non-life insurance was 3%, for a total of 6%. This measured well against a country like the United States that had figures of 3.6% for life insurance, 4.5% for non-life insurance, a total of 8.1%.

4.6.6 Right to Suitability

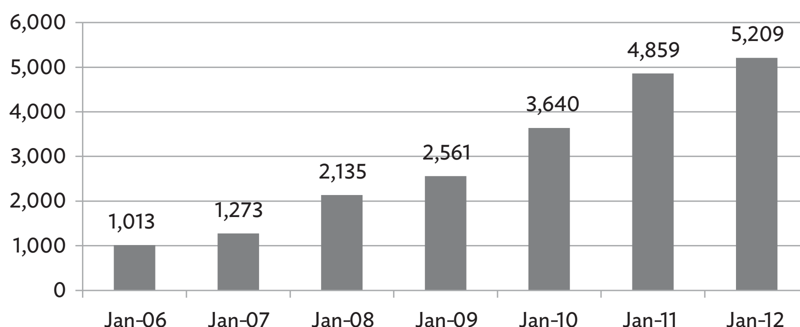
Low-income households and businesses often find a range of products and services that are outside their current scope of need. In addition, the lack of financial literacy disadvantages new financial consumers who do not understand the products offered. The Mor Committee proposes the concept of affordable and suitable financial services. Clients must also be allowed to seek legal redress against wrongfully imposed services.

Banks are not required to present or envision products that are suitable. Instead, there is implied consent that banks offer suitable products to achieve a maximum return. Currently there is no regional or district-level tracking, but there are 15 banking ombudsmen who provide redressal services for customers of financial services.

4.7 Micro, Small, and Medium-Sized Enterprises in India

Financial access is critical for MSMEs growth. To ensure credit flow to the sector, in 2010 the prime minister’s task force on micro, small, and medium enterprises encouraged banks to achieve 20% year-on-year growth in credit to micro and small enterprises (Chakrabarty 2011). The task force also advised allocation of 60% of credit to micro and small enterprises being channeled to microenterprises by 2012–2013. The RBI is in charge of monitoring the progress. Bank credit to the MSME sector experienced a compound average growth rate of 31% from 2006 to 2012 (Figure 4.4). Public sector banks provided 76%, followed by private sector banks with 20%, and foreign banks with 4%.

Figure 4.4 Bank Credit to Micro, Small, and Medium-Sized Enterprises (Rs million)



Source: Bhaskar (2013).

Banks need capacity building in risk assessment and risk management capabilities. They also need to recognize the potential that exists in lending to MSMEs. Banks have made voluntary targets in their code of commitment to MSME borrowers. Banks can help to better coordinate credit services and noncredit services for these enterprises, train staff to deal effectively with MSME needs, create differentiated products for MSMEs, and provide counseling, guidance, and market support.

4.8 Challenges and Opportunities

Financial inclusion in India has seen unprecedented growth and policy action since mid-2000. Challenges remain and new opportunities are available.

4.8.1 Opportunities

To expand financial inclusion requires enhancing FIPs and embracing mobile technology.

Financial Inclusion Plans 2013–2016

FIPs provide an opportunity to promote financial inclusion. The 2013 RBI review of FIPs recognized the following needs:

Increasing Reach
- ensuring coverage of all unbanked villages in next 3 years
- increasing rural branches
- opening of bank accounts for all eligible individuals

Increasing Transactions
- leveraging direct benefit transfers
- delivery of credit products through business correspondents
- hassle free emergency credit (that is, automatic overdraft)

Human Resources Structure
- banks to review human resources policy in view of financial inclusion requirements
- consider appointing a separate cadre of staff for cost optimization

Fine-tuning the Business Correspondents Model
- stabilizing the business correspondents delivery model
- encouraging innovations in remittances model
- review of cash management for these operations

Spreading Financial Literacy
- implementing a national strategy for financial education
- creating a dedicated website
- organizing financial literacy camps (Chakrabarty 2013a).

Information technology

The banking system can use IT to enhance inclusion. Mobile technology for payments is one example. Payment infrastructure in India is advanced and the National Electronic Funds Transfer system provides retail systems with near-real time transaction processing. Mobile payments could be combined into the system for maximum benefit.

Remittances are important to the economy because India has a large scattered population. However, most recipients of remittances do not have access to formal banking services. The RBI recently approved a payment system idea using ATMs that will allow funds to be transferred from bank account holders to those without accounts. This allows the sender to have money withdrawn from a personal account via an ATM transaction and those without accounts can gain access to remittances through ATMs across the country. The system could use the UID as a sole means for verification of the recipient.

Much has been made of mobile money and India's high density of mobile phone users, but what is less well known is that most mobile devices are not smartphone capable and connections are prepaid subscriptions. This limits the users and products available. The RBI's Technical Committee on Mobile Banking 2014 report recommended the need for standardized and simplified procedures for customers to register and authenticate mobile banking services (RBI 2014). Additionally, mobile financial awareness programs should be executed, along with the use of text messages and other encryption technology for secure

transactions, and across platform access regardless of phone type. The Telecom Regulatory Authority of India has issued service parameters and a ceiling on charges for mobile services.

4.8.2 Challenges

The past decade has seen economic growth and increasing financial inclusion in India, but challenges exist in financial literacy and education, financial infrastructure, and business financial access for MSMEs.

Financial literacy and financial education

The RBI believes that improving financial literacy will generate demand for financial services. For India, financial illiteracy is more pronounced in rural areas. Financial education presents the demand side of promoting the awareness of the benefits of available financial services. *Financial Inclusion in India—An Assessment* discussed two strategies for promoting financial stability and literacy: (i) Financial Stability and Development Council (FSDC) mandate to focus on financial inclusion and financial literacy together; and (ii) revised RBI guidelines on setting up financial literacy centers issued in June 2013 (Bhaskar 2013).

The FSDC launched a National Strategy on Financial Education in 2012. Financial literacy and education programs will target groups—students, women, rural and urban poor, and elderly—to enable informed financial decisions.

The RBI created standardized literacy material in 2013 including a comprehensive guide containing guidance notes for trainers, operational guidelines for conduct of financial literacy camps, standard financial literacy material, and a diary to instruct rural customers (RBI 2013b). The materials bridge the linguistic and illiteracy gap by using images and graphics to display concepts and have been translated into local dialects for easier comprehension. The RBI has asked banks to use the material as a standard curriculum for basic understanding of financial services and products.

As financial access improves, education must also improve so that users understand what products exist and can then make informed decisions. Access by itself does not amount to inclusion—effective and informative use of access is a sign that inclusion is empowering the poor. Financial learning is a responsible step and while a burden exists on the user to perform due diligence, financial institutions and providers of products will want to also prevent poor decisions from being made.

Financial infrastructure

Progress has been made to supply financial infrastructure across India, but much remains to be done. K. C. Chakrabarty of the RBI noted in a speech in 2013 that while the number of bank branches has increased, the usage rates remain minimal (Chakrabarty 2013a). Nearly half the basic savings accounts do not see transactions. The lack of transactions also reduces the viability of business correspondents, since they are paid on a per transaction basis. One of the reasons for lack of use by account holders is that the technological infrastructure to access their accounts does not exist, and where they can access them, many businesses do not process digital transactions, resulting in a return to cash-based living.

Market size—micro, small, and medium-sized enterprises

India is a large geographic and demographic area that provides ample opportunity for entrepreneurs to pursue small business ideas. Unfortunately, MSME growth is difficult due to three factors. First, credit to MSMEs has increased but access to appropriate credit at a reasonable cost is an issue. The majority of MSMEs (93%) depend on self-finance or informal sources. More must be done to help MSMEs find formal sources. Second, new entrepreneurs quickly discover that accessing financing from banks requires collateral that they lack. More needs to be done to help new entrepreneurs generate collateral for financing. Third, MSMEs are prone to what is referred to in India as “sickness” (that is, weak management and poor finances) that can lead to bankruptcy. In India the turnover rate of MSMEs is high. Sick businesses need help and inadequate credit is often one of the problems, along with a lack of proper skills and inadequate infrastructure.

4.9 Conclusion

Policies pursued by the government and implemented by the RBI have encouraged financial inclusion for millions of rural Indian households and small businesses. Bank branch and ATM expansion, business correspondents, the development of UID attached bank accounts, and FIPs have resulted in growing access to financial services. Leveraging technology, nonbank actors, mobile markets, and MFIs have enhanced financial possibilities for small enterprises and households. The progress has focused on the rural poor and rural areas.

Considering the challenges these present, the RBI’s FIPs in 2010–2013 have shown the power, speed, and efficiency by which inclusion and financial access can be expanded for households and MSMEs. The upward inclusion trends found in the FIP results and other reports show that progress is being made for all actors, across all industries, and in both rural and urban areas. Furthermore, the recent

reviews and committee reports have highlighted the use of expanding universal identification and embracing mobile technology as enabling agents.

In spite of the progress, the need to broaden inclusion further is paramount. The greatest sign of access—having a bank account—stands at only 36% of the population. This leaves an urgent gap that must be addressed. MSMEs are drivers of growth but the majority rely on informal financial arrangements. Therefore, financial products and services need to be designed around the needs of households and businesses. Boosting the number of bank branches and business correspondents has not resulted in greater use, because new customers are often financially illiterate. The forthcoming FIPs focus on reaching the most excluded portions of society and increasing financial education, while providing suitable products. The use of UID linked bank accounts will also help reduce the financial gap for millions of Indians.

References

Asian Development Bank (ADB). 2014. India. http://www.adb.org/countries/india/main (accessed 29 July 2014).

Asian Development Bank Institute (ADBI). 2010. *Promoting Financial Inclusion Through Innovative Policies.* Advisory Group on APEC Financial System Capacity, APEC Business Advisory Council, ADBI, and Alliance for Financial Inclusion. Tokyo: Asian Development Bank Institute.

Banerjee, S. S. 2014. Can a Digitized Post Realize India's Financial Inclusion Dreams? CGAP Blog. 4 June. http://www.cgap.org/blog/can-digitized-post-realize-india%25E2%2580%2599s-financial-inclusion-dreams

Bhaskar, P. V. 2013. Financial Inclusion in India—An Assessment. Address at the Microfinance Institutions Network and Access-Assist Summit. New Delhi. 10 December.

Chakrabarty, K. C. 2011. Empowering MSMEs for Financial Inclusion and Growth—Issues and Strategies. Keynote Address at the Central Bank of India SME Conclave. Mumbai. 20 December.

———. 2013a. Financial Inclusion in India—Journey So Far and Way Forward. Keynote Address at the Finance Inclusion Conclave. Organized by CNBC TV 18. New Delhi. 6 September.

———. 2013b. Regulation for Financial Consumer Protection: Present Status and Future Directions. Opening Remarks at Conference of Principal Code Compliance

Officers 2013. Organized by the BCSBI at the College of Agricultural Banking. Pune. 29 April.

CRISIL. 2013. CRISIL Inclusix—An Index to Measure India's Progress on Financial Inclusion. Developed with support from Ministry of Finance, Government of India, and Reserve Bank of India. June.

Demirguc-Kunt, A., L. Klapper, and D. Randall. 2013. World Bank Global Findex Database—Financial Inclusion in India. World Bank and Gates Foundation.

Economist Intelligence Unit (EIU). 2013. Global Microscope on the Microfinance Business Environment 2013. www.eiu.com/microscope2013 (accessed 10 July 2014).

Financial Inclusion Insights. 2014a. *Digitized Government Payments in India: Qualitative Study*. Developed with support from InterMedia and the Bill and Melinda Gates Foundation. April.

———. 2014b. *India: Financial Services Use and Emerging Digital Pathways.* Developed with support from InterMedia and the Bill and Melinda Gates Foundation. Conducted October 2013—January 2014.

Government of India (GoI). 2013. *Annual Report 2012-13: Micro, Small & Medium Enterprise*. New Delhi: Ministry of Micro, Small and Medium Enterprises.

———. 2014. *National Commission on Population: Facts*. New Delhi: Ministry of Health and Family Welfare. http://populationcommission.nic.in/ (accessed 3 August 2014).

The Hindu. 2014. India has Slowest Internet Penetration Growth in APAC. 5 June. http://www.thehindu.com/sci-tech/technology/internet/india-has-slowest-internet-penetration-growth-in-apac/article6085420.ece (accessed 3 August 2014).

India Post website. http://www.indiapost.gov.in/Our_Network.aspx (accessed 3 August 2014).

Jones, H. and Y. S. P. Thorat. 2011. Remittance Needs and Opportunities in India. Joint Report by National Bank for Agriculture and Rural Development and GIZ.

Joshi, D. P. 2014a. Strategy Adopted for Financial Inclusion. Address at a workshop organized by the Government of Madhya Pradesh. New Delhi. 24 January.

———. 2014b. Financial Intermediation for All—Economic Growth with Equity. Speech at the Financial Inclusion Conclave of Dun & Bradstreet. Mumbai. 26 August.

Khan, H. R. 2011. Financial Inclusion and Financial Stability: Are They Two Sides of the Same Coin? Address at BANCON 2011. Organized by the Indian Bankers Association and Indian Overseas Bank. Chennai. November.

Malegam Committee. 2011. *Report of the Sub-Committee of the Central Board of Directors of Reserve Bank of India to Study Issues and Concerns in the MFI Sector.* Developed with support from the Government of India and Reserve Bank of India.

Mor Committee. 2013. *Committee on Comprehensive Financial Services for Small Businesses and Low Income Households Report.* Developed with support from the Government of India and Reserve Bank of India.

Pradhan, N. C. 2013. *Persistence of Informal Credit in Rural India: Evidence from All-India Debt and Investment Survey and Beyond.* New Delhi: Reserve Bank of India.

Rajan, R. 2008. *A Hundred Small Steps: Report of the Committee on Financial Sector Reform.* New Delhi: Government of India Planning Commission.

———. 2013. Statement on Taking Office. Speech at the Reserve Bank of India. 4 September.

———. 2014. Financial Inclusion—Technology, Institutions, and Policies. Keynote Address at the National Association of Software and Services Companies India Leadership Forum. Mumbai. 12 February.

Reserve Bank of India (RBI). 2013a. *Monetary Policy Statement 2013-14*. New Delhi. 3 May.

———. 2013b. *RBI Releases Financial Literacy Material*. 31 January. http://rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=28057

———. 2013c. *RBI Releases Guidelines for Licensing of New Banks in the Private Sector*. 22 February. http://rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=28191

———. 2014. *RBI Report of the Technical Committee on Mobile Banking*. 7 February. http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=760

World Bank. 2014. *Global Financial Development Report 2014: Financial Inclusion*. Washington, DC: World Bank.

Thailand's State-Led Approach to Financial Inclusion

Yuka Terada and Paul Vandenberg

5.1 Introduction

Thailand is the second-largest economy in Southeast Asia with relatively high per capita income and strong export sectors in automobiles, electronics, and farm commodities. Currently classified as an upper-middle-income country, it experienced years of strong growth culminating in the golden decade of 1987–1996 with the economy expanding at more than 9% annually. The high growth years came to an abrupt halt with the onset of the Asian financial crisis in the late 1990s and it took several years to regain momentum. Despite its structural transformation into industry and services, the economy retains a large agricultural sector and informal activities employ the bulk of the workforce.

Following the Asian financial crisis, efforts were made to stabilize the financial sector and ensure that banks were well regulated. These efforts were largely successful and a stronger financial sector emerged. In addition, since the early 2000s, successive governments have sought to ensure a better distribution of the gains from renewed growth, especially in the poorer regions of the north and northeast. A key aspect of this inclusive growth strategy has been an effort to expand access to financial services.

As a result, a significant increase in financial inclusion has occurred over the past 15 years and has been achieved mostly through state-owned financial institutions and programs. Thus, unlike other countries where financial inclusion has been driven by microfinance institutions that operate as commercial entities

or nongovernment organizations, financial inclusion in Thailand has been driven by the state. Access to credit has increased substantially along with the use of deposit, insurance, and payments services. Nonetheless, key challenges remain including expanding access to the full range of financial services and reaching the minority who remain excluded or need to resort to high-priced moneylenders.

5.2 Defining Financial Inclusion

Financial inclusion can be defined as the provision of universal access to financial services.[1] Wealthier households and large businesses normally have good access to these services, and thus efforts to expand access target low-income households, which tend to concentrate in rural areas, along with small-scale farmers and the owners of micro and small enterprises. Furthermore, access means not only that services are offered to the public but that they are offered at affordable cost (such as transactions fees and interest rates) and can be readily accessed (for example, close proximity and reasonable documentation requirements). Finally, financial services relate to a range of functions from credit and deposits to more diverse services including insurance, pensions, investment products, and leasing. The four main services that define the level of financial inclusion are credit, deposit and savings accounts, money transfers, and insurance.

In short, financial inclusion addresses: (i) who has access; (ii) how easy it is to access (cost, distance); and (iii) what types of services are accessible. At the Millennium Development Goals Summit of 2010 these elements were combined to define financial inclusion as "universal access, at a reasonable cost, to a range of financial services for everyone needing them, provided by a diversity of sound and sustainable institutions" (Maxima 2010).

5.3 Financial Sector: Supply Side

Thailand has a diverse financial sector with a range of institutions operating at different levels. A key feature is its mix of public, private, and community-based providers. While private commercial banks hold an important position in the financial sector and are key to the efficient operation of industry, commerce, and the urban sector, public institutions have played a significant role in the expansion of financial access over the past 15 years.

1 Authors' definition.

The financial sector in Thailand comprises three levels: formal, semi-formal, and informal (Table 5.1). The formal sector consists of banks, finance companies, nonbank financial institutions, and credit fonciers, as well as state-owned specialized financial institutions (SFIs). Together, these formal institutions account for over 90% of total loans by value. Commercial banks are the main lenders. There were 36 commercial banks, finance companies, and credit fonciers in mid-2013 with a total network of 6,447 branches (Prayoonsin 2014).

The eight SFIs service parts of the economy not adequately served by private institutions. They are major providers of financial services to small and medium-sized enterprises (SMEs), the farm sector, and rural enterprises, and together operate a network of 2,260 branches (Prayoonsin 2014). The three largest SFIs are the Government Savings Bank, the Bank for Agriculture and Agricultural Cooperatives, and the Government Housing Bank. The other five SFIs have more specific mandates as suggested by their names: Export-Import Bank of Thailand, Islamic Bank of Thailand, Secondary Mortgage Corporation, Small and Medium Enterprise Development Bank of Thailand, and Thai Credit Guarantee Corporation.

The semi-formal financial sector comprises cooperatives, credit unions, and Village Funds (a special government program set up in 2001) that are regulated by the Ministry of Agriculture and Cooperatives and the Ministry of Industry. There are currently about 13,000 cooperatives offering services to 21 million

Table 5.1 Financial Institutions in Thailand

Sector	Providers	Regulators	No. of institutions	Credit volume
Formal	Commercial banks, finance companies, credit fonciers	Bank of Thailand	36	$395.5 billion (92.7%)
	Specialized financial institutions	Ministry of Finance	8	
	Nonbank financial institutions	Bank of Thailand	28	
Semi-formal	Cooperatives	Ministry of Agriculture and Cooperatives	13,000	$29.8 billion (7%)
	Village funds	Ministry of Industry	80,000	
Informal	Self-help	None	28,000	$1.26 billion (0.3%)
	Community organizations			
	Money lenders			

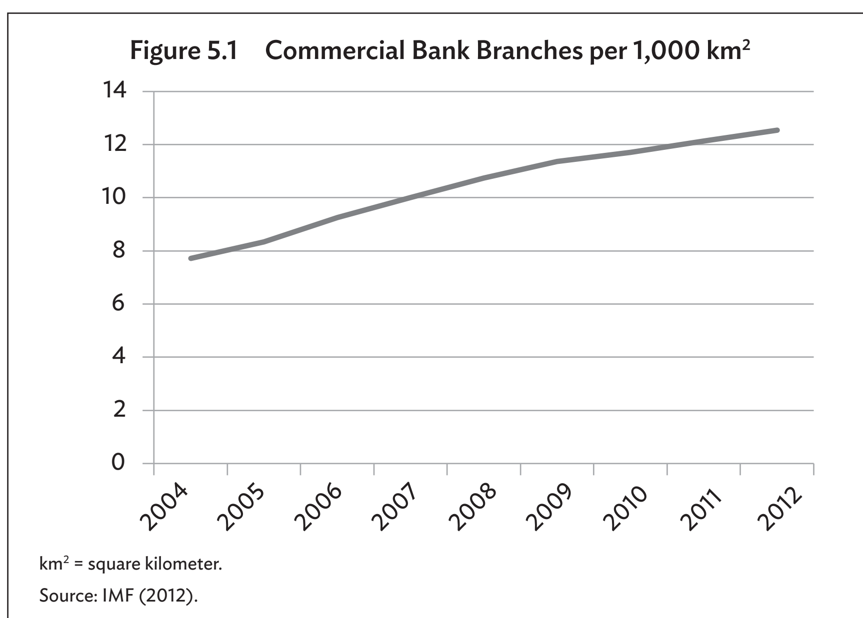
Source: Tambunlertchai (2014). Compiled from most recent data available in mid-2013.

members while almost 80,000 Village Funds provide financial services to 12 million members (Prayoonsin 2014).

The informal financial sector comprises self-help savings and credit groups, pawnshops, and moneylenders. They are individual providers that are not supervised by the government. There are nearly 27,000 savings groups serving 3.6 million members, 3,000 other local savings groups with 2.2 million members, and 577 pawnshops (Prayoonsin 2014).

The geographical outreach of financial institutions has increased significantly over the past decade. The number of commercial bank branches increased by 50% from 8 to 12 branches per 1,000 square kilometers (km^2) from 2004–2012 (Figure 5.1). It is higher than the number in the People's Republic of China (PRC) and Indonesia (both 9), and Viet Nam (7), but lower than the Philippines (17). The number of automated teller machines (ATMs) quadrupled from 20 to 89 per 1,000 km^2 in the same period (Figure 5.2). The density of ATMs in Thailand is high compared to most other countries in Southeast Asia, and is twice as high as in the PRC, Philippines, and Malaysia, for example (IMF 2012). ATM and bank density are considerably below that of more developed countries in Asia with the number of ATMs per 1,000 km^2 reaching over 380 in Japan and 1,200 in the Republic of Korea (IMF 2012).

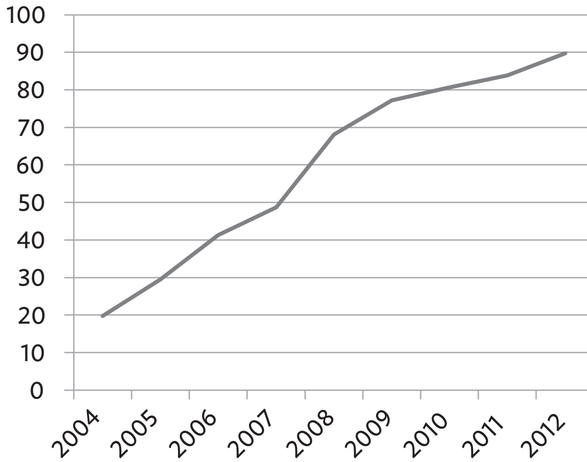
Figure 5.1 Commercial Bank Branches per 1,000 km^2



km^2 = square kilometer.

Source: IMF (2012).

Figure 5.2 ATMs per 1,000 km²



ATM = automated teller machine; km² = square kilometer.

Source: IMF (2012).

Physical access is defined not only by the number of commercial bank branches and ATMs, however. Thailand has over 260,000 point of sale devices in operation for making purchases and about 100,000 MPay stations used for electronic bill payments. In addition, the SFIs and Village Funds reach out to those villages not covered by commercial banks. In 2010, commercial banks were not present in about 35% of Thailand's 878 districts but after adding the SFI branches, notably from the Bank of Agriculture and Agriculture Cooperatives (BAAC), only 10% of districts were not serviced. Including Village Funds, all districts had access (ADB 2013).

5.4 Government Policy and Initiatives

The government, with the Central Bank of Thailand, is both a provider of financial services and a regulator—and it uses both these roles to promote financial inclusion. The Government Savings Bank, the country's first SFI, was created in 1913 as the Savings Office and changed to its current name in 1949. The BAAC was established in 1966 to bring services to the large rural sector. Both these initiatives had an important impact on financial inclusion, even though the term was not yet in common use. Other SFIs have been created and have produced additional access. However, the real push to increase financial inclusion has only come over the past 15 years.

In the wake of the 1997–1998 Asian financial crisis, the pressing need was to stabilize the commercials banks. As that was being achieved, the new government in 2001 set out to bring financial services to low-income households and producers in rural areas. The two key initiatives were the Village Funds (discussed in section 5.7) and the universal health insurance coverage scheme. These were followed by efforts to provide a comprehensive approach to the management of the sector with the approval of Financial Sector Master Plans I and II covering 2004–2009 and 2010–2014.

Recently, the government made financial inclusion an explicit part of the policymaking apparatus with the establishment in 2011 of the Bureau of Financial Inclusion and Policy Development within the powerful Fiscal Policy Office. That same year, guidelines for microfinance were set and a microinsurance framework approved in recognition of the need both to promote and to properly regulate in these areas. The Agricultural Insurance Scheme was created in 2011 and the National Savings Fund and National Catastrophe Insurance Fund were created a year later. The Payment Systems Roadmap 2012–2016 was also finalized. These efforts were designed to provide regulation and support to the noncommercial banking aspects of the financial sector, areas more likely to service lower income and financially excluded individuals.

To provide strategic direction of policies, programs, and institutions in support of financial inclusion and to ensure that segments of the population are properly serviced, the government is currently engaged (as of mid-2014) in the development of a national financial inclusion master plan or strategic framework.[2] This is a case in which government action has preceded the formulation of a guiding plan.

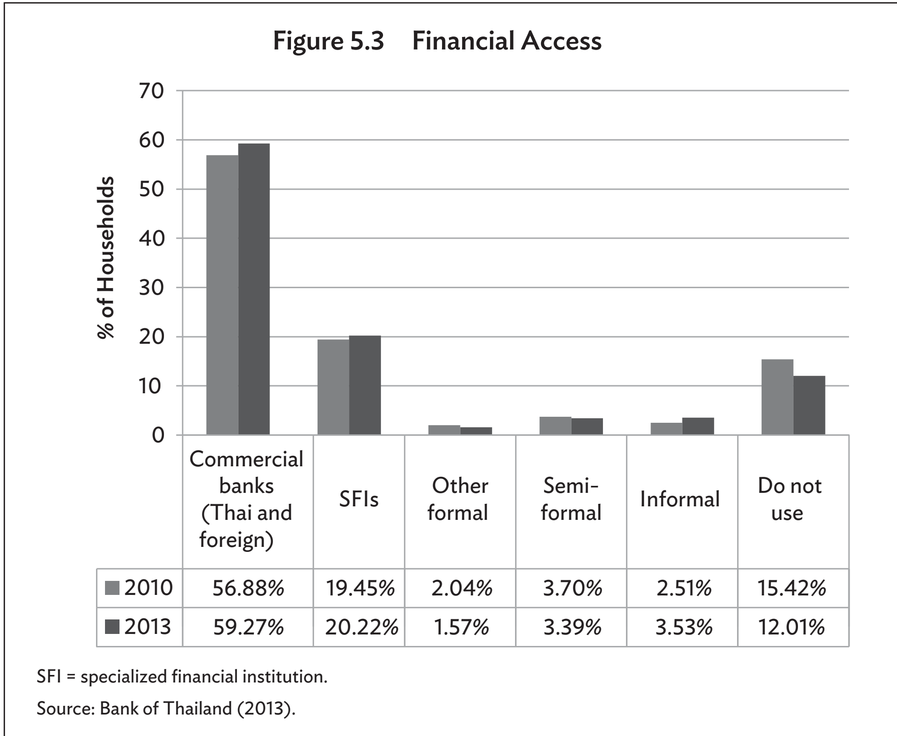
5.5 State of Financial Inclusion: Demand Side

Financial access has been rising in recent years with 88% of the Thai population having access to at least one type of financial service in 2013, compared to 85% three years earlier (Figure 5.3).[3] These results flow from surveys of over 10,000 households by the Bank of Thailand. The share of households that are financially excluded fell from 15% to 12% in 2010–2013. Furthermore, the share of households that could, but chose not to, access services fell from 12% to 8% over the same period. 81% of the population access the formal financial sector, whereas 3% access semi-formal institutions, and about 4% use informal arrangements. Of

[2] The government requested and is receiving technical assistance to develop such a plan or strategy from the Asian Development Bank with support from the United Nations Capital Development Fund (ADB 2013).

[3] These figures are from the Financial Access Survey conducted by the Bank of Thailand (2013). Another key data source for financial inclusion is the FinScope survey (UNCDF–FT 2013). The two surveys are referred to in this chapter. They provide somewhat different findings.

Figure 5.3 Financial Access



	Commercial banks (Thai and foreign)	SFIs	Other formal	Semi-formal	Informal	Do not use
2010	56.88%	19.45%	2.04%	3.70%	2.51%	15.42%
2013	59.27%	20.22%	1.57%	3.39%	3.53%	12.01%

SFI = specialized financial institution.

Source: Bank of Thailand (2013).

the 12% of the population that does not access financial services, 8% choose not to gain such access and only 4% are financially excluded from all services (that is, they want access but are not able to obtain it). The majority of the excluded are from low- and middle-income households and reside in the north and northeast.

73% of the Thai population age 15 years and older have a bank account at a formal financial institution (World Bank 2014). This is higher than in Malaysia at 66%, the People's Republic of China at 64%, and Indonesia at 20% (Table 5.2). In Thailand, 82% of those in urban areas and 70% in rural areas have a bank account. The level of bank access rises sharply with income and education. 91% of people with at least secondary education have bank accounts with formal institutions but only 64% of those with no more than primary education have such access. Similarly, 79% of the richest 60% of the population have bank accounts, compared to only 61% of the poorest 40%. In terms of gender, Thailand is one of the few countries where there is essentially no gender gap in account penetration, with 73% of both men and women having bank accounts. In addition to banks being used for the basic purpose of saving money, 34% of bank account holders use their account to receive wages, 17% to receive remittances, 10% to send remittances, and 9% to receive government payments.

Table 5.2 Account at a Financial Institution, Selected Asian Countries (% of population)

	Share of population age 15+ with account at a formal financial institution
Thailand	72.7
Malaysia	66.2
People's Republic of China	63.8
India	35.2
Lao People's Democratic Republic	26.8
Philippines	26.6
Viet Nam	21.4
Indonesia	19.6
Cambodia	3.7

Source: World Bank (2014).

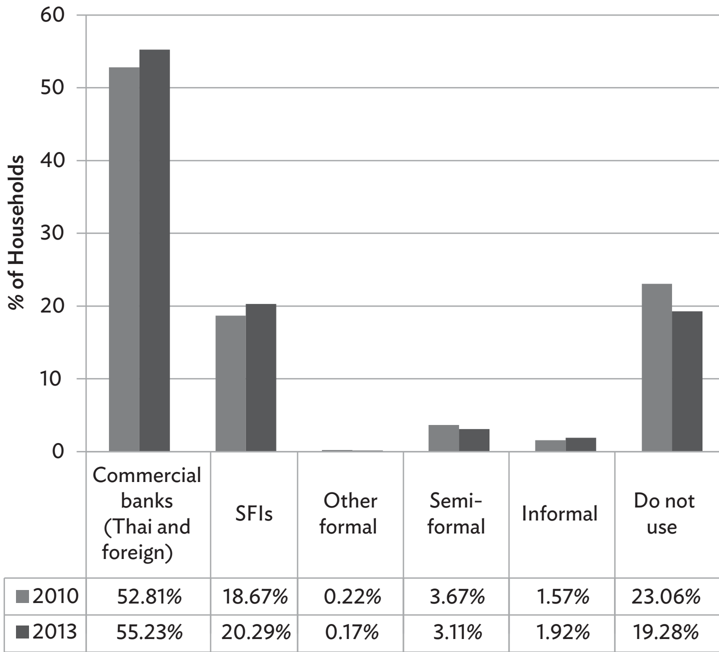
5.5.1 Deposits and Savings

81% of households had access to a deposit account in 2013, up from 77% three years earlier (Figure 5.4). Most accounts are held at commercial banks and SFIs with a small share held at semi-formal institutions and in informal arrangements. The majority of those without a deposit account did not want one, and only 7% of all households wanted but could not set up a deposit account. Some barriers to accessing deposit services are distance to bank branches, high service charges, and account maintenance fees.

The number of deposit accounts at commercial banks has been rising with 1,468 accounts per 1,000 adults in 2012 up from 1,110 in 2004 (Figure 5.5). On average, every adult has more than one account, but this is an average and, as noted, some adults have no account. About 88% of bank accounts have deposits that are below B50,000 ($1,500) (Prayoonsin 2014).

About two-thirds of adults are able to save from their income, according to a recent survey (UNCDF–FT 2013). 42% of those who could save had enough to cover one month of expenses, while 53% have insufficient savings to cover one-month expenses. The other 5% did not respond to the question (UNCDF–FT 2013). Many households save for possible future job loss, and to cover medical expenses and other emergencies. Other reasons for saving money are retirement, education, funerals, home purchase, home renovations, and farm expenses and investments. Of the one-third of adults who are unable to save at financial institutions, 80% do not have any money left after paying living expenses, 8% store their money at home, and 12% have no income (UNCDF–FT 2013).

Figure 5.4 Access to Deposit Accounts

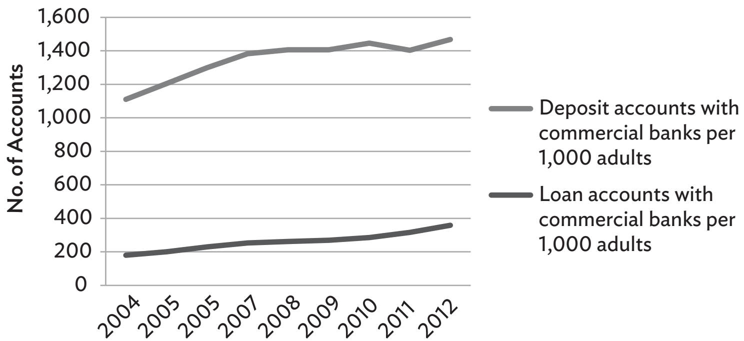


	Commercial banks (Thai and foreign)	SFIs	Other formal	Semi-formal	Informal	Do not use
2010	52.81%	18.67%	0.22%	3.67%	1.57%	23.06%
2013	55.23%	20.29%	0.17%	3.11%	1.92%	19.28%

SFI = specialized financial institution.

Source: Bank of Thailand (2013).

Figure 5.5 Deposit and Loan Accounts



Source: IMF (2012).

5.5.2 Credit

About 40% of households borrowed money in 2013, most of them from SFIs (14%) followed by commercial banks (9%), and semi-formal institutions (8%), according to the Bank of Thailand's financial access survey (Figure 5.6). The share of those borrowing from commercial banks increased slightly in 2010–2013 while the share borrowing from the informal sector declined in that period suggesting a gradual shift to formal sources of finance. Using a slightly different metric, the number of loan accounts at commercial banks has increased steadily over the past decade to reach 358 accounts per 1,000 adults in 2012 (Figure 5.5).

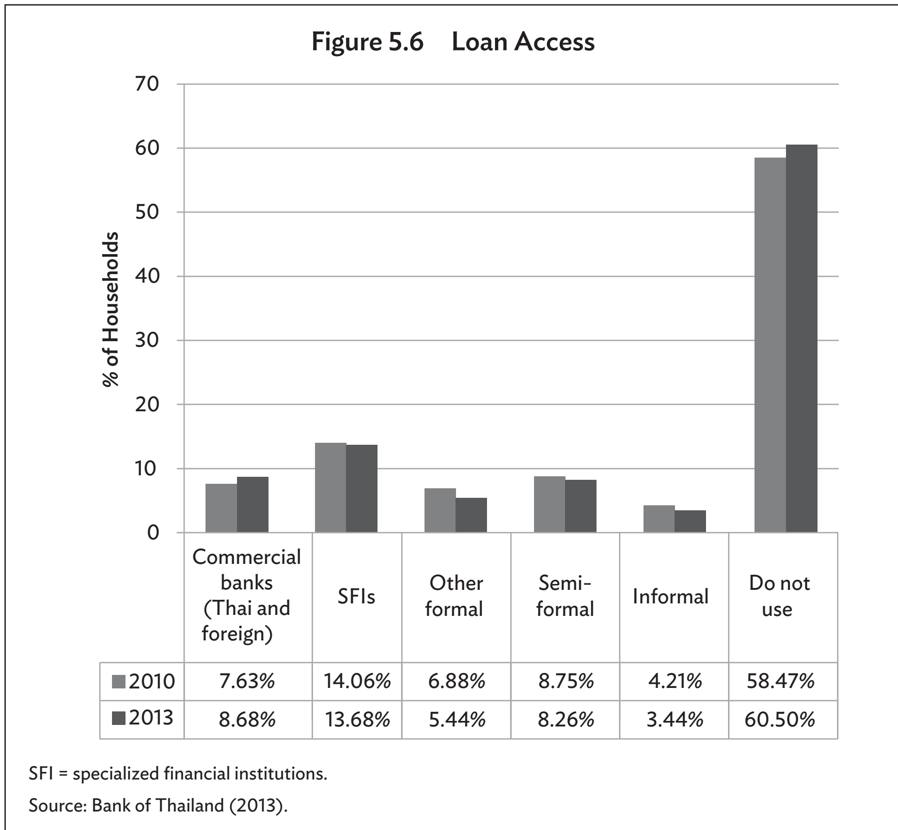
The FinScope survey shows somewhat different results from those provided in Figure 5.6 and cited above. While both surveys show SFIs are the main source of credit, the FinScope survey shows Village Funds as an equally important source (UNCDF–FT 2013). Together SFIs and Village Funds provide credit to about 14.5 million borrowers annually with the share split roughly evenly between the two. This dwarfs the 2.1 million borrowers from commercial banks, although individual loan amounts by the latter are much larger (ADB 2013).

The government imposes a cap on interest rates set at 15% that applies not only to commercial banks but also to other credit providers including SFIs and Village Funds. This cap helps to keep credit affordable for those who can meet the other lending requirements. There are two recent exceptions where the cap is set at 28% and both relate to small loans: personal unsecured loans from any institution, and microfinance loans by commercial banks for business or professional purposes. The higher cap for personal loans has resulted in a large increase in lending by nonbank financial companies, but the higher cap on commercial banks' microfinance loans does not seem to have encouraged to enter the microfinance field (ADB 2013).

While the provision of credit through government institutions reduces the dependence on informal moneylenders, the latter still service a significant number of clients. In 2013, approximately 1.7 million borrowers obtained credit from moneylenders, who charge much higher rates of interest than other sources. These rates range from 36% (on an annualized basis) to 3% per day for short loans (ADB 2013). Moneylenders remain in business by servicing a specific clientele who are excluded from other sources, need cash quickly, or wish to service their loans from Village Funds, the BAAC, or other sources to maintain their credit standing with these organizations.

Most households borrow money to invest in agriculture and to pay daily expenses (Prayoonsin 2014). About 60% of households do not borrow money—many avoid credit for fear of not being able to repay while others are deterred by high interest rates (UNCDF–FT 2013).

Figure 5.6 Loan Access



	Commercial banks (Thai and foreign)	SFIs	Other formal	Semi-formal	Informal	Do not use
2010	7.63%	14.06%	6.88%	8.75%	4.21%	58.47%
2013	8.68%	13.68%	5.44%	8.26%	3.44%	60.50%

SFI = specialized financial institutions.

Source: Bank of Thailand (2013).

SMEs borrow mostly from commercial banks and SFIs. SMEs are an integral component of Thailand's economy, employing 78% of the labor force and contributing almost 40% of gross domestic product (GDP). SFIs in particular, have increased lending to SMEs in recent years, with total loans rising to over B800 billion since late 2011 (Wangtal 2014). As SMEs are important to economic growth and essential to generate employment, the Bank of Thailand promotes lending to SMEs by commercial banks. The central bank also collaborates with banks to help SMEs during crises. For example, during the major flooding in Bangkok in 2011, Bangkok Bank provided assistance to SMEs by lowering interest rates from 7% to 3% for 5 years (Bangkok Bank 2012). More recently, the Bank of Thailand instructed banks to help SMEs in the services sector affected by the political unrest that began in late 2013 by lowering interest rates or extending repayment deadlines.

5.5.3 Payment Services and Remittances

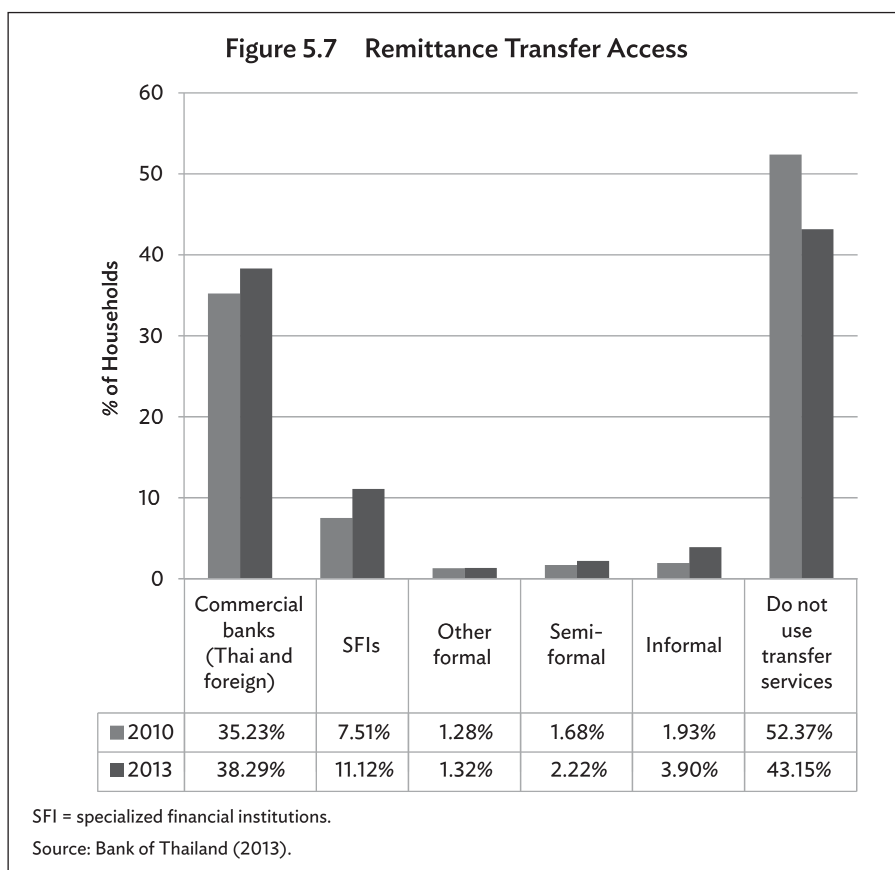
Remittances are the main source of income for more than 10% of the population and a partial source for many others. Thus, remittance and payments transfer

services are an important financial service. The use of remittance services increased from 48% to 57% of households in 2010–2013 (Figure 5.7). Commercial banks, both Thai and foreign, are the main providers. One-third of those who send money domestically live in Bangkok and another one-quarter are from the central region (Figure 5.8). People send money to urban areas for their children's education and business activities. From urban areas money is sent to parents, spouses, and other family members in rural areas. The major method of sending remittances is through commercial banks and ATMs.

Forty-three percent of households do not send or receive remittances but the majority of these do not want to. Only a small portion (3% of all households) would like to send money but do not have access. The main reasons households have difficulty accessing remittance services are high transaction fees and long distances to reach a bank.

According to the Bank of Thailand, the cost of transferring money within the country is relatively low, ranging from B50 ($1.50) to B120 ($3.60). Many people

Figure 5.7 Remittance Transfer Access

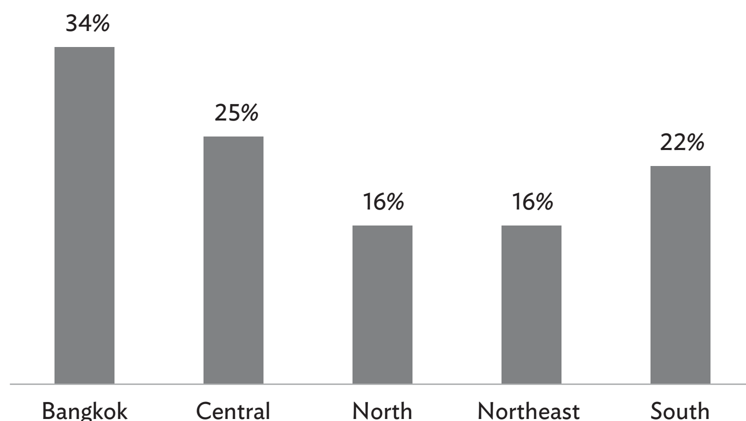


	Commercial banks (Thai and foreign)	SFIs	Other formal	Semi-formal	Informal	Do not use transfer services
2010	35.23%	7.51%	1.28%	1.68%	1.93%	52.37%
2013	38.29%	11.12%	1.32%	2.22%	3.90%	43.15%

SFI = specialized financial institutions.

Source: Bank of Thailand (2013).

Figure 5.8 Regional Profile of Those Sending Money



Source: UNCDF–FT (2013).

also remit money internationally, which is more costly, ranging from B200 to B500, while the cost of receiving a remittance averages B500 to B1,000 ($15 to $30) but rises to $1,000 in some cases (Bank of Thailand 2013). Transfers can be costly for rural residents because funds are sent and received through banks that are located mostly in urban areas (Tambunlertchai 2014).

5.6 Financial Literacy

Thailand has made progress in increasing financial literacy with more people now understanding the basic use and benefits of financial services. The country ranks seventh among 16 countries in the Asia and Pacific region in terms of financial literacy and is above all other developing countries in the region surveyed except Malaysia (Choong 2013). However, much remains to be done, notably among rural and low-income households. Focus group discussions conducted to help the government develop a financial inclusion master plan suggest that key debt and insurance concepts are not well understood (ADB 2013). Some people are not able to calculate interest payments when given the rate and principal. While such people may borrow money, they tend to pay the amounts indicated by the borrower. In addition, the group discussions revealed that many do not understand basic insurance concepts such as "premium" and "benefits".

These problems with understanding concepts may be part of the reason that 60% of the population feels "burdened" or "stressful" when dealing with finances. Only one-third try to track their monthly income and expenses, even though about 80% recognize that it would be useful in managing the household budget (ADB 2013).

Most financial literacy programs in Thailand use a classroom-based, group approach. While the effectiveness of these programs has not been properly assessed, global experience suggests that it might not be the best approach as participants receive theory without practical training. Financial literacy of a sort is conveyed through the mass media, notably TV, radio and newspapers, but this tends to target middle class and wealthier households and focuses on stocks and mutual fund investments and financial planning. In rural areas, the BAAC teaches budgeting to its clients and given its large outreach and network of rural offices could provide a system through which financial literacy could be expanded (ADB 2013).

5.7 Key Programs

Thailand has employed a state-led approach to financial inclusion with government programs and institutions playing a major role in reaching out to low-income and rural households. Village Funds and the Bank for Agriculture and Agricultural Cooperatives are two of the key institutions.

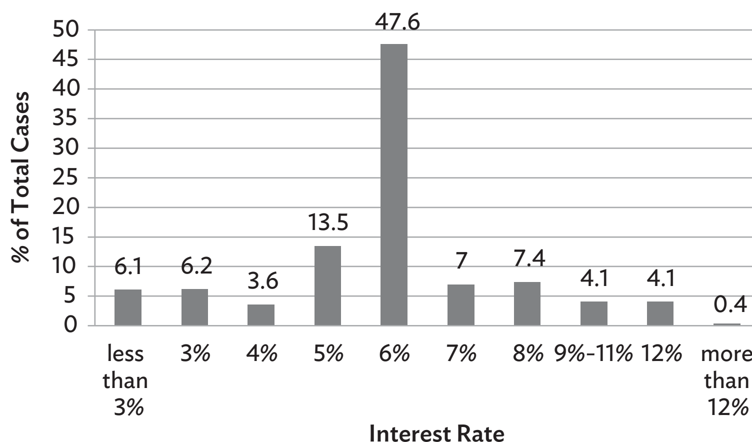
5.7.1 Village Funds

The Thailand Village and Urban Revolving Fund was launched in 2001 and is now one of the largest microcredit programs in the world. It was designed to improve access to finance, raise income, and reduce poverty in rural areas. The central government provided initial capital of B1 million to each of the country's 80,000 villages, be they small or large, poor or wealthy, urban or rural.

Each Village Fund is overseen by an intermediary with the Government Savings Bank playing this role in urban areas, and the BAAC in rural and semi-urban communities. A village sets up a committee consisting of about ten people. The committee manages the fund and determines the lending criteria, including interest rates, loan duration, and maximum loan size. The committee opens an account at a branch of the intermediary bank and the government deposits B1 million into the account. The committee receives and assesses loan applications from individuals, and loans are disbursed and repaid through the intermediary bank.

Most local committees require a minimum of two guarantors to approve a loan. The repayment period is a maximum of one year. A loan not secured with collateral is typically not larger than B20,000 ($600) and the average amount borrowed in 2009 was B15,790 (National Statistical Office 2009). Nearly half of all loans carried an interest rate of 6% and the rates on the other loans varied from less than 3% to over 12% (Figure 5.9).

Figure 5.9 Interest Rates Charged by Village Funds



Source: National Statistical Office (2009).

Village Funds have increased financial inclusion and boosted substantially the provision of rural credit. 99% of villages had access to these funds (Boonperm et al. 2012). Loans were provided mostly to poor rural households to finance farming activities or consumer purchases. The program has about 7.4 million borrowers, as well as a large number of savers (ADB 2013). The four poor northeast provinces of Chachoengsao, Buriram, Lopburi, and Sisaket showed a large increase in borrowing after Village Funds were introduced with less than 40% of households borrowing money (from any source) before 2001 and more than 70% doing so afterwards (Kaboski and Townsend 2012). The default rate has been low at 1% to 3% (Table 5.3). The government plans to inject an additional $2.6 billion into the program and raise the number of recipients to 20 million by 2016 (EIU 2013).

Table 5.3 Default Rate on Village Funds

Year	Default rate
2002	1%
2003	3%
2004	2%
2005	2%
2006	1%
2007	2%

Source: Kaboski and Townsend (2012).

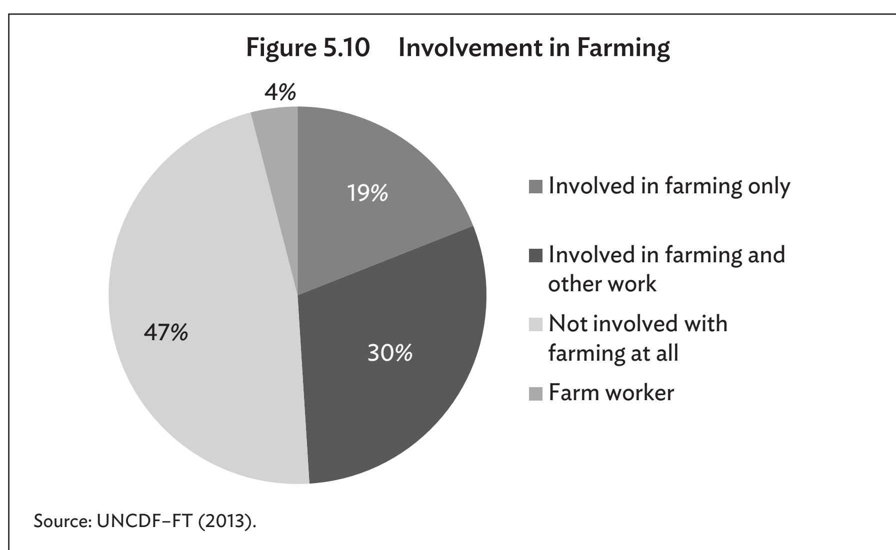
5.7.2 Bank of Agriculture and Agriculture Cooperatives

About 40% of the national workforce is engaged directly in agriculture (World Bank 2012), with the figure rising to over 50% when other farm-related work is included (Figure 5.10). Thus providing access to financial services for farm households is critical for financial inclusion. The Bank of Agriculture and Agriculture Cooperatives (BAAC) plays a key role in this endeavor. It provides finance in rural areas, fulfilling its mandate to improve the economic wellbeing of farmers and low-income families. It provides financial services to households and agricultural cooperatives to support investment, working capital, and marketing through a network of 77 provincial offices and 1,118 branches (BAAC 2014).

BAAC has expanded the range of its lending activities. While traditionally providing loans only to farmers for farm activities, an amendment to the BAAC Act authorized lending to individuals and micro, small, and medium-sized enterprises in the non-agricultural sector from 2006. The share of loans to non-farm borrowers cannot exceed 20%. Thus, it provides personal loans to meet household expenses and education costs. It has recently introduced a credit card for rice farmers that is interest free for up to five months and issued for purchasing farm inputs. In addition, BAAC launched a Village Bank microfinance program in 2010 to help low-income households and entrepreneurs to switch away from informal moneylenders.

About 95% of farm households (7.27 million) have access to BAAC's financial services, according to the institution (BAAC 2014). It maintains low lending

Figure 5.10 Involvement in Farming



Source: UNCDF–FT (2013).

rates of 7% to individuals and 5% to farm cooperatives, community groups, and SMEs. In addition, the loan recovery rate is high as a result of tight monitoring and an effective risk management system. Field officers pay frequent visits to clients to monitor their activities and cash flow, which helps the bank receive payments on time.

5.8 Challenges and Opportunities

Despite considerable progress, financial inclusion can be increased further. Efforts can be made to lower the regulatory hurdles for microfinance institutions; reduce distance barriers, in part by expanding mobile banking; and improve access for low-income households. In addition, Thailand faces potential problems arising from over-indebtedness.

5.8.1 Regulations for Non-state Microfinance Providers

While state institutions have expanded financial access, non-state institutions, including private and foreign banks, and non-profit organizations, have not been able to play a major role. Licenses for non-profit and nongovernment organizations to engage in microfinance activities are granted on a case-by-case basis and must meet regulatory requirements. Under Thai law, a financial services provider needs minimum capital of B50 million (about $1.4 million) to obtain a license, which is more than most nongovernment organizations can provide (Bird et al. 2011). As a result of licensing restrictions and other regulations, Thailand was ranked a low 48 out of 55 countries by the *Global Microscope on the Microfinance Business Environment* (EIU 2013).

5.8.2 Distance Barriers

Distance barriers have been reduced, especially through Village Funds and SFIs that have helped bring financial access points closer to households. However, some households continue to find it time consuming to access services. Approximately 60% of the population can access a bank branch and ATM in less than 30 minutes (Figure 5.11). Most of the remainder take up to one hour and 5% of the population requires up to two hours. The distance barrier can be overcome through the development of mobile banking that relies on the use of mobile phones. Customers can access their bank accounts, pay bills, and transfer funds through their mobile phone. With 88% of the population owning mobile phones in Thailand, the infrastructure at the client level is already in place (UNCDF–FT 2013). Siam Commercial Bank and Bangkok Bank currently provide mobile banking but only allow clients to check account balances. Services for making

payments, including remittances, could be added. In additional to commercial banks, other financial institutions, notably SFIs that cater to low-income households and SMEs, could offer mobile services.

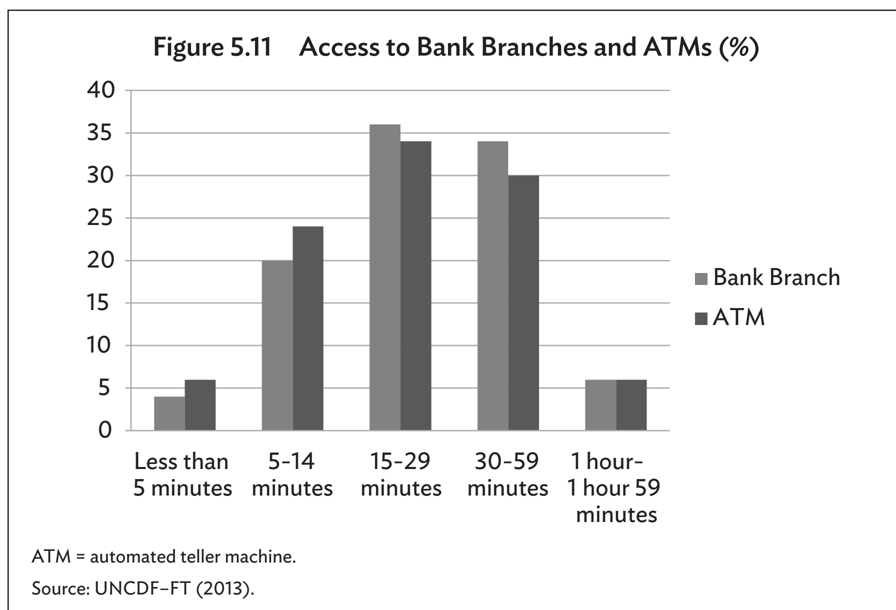
5.8.3 Access for Low-income Households

Access of financial services varies widely by income group. Low-income households, defined as the poorest 40% of the population, have less access to financial services, especially households in the south and northeast (Bird et al. 2011). About 38% of low-income households use only one or two types of financial services and a further 16% do not access any service at all. In comparison, the richest 60% of the population tend to access three or more services. Most households have access to a savings account (Figure 5.12) but only half of them have a debit or ATM card. Less than 10% of those who use commercial banks (for deposits) have borrowed or obtained credit cards through these banks.

5.8.4 Indebtedness

Over-indebtedness is emerging as a concern in Thailand. The ratio of household debt to GDP rose from 56% in 2008 to 82% in 2013 (Tambunlertchai 2014). Households borrow from multiple lenders and the lack of information sharing

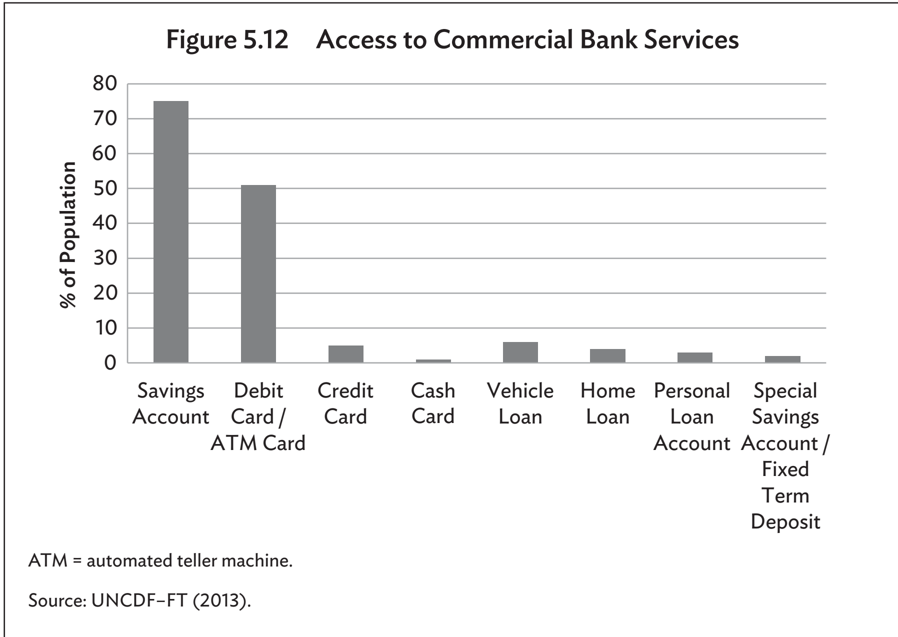
Figure 5.11 Access to Bank Branches and ATMs (%)



ATM = automated teller machine.

Source: UNCDF–FT (2013).

Figure 5.12 Access to Commercial Bank Services



ATM = automated teller machine.

Source: UNCDF–FT (2013).

among lenders means each lender does not know the total debt burden of a potential borrower. Indebtedness is more pronounced in rural areas where many households have over-subscribed to credit products (Table 5.4). The development of a system to share information between all credit providers could help relieve this problem. There is a National Credit Bureau in operation but the Village Funds, the BAAC, and the cooperatives are not members.

Table 5.4 Share of Households with Debt (%)

	Rural	Urban
Northeast	73	58
North	61	49
Central	50	40
Bangkok	--	42
South	51	40

Source: Tambunlertchai (2014).

5.9 Conclusion

Thailand has taken great strides over the last 15 years to expand financial inclusion. 88% of the population has access to some type of financial service and only 4% want but are not able to obtain assess. The chief form of access is holding a deposit account at a financial institution. While access to loans from commercial banks remains limited for most households, the establishment of Village Funds in 80,000 villages across the country has enhanced the provision of credit, including to rural farmers and poor rural households. The Bank for Agriculture and Agricultural Cooperatives, a public sector institution, has also increased access for rural dwellers and expanded credit to non-farm borrowers, including micro and small enterprises. SMEs have benefitted from this measure as well as from the expansion of the Small and Medium Enterprises Development Bank. A symbol of increased financial access across the country—but also a sign that the system can err on the side of excess—is an increase in household debt and the potential for over-indebtedness.

Still, barriers to financial inclusion persist and affect mainly low-income households. The range of financial services available could also be expanded. An increase in the use of mobile banking, to include not just account information but also allow payments and transfers would help rural and remote dwellers to make more frequent use of the services they already access and provide access to others who are currently excluded.

Thailand has brought about an increase in financial access through the use of public financial institutions, including the Village Funds but also the eight SFIs. The expansion of non-state microfinance institutions—a key vehicle for promoting financial inclusion in other countries—has not been fully developed. Nonetheless, the state-led approach may be a model for other countries but only in cases where the system can be effectively managed and services can be provided on a scale sufficient to meet fully the needs of the population.

References

Asian Development Bank (ADB). 2013. Thailand Financial Inclusion Synthesis Assessment Report. Technical Assistance Consultant's Report. TA7998-THA. Manila: Asian Development Bank.

Bank for Agriculture and Agricultural Cooperatives (BAAC). 2014. *About BAAC*. http://www.baac.or.th/baac_en/content-about.php (accessed 23 April 2014).

Bangkok Bank. 2012. *Bangkok Bank Ready to Support Customers through BOT Soft Loans.* http://www.bangkokbank.com/BangkokBank/AboutBangkokBank/AboutUs/MediaRoom/2012/March/Pages/PressRelease13Mar.aspx

Bank of Thailand. 2013. *Financial Access Survey of Thai Households 2013*. http://www.bot.or.th/Thai/FinancialInstitutions/Documents/FinancialAccessSurveyOfThaiHouseholds_2013.pdf

Bird, K., K. Hattel, E. Sasaki, and L. Attapich. 2011. Poverty, Income Inequality, and Microfinance in Thailand. Asian Development Bank. Southeast Asia Working Paper Series No.6.

Boonperm, J., J. Haughton, S. R. Khandker, and P. Rukumnuaykit. 2012. Appraising the Thailand Village Fund World Bank Policy Research Working Paper 5998.

Choong, D. 2013. *MasterCard Index of Financial Literacy Report (2013H1)*. http://www.masterintelligence.com/content/intelligence/en/research/reports/2013/mastercard-index-of-financial-literacy-report-2013h1.html

Economist Intelligence Unit (EIU). 2013. *Global Microscope on the Microfinance Business Environment 2013.* http://www.eiu.com/site_info.asp?info_name=Global_Microscope_2013&page=noads (accessed 21 April 2014).

International Monetary Fund (IMF). 2012. Financial Access Survey. http://fas.imf.org/ (accessed 24 April 2014).

Kaboski, J. P. and R. M. Townsend. 2012. The Impact of Credit on Village Economies. *American Economic Journal: Applied Economics.* 4(2) 98-133.

Maxima, P. 2010. Financial Inclusion: A Path to the Millennium Goals. Speech by the UN Secretary-General's Special Advocate for Inclusive Financed for Development at a side event during the MDG Summit 2010. http://www.koninklijkhuis.nl/globale-paginas/taalrubrieken/english/speeches/speeches-archive/2010/september/speech-by-princess-maxima-un-secretary-general%E2%80%99s-special-advocate-for-inclusive-finance-for-development/

National Statistical Office. 2009. Thailand Socio-Economic Survey. http://service.nso.go.th/nso/nso_center/project/search_center/23project-en.htm (accessed 21 July 2014).

Prayoonsin, C. 2014. Financial Inclusion in Thailand. Presentation at the 2104 Asia-Pacific Forum on Financial Inclusion: Realizing Financial Inclusion in Asia. Shanghai, People's Republic of China. 19-20 March.

Tambunlertchai, K. 2014. Financial Inclusion, Financial Regulation, and Financial Education in Thailand. Presentation at the Conference on Financial Inclusion, Regulation, and Education. Tokyo. 23 April.

United Nations Capital Development Fund and Finmark Trust (UNCDF–FT). 2013. *Survey Highlights: FinScope Thailand 2013.* http://www.uncdf.org/sites/default/files/download/thailand_booklet_final_06_august_2013.pdf

Wangtal, S. 2014. SMEs Finance in Thailand. Presentation at the JFSA–ADBI–IMF Joint Conference: Financial System Stability, Regulation, and Financial Inclusion. Tokyo. 27 January.

World Bank. 2012. World Development Indicators: Thailand. http://data.worldbank.org/country/thailand#cp_wdi (accessed 12 June 2014).

———. 2014. *2014 Global Financial Development Report*. Washington, DC: World Bank.

6 From Microfinance to Mobile Banking: Making Financial Inclusion Work in the Philippines

Ami Fujimoto and Aladdin D. Rillo

6.1 Introduction

Even before financial inclusion became a global agenda, the Philippines had recognized the importance of embracing the poor segments of the population with financial services. This was first affirmed with the formation of the National Strategy for Microfinance[1] in 1997 by the National Credit Council, in which the government called on the private sector to actively develop the microfinance sector. Since then, enhancing financial access—and inclusion—has become a long-standing policy objective and has set the stage for many enabling laws and regulations to support the poor.[2] Many agencies in the country have incorporated the vision of inclusive finance in their programs. In fact, the current Philippine Development Plan 2011–2016 explicitly envisions “an inclusive financial system which provides for the evolving needs of its diverse public” (NEDA 2011).

1 The National Credit Council was a policymaking body created under the Department of Finance. In implementing this strategy, the Council focused on the following key principles: (i) greater participation of private sector and/or microfinance institutions (MFIs), (ii) an enabling policy environment to induce private sector participation, (iii) market-oriented financial and credit policies such as market-oriented interest rate, and (iv) non-participation of government line agencies in the implementation of credit and guarantee programs.

2 Among the important laws passed to complement the national strategy for microfinance are the Social Reform and Poverty Alleviation Act (1997), Agriculture and Fisheries Modernization Act (1997), General Banking Law (2000), and Micro, Small and Medium Enterprise Law (2008).

In the Philippines, where poverty still remains a pressing issue, providing access to financial services such as savings, payments, and credit is crucial to sustaining economic and social development (Llanto 2004). It is also associated with reducing poverty and inequality (World Bank 2014). For poor households greater access means the ability to manage their limited income to meet their daily needs. For micro, small, and medium-sized enterprises access to financing—in addition to better understanding of the basic fundamentals of risk and finance—will enable them to pursue productive activities and business opportunities. Overall, it is believed that a more inclusive and diversified financial system will lead to more efficient allocation of savings and investment, and consequently, to greater financial stability and growth.

Despite the perceived positive impact of financial inclusion and sustained efforts to promote it, the state of financial inclusion in the Philippines is far from ideal. According to the World Bank only 27% of adults in the Philippines had formal bank accounts by end-2011, well below the average for the world economy (46%) and the East Asia and Pacific region (42%). While 19% of firms have sourced their working capital from the banks, a significant majority of small enterprises in the informal sector still face severe financing constraints.[3] At the end of 2012, micro-loans represented a meager share (less than 1% or P8.4 billion) of total banking loans in the country (P3,622 billion) despite the fact that these micro, small and medium-sized enterprises account for 99.6% of industries in the Philippines (BSP 2014b).

Although the Philippines has made some progress in promoting an inclusive financial system over the years, increasing access to financial services remains challenging. The Philippines is a recognized leader in mobile banking yet bank penetration access is still low, particularly in remote areas. Similarly, the Philippine microfinance sector ranks as one of the top in the world yet a large unmet demand for microfinance services still exists. One issue to address is to what extent the country's programs and initiatives have resulted in inclusive finance, and whether the regulatory and policy environment has made a significant difference.

This chapter analyzes these issues along with the recent achievements and new challenges of achieving financial inclusion in the Philippines. Section 6.2 is an overview of financial inclusion in the Philippines by looking at financial services in terms of the profile of Filipinos demanding financial services, as well as the available supply of financial services and their providers. Section 6.3 discusses the major achievements of the country's financial inclusion programs by focusing on the successes of mobile banking and microfinance, along with the key challenges as discussed in Section 6.4. Finally, Section 6.5 concludes.

[3] In 2005, ADB reported that almost two-thirds of poor families (17 million) cannot access microfinance services despite the fact that 4.1 million of them are engaged in microenterprise activities for their livelihood (ADB 2005).

6.2 Financial Inclusion in the Philippines: Basic Facts and Trends

In the Philippines, financial inclusion is defined as "a state wherein there is effective access to a wide range of financial services for all" in line with internationally accepted definitions (BSP 2013a). This implies that while access is important, there is a need as well to design an appropriate and quality set of financial products and services (for example, savings, credit, payments, and insurance) for all market segments (particularly the unserved or underserved). In addition, financial inclusion should be viewed in terms of how the various financial products and services impact the experience and welfare of the consumers.

Over the years commitment to financial inclusion has increased. The Philippine Development Plan 2011–2016, for example, has envisioned the establishment of a "resilient and inclusive financial sector" as part of its strategy to sustain growth and development. To achieve that goal, the Philippines is committed to: (i) implementing a good regulatory policy that balances financial inclusion with financial stability, (ii) using alternative products and delivery channels to reach the underserved segments of the markets such as the poor, women, and persons with a disability, and (iii) adopting a holistic approach to financial literacy and education. Similarly, in its Maya Declaration[4] announced in 2011, the Philippines reaffirmed its commitment to "pursue financial inclusion side-by-side with the promotion of price and financial stability" and to "create the enabling environment to make it possible for all adults to have a deposit account" (BSP 2014a).

The Philippines has been an active participant in global discussions of financial inclusion such as those initiated by the Consultative Group to Assist the Poor (CGAP) and Alliance for Financial Inclusion, promoting knowledge sharing and providing leadership in financial inclusion. Currently, the country works closely with international standard-setting bodies[5] in developing and implementing international standards and regulatory frameworks in the financial sector and in relation to financial inclusion. Understandably, these efforts reflect the fact that financial inclusion is a serious item on the policy agenda in the Philippines.

---

4 The Maya Declaration is an agreement among 90 countries in the world (representing 75% of the world's unbanked population) to make measurable commitments in four broad areas to advance financial inclusion. These are: (i) create an enabling environment to harness new technology that increases access to and lowers the costs of financial services; (ii) implement a proportional framework that advances synergies in financial inclusion, integrity, and stability; (iii) integrate consumer protection and empowerment as a key pillar of financial inclusion; and (iv) utilize data for informed policymaking and tracking results. The Philippines joined the Maya Declaration in 2011 during the annual meeting of the Alliance for Financial Inclusion Group.

5 These include the Financial Action Task Force, Basel Committee on Banking Supervision, Committee on Payment and Settlement Systems, International Association of Insurance Supervisors, and International Association of Deposit Insurers (Global Partnership for Financial Inclusion 2011).

6.2.1 Demand Trends in Financial Inclusion

In general, financial inclusion can be measured by the usage of (demand), and (supply) access to financial services by the adult population and firms (World Bank 2014). In terms of demand, the indicators relate to account ownership, payments, savings, and borrowing. We use this as a guide to examine the current trends of financial inclusion in the Philippines in terms of demand for and supply of financial services in the country.

According to the World Bank's Global Findex Survey (World Bank 2011), 27% of the adult population in the Philippines are still considered unbanked or don't have any access to formal bank accounts. Compared to its peers[6] (Table 6.1) with relatively the same level of financial inclusion, the Philippines performs better than Peru in terms of bank account penetration. But it falls behind other economies, particularly against the group of developing countries in general where 30% of adults have reported having an account at a formal financial institution.

Other indicators of usage of financial services from the World Bank survey are less encouraging. Only 10.5% of Filipino adults have reported acquiring a loan from a formal financial institution over the past year, and even a smaller percentage of them (2.1%) have accessed electronic payment services. Other countries ended up slightly better than the Philippines, except Kenya and Mexico (regarding loans from a financial institution in the past year) and Peru (regarding the use of electronic payments).

Results of the latest Consumer Finance Survey (BSP 2009) also confirm limited usage of financial services in the country. Only two out of ten Filipino households

Table 6.1 Level of Financial Inclusion for Individuals: Philippines versus Peers, 2011 (%, age 15+)

	Kenya	Malaysia	Mexico	Peru	Philippines	Thailand
Account at formal financial institution	42.3	66.2	27.4	20.5	26.6	72.7
Loan from a financial institution in the past year	9.7	11.2	7.6	12.7	10.5	19.4
Electronic payments used to make payments	5.4	12.6	8.3	1.9	2.1	8.6
Debit card	29.9	23.1	22.3	14.1	13.2	43.1

Source: World Bank (2014).

6 These countries are Kenya, Malaysia, Mexico, Peru, and Thailand. They are selected as appropriate peers for benchmarking financial inclusion levels, as identified by the Alliance for Financial Inclusion in their data assessment report for the Philippines.

have a bank deposit, or equivalent to 4,288 deposits per every 10,000 adults as of 2012.[7] The majority of the unbanked households (84%) are found outside the urban areas of the National Capital Region (which include Manila and adjacent 15 cities and 1 municipality). For example, the Autonomous Region of Muslim Mindanao that is considered the most underserved and depressed region in the Philippines, has 467 bank deposit accounts per 10,000 adults compared to 21,491 bank accounts in the National Capital Region.

The majority of households maintain only one deposit account, which is mainly with commercial banks, and each account has a median outstanding balance of P6,875. Interestingly, households outside the urban areas prefer to have deposits in rural banks, thrift banks, cooperatives, and microfinance banks instead of large commercial and universal banks. Among those without bank accounts (79% of surveyed households), the number one reason cited for the lack of a bank account is lack of money.

Aside from bank deposits, only a small percentage of households own other financial assets such as mutual funds and stocks, although around 43% of households have retirement or insurance plan. Housing and consumer loans constitute the typical liabilities of households, but the loans are sourced mainly from nonbanks such as moneylenders, cooperatives, and government financing institutions.

Unlike individuals, a majority of firms in the Philippines use bank accounts (98%). Account ownership is high and compares favorably with the level of inclusion by firms in Malaysia and Thailand. However only 33% of the firms report they have loans, a level that is similar to Mexico, but is well below Malaysia, Peru, and Thailand (Table 6.2). Access to finance remains a major problem for the majority of the firms. Only a small percentage of firms use bank financing to support

Table 6.2 Level of Financial Inclusion for Firms: Philippines versus Peers, 2011 (%)

	Kenya	Malaysia	Mexico	Peru	Philippines	Thailand
Firms with a checking or savings account	89.1	97.7	61.8	87.4	97.8	99.6
Firms with a bank loan/line of credit	25.4	60.4	32.0	66.8	33.2	72.5
Firms using banks to finance investments	22.9	48.6	16.2	45.9	21.9	74.4
Firms using banks to finance working capital	26.0	49.3	26.9	49.9	19.1	71.9

Source: World Bank (2014).

[7] The figures on bank deposits are from the supply-side data released by the Bangko Sentral ng Pilipinas (BSP 2009).

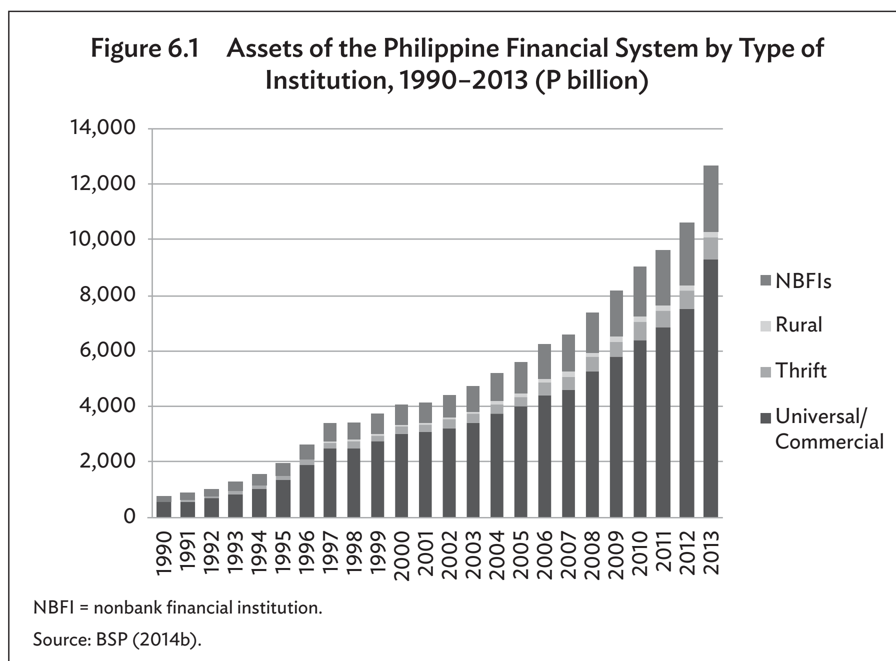
their new investments and they seem to rely on other sources for their working capital. This situation is evident also in other countries like Kenya and Mexico in the survey, thus supporting the prevailing view that financing is indeed a major constraint for financial inclusion by firms.

6.2.2 Supply Trends in Financial Inclusion

In the Philippines, the financial system consists of banks and nonbank financial institutions. Banks are classified as commercial banks, universal banks (expanded commercial banks), thrift banks (savings and mortgage banks, stock savings and loan associations), private development banks, rural banks, cooperative banks, and Islamic banks. Nonbank financial institutions include insurance companies, investment houses, financing companies, securities dealers and brokers, fund managers, lending investors, pension funds, pawnshops, and non-stock savings and loan associations.

As seen in Figure 6.1, banks accounted for P10,311 billion of financial assets in 2013 and thus dominate financial services. Universal/commercial banks are the key players with assets of P9,300 billion. Commercial banks experienced a significant expansion following the deregulation of bank entry and branching in early 1990s. In contrast, the asset base of thrift and rural banks has remained steady, with assets of P809 billion and P202 billion, respectively.

Figure 6.1 Assets of the Philippine Financial System by Type of Institution, 1990–2013 (P billion)



NBFI = nonbank financial institution.

Source: BSP (2014b).

One direct effect of deregulation is a rapid growth of banking offices and branches since the 1990s, with significant growth also evident across bank categories including rural and thrift banks (Milo 2001). Although there has been a decline in the number of head offices beginning in 2000 due to mergers and consolidation, the banking network in the Philippines remains extensive (Table 6.3). Between 2000 and 2013, the total banking network increased by 31% from 7,554 head offices and branches in 2000 to 10,020 in March 2014.

The increase is evident across bank types. Interestingly, the number of rural and cooperative banks increased by 38% during this period, from 1,913 branches and offices in 2000 to 2,646 in March 2104, the highest increase among the banking types. Not only has the number increased, but it has also led to a positive impact on regional access to basic banking services. Aside from its extensive banking network, the Philippines also managed to rapidly expand its network of automated teller machines (ATMs) across the country (Figure 6.2)—indicating improved financial access. There are now 14,530 ATMs (including both on-site and off-site ATMs[8]) all over the country compared to only 3,650 in 2000—a growth of over 200% over the last 14 years. Interestingly, in the rural areas where many of the financially excluded people live, ATM expansion has been more rapid. Between 2005 and 2013, the ATM network associated with rural and cooperative banks expanded by more than 700%, from 42 ATMs in 2005 to 339 in 2013 (Figure 6.3).

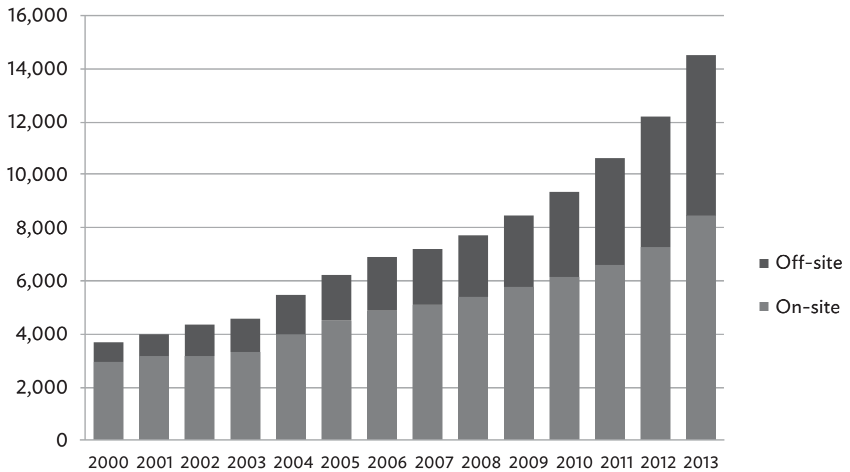
Table 6.3 Number of Banking Institutions in the Philippines, 2000–2014

	2000	2005	2010	2013	March 2014
All Banks	7,554	7,670	8,877	9,935	10,020
Head offices	947	879	758	673	667
Branches/Agencies	6,607	6,791	8,119	9,262	9,353
Universal and Commercial	4,250	4,318	4,681	5,461	5,514
Head offices	45	41	38	36	36
Branches/Agencies	4,205	4,277	4,643	5,425	5,478
Thrift Banks	1,391	1,293	1,418	1,828	1,856
Head offices	112	84	73	71	70
Branches/Agencies	1,279	1,209	1,345	1,757	1,786
Rural Banks and Cooperatives	1,913	2,059	2,778	2,646	2,650
Head offices	790	754	647	566	561
Branches/Agencies	1,123	1,305	2,131	2,080	2,089

Source: BSP (2014b).

[8] On-site means that ATMs are inside the banks and bank branches, while off-site refers to ATMs outside the banks and bank branches such as in shopping malls and those located on the street.

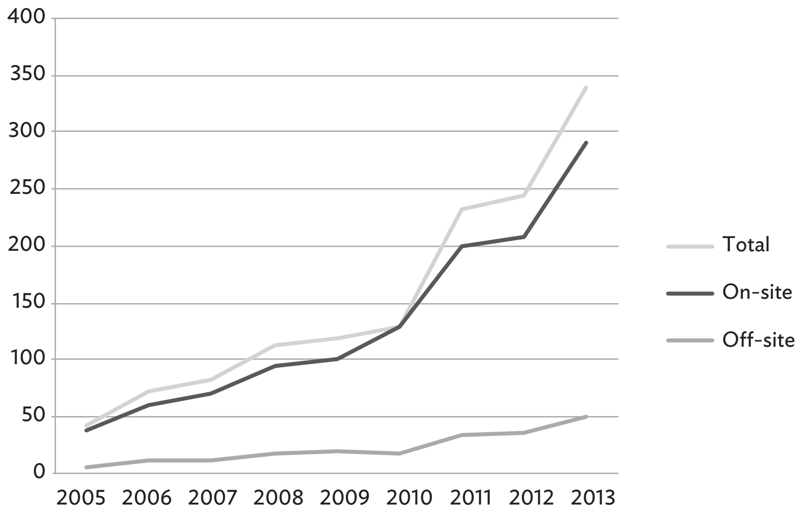
Figure 6.2 ATM Network: Philippine Banking System



ATM = automated teller machine.

Source: BSP (2014b).

Figure 6.3 ATM Network: Rural and Cooperative Banks



ATM = automated teller machine.

Source: BSP (2014b).

One problem facing the Philippines is its archipelagic nature which imposes serious barriers to financial access (Espenilla 2012). Banks are still concentrated in high income and urban areas. As a result, 37% of the country's cities and municipalities (representing around 14 million unbanked Filipino adults) still did not have a banking office as of 2012 (BSP 2012). Although the percentage of unbanked municipalities declined from 42% in 2000, the current trend remains high.

In the Philippines one unique feature is the presence of alternative financial service providers (FSPs) that serve as critical access points in many unbanked areas. These include pawnshops, remittance agents, credit cooperatives, moneychangers, and foreign exchange dealers that provide specific financial services. The latest data (2012) from the *Bangko Sentral ng Pilipinas* (BSP) shows that if these FSPs are accounted for, only 13% of the municipalities can be considered technically as underserved or unserved.[9] For example, a study by Bankable Frontier (BFA 2010) showed that 55% of adults in the Philippines use money transfer facilities for their domestic payments. Similarly, in many unbanked areas, pawnshops have become an important access point for providing auxiliary services like remittances, money changing, and payment services (Martin and Samarapally 2014).[10]

Despite these improvements, financial access in the Philippines still lags in some aspects compared to other countries (Table 6.4). This implies that there

Table 6.4 Geographical Reach: Philippines versus Peers, 2012

	Kenya	Malaysia	Mexico	Peru	Philippines	Thailand
CB branches per 1,000 km^2	2.31	13.0	6.41	11.57	17.26	12.55
CB branches per 100,000 adults	5.49	19.91	14.52	69.73	8.13	11.77
ATMs per 1,000 km^2	4.18	34.56	20.89	5.91	41.0	89.70
ATMs per 100,000 adults	9.94	52.94	47.33	35.61	19.31	84.16
All MFI branches per 1,000 km^2	0.14	---	0.43	4.49	1.12	---
All MFI branches per 100,000 adults	---	---	1.91	54.91	1.02*	---

* 2011 data; --- indicates no data.

ATM = automated teller machine; CB = commercial bank; km^2 = square kilometer; MFI = microfinance institution.

Source: IMF (2012).

9 For example, in 2012, out of the 611 unbanked municipalities, 395 have access to alternative FSPs, thus leaving only 216 municipalities without any access points or 13% of total cities and municipalities in the Philippines.

10 For example, in their blog, Martin and Samarapally documented how the Philippine government's poverty alleviation programs have utilized pawnshops (17,000 of them all over the country) as cash-in and cash-out centers for payment of subsidies and conditional cash transfers to the beneficiaries of the programs who live in remote and far away rural areas.

is a need to further address the constraints that affect the usage and access of financial services in the country. One key consideration is to provide the enabling environment for inclusive finance by ensuring that policy frameworks and strategies work. In fact, some of the early achievements of financial inclusion in the Philippines, as well as the recent ones, have been a direct result of good policies and strategies. This will be discussed in section 6.3.

6.3 Realizing Financial Inclusion in the Philippines: From Microfinance to Mobile Banking

In the Philippines there is no single entity that has been mandated by law to lead the various financial inclusion initiatives. Many institutions are involved in expanding financial services with different supervisory regimes. For example, the central bank is responsible for banking services while the Cooperative Development Authority takes care of licensing cooperatives and other non-financing entities. Despite this, the Philippines has managed to secure an enabling environment for promoting financial inclusion and has implemented best practices and programs that are recognized by other countries. In fact, the Philippines is now recognized as one of the global leaders in mobile banking and one of the top countries in the world in the development of microfinance sector.[11]

Because financial services are dominated by banking, the Philippine central bank (BSP) has become a strong supporter of inclusive finance. Since the recognition of microfinance as a legitimate banking activity in 2000, it has issued many laws and regulations to improve the business environment for micro and small enterprises. As financial inclusion came to be increasingly understood as involving a wide range of services such as savings, credit, insurance, payment services, and remittances, the BSP also began formulating policies for various financial inclusion initiatives. Thus, as an enabler of financially inclusive environment through regulatory policy (Espenilla and Roman-Tayag 2011), the role of the BSP has been crucial.[12] This is evident in the outcomes of the various initiatives the government has implemented over the years, as discussed below.

---

[11] For example, from 2009 to 2013, the Philippines' regulatory environment for microfinance is consistently ranked one of the best in the world by the EIU Global Microscope on the Microfinance Business Environment (BSP 2013c).

[12] In providing a supportive regulatory environment, the BSP is guided by the following principles: (i) promotion of financial inclusion in line with financial stability and efficiency; (ii) adoption of market-based solutions to address financial access; and (iii) promotion of consumer protection and financial system integrity. Within these principles, the BSP has adopted a four-point strategy that includes policy, regulation and supervision, consumer protection and financial education, advocacy, and data measurement and management. For further discussion, see Roman-Tayag (2013) and Espenilla (2012).

6.3.1 Finance for Microenterprises

In the Philippines microfinance refers to the provision of financial services such as credit, savings, and insurance and other non-financial programs for the poor to improve their livelihood (Mercado-Bunker 2014). Since the first national policy on microfinance was developed in 1997, efforts to develop the microfinance sector have intensified. As a result, microfinance became a core program by the government to implement its various poverty reduction strategies, starting in 1997 with the passage of Social Reform and Poverty Alleviation Act. This was followed by the formulation of General Banking Law in 2000 that recognized microfinance as a legitimate banking activity. Most recently, the Philippine Development Plan identified microfinance as one of the pillars for resilient and inclusive financial sector.

As of 2011, there were 14,938 microfinance institutions (MFIs) across the country providing financial services for the poor, particularly small loans for microenterprises. Most of these MFIs are credit cooperatives (98%), while the rest are banks and nongovernment organizations with microfinance operations such as rural banks, thrift banks, and cooperative banks (Mercado-Bunker 2014). As shown in Table 6.5, the microfinance sector in the Philippines has grown over the years with visible impact on coverage and services being provided such as loans and savings (Habaradas and Umali 2013). By end-2011, MFIs generated P20.6 billion in loans and P9.2 billion in savings to around four million beneficiaries.

6.3.2 Micro-banking Offices and Branches

One important factor to this growth is the supportive policy and regulatory environment for microfinance, particularly regulations that promote innovative products[13] and commercially sustainable microfinance (Table 6.6). A good example is the emergence of microfinance-oriented banks. Established to serve the specific needs of microfinance clients, micro-banks exemplify how the banking system transformed itself to deliver effective microfinance services. As of March 2013, the BSP reported that the microfinance loan portfolio of the banking sector amounts to more than P8 billion, of which 82% are loans to microenterprises and small businesses (BSP 2013b).

Complementing these micro-banks is a network of micro-banking offices (MBOs) scattered all over the country especially in areas "where it may not be immediately economically feasible to put up a full banking office" (BSP 2014a). As of 2012, the BSP has approved 370 MBOs to operate in 232 municipalities. Fifty of these municipalities are served by MBOs alone (Roman-Tayag 2013). These translate

[13] These innovative products include microenterprise loans, housing microfinance loans, micro-agri loans, and microfinance plus.

Table 6.5 Microfinance in the Philippines: Outreach

Selected indicators	2005	2007	2009	2011
No. of Active Borrowers ('000)	1,508	2,143	2,887	3,600
Banks	597	779	883	1,032
NGOs	839	1,353	1,985	2,478
Cooperatives	72	11	19	90
Loans Outstanding (P million)	7,478	12,979	16,547	20,605
Banks	3,478	5,676	6,677	7,207
NGOs	3,581	7,226	9,703	12,701
Cooperatives	419	77	167	697
Savings Deposit (P million)	2,615	4,858	6,841	9,225
Banks	1,066	1,990	2,977	3,891
NGOs	1,417	2,868	3,792	5,003
Cooperatives	132	...	72	331
No. of MFIs Reporting Data	227	258	241	218

... = indicates no data, MFI = microfinance institution; NGO = nongovernment organization.

Source: Habaradas and Umali (2013).

to 1 million micro-deposit accounts amounting to P2.4 billion. According to the data submitted by the top nine banks that make up these accounts, around 90% of micro-deposits are in the range of P5000 and below. However, the distribution of deposits has been increasingly moving toward higher amounts (between P10,000 and P40,000) confirming the potential of microfinance clients to build up their savings and become net savers (BSP 2014a). The findings also highlight the role that banks can play in mainstreaming microfinance in a banking industry to facilitate the participation of the poor in the formal banking sector through responsive and relevant regulations.[14]

6.3.3 Micro-insurance

Another important milestone in the Philippine microfinance sector is the development of micro-insurance. In 2010, the Philippines became the first country in the world to develop a micro-insurance framework with the launch of the Regulatory Framework for Micro-insurance by the Department of Finance

[14] The BSP has issued over the last 10 years around 40 regulations to support the microfinance sector. In the case of micro-deposits, for example, the BSP has started to refine its existing regulations to be more responsive to the needs of the micro-bank clients. For example, in 2013, a new regulation was issued to increase the average daily balance of micro-deposits from P15,000 to P40,000, when the appetite for higher savings by microfinance clients became evident.

(DOF) and National Credit Commission (NCC). Under this framework, the goal is to provide the informal and low-income segments of the population with simple, low premium, and easy to understand insurance products.

The latest available data (2013) show that about 20 million Filipinos and their dependents have micro-insurance (Gil 2014). The government has licensed around 54 insurance providers, including 19 mutual benefit associations, to sell

Table 6.6 Selected BSP Regulations on Microfinance

Circulars	Key provisions
Microfinance Loans	
No. 272 (30 Jan 2001)	Recognizes cash-flow based lending as a peculiar feature of microfinance, defines microfinance loans and provides for the exemption of microfinance loans from rules and regulations issued with regard to unsecured loans
No. 282 (19 Apr 2001)	Opens a rediscounting facility for rural banks/cooperative rural banks engaged in microfinance
No. 364 (19 Jan 2003)	Reduces to 75% the risk weight applicable to small and medium-sized enterprises and microfinance loan portfolios that meet prudential standards
No. 409 (14 Oct 2003)	Provides the rules and regulations for the portfolio-at-risk and the corresponding allowance for probable losses which depend on the number of days of missed payment
No. 549 (9 Oct 2006)	Exempts microfinance from the required submission of additional documents (income tax return, financial statement) for the granting of loans
Microfinance Products	
No. 678 (6 Jan 2010)	Provides rules and regulations that govern the approval of banks' housing microfinance products
No. 680 (3 Feb 2010)	Provides rules and regulations on the approval of banks' micro-agri loans
No. 744 (28 Dec 2011)	Defines microenterprise loan plus or "microfinance plus" which ranges from P150,001 to P300,000 and caters to the growing business of microfinance clients
No. 782 (21 Jan 2013)	Amends the characteristics of a microfinance client to include among the types of clients those poor and low income clients with annual family income below the national average based from the latest available National Statistics Office Family Income and Expenditure Survey

continued on next page

Table 6.6 *continued*

Circulars	Key provisions
Liberalized Branching for Microfinance Banks	
No. 273 (27 Feb 2001)	Partial lifting of moratorium on establishment of new banks as long as the new banks are microfinance-oriented
No. 505 (22 Dec 2005)	Revises branching guidelines by allowing qualified microfinance oriented banks and microfinance oriented branches of regular banks to establish branches anywhere in the Philippines
No. 624 (13 Oct 2008)	Amends branching policy and guidelines that governs the establishment of branches, extension offices and other banking offices
No. 694 (14 Oct 2010)	Allows for the establishment of micro-banking offices and defines microfinance products
Governance on Microfinance Banks (Bank-NGO relationships)	
No. 725 (16 Jun 2011)	Provides the framework for governance arrangements and contractual agreements between a bank with microfinance operations and a related microfinance non-government organization/foundation
Microfinance Rating Agencies	
No. 685 (7 Apr 2010)	Provides rules and regulations in the recognition of microfinance institution rating agencies

BSP = Bangko Sentral ng Pilipinas; NGO = nongovernment organization.

Source: BSP (2014c).

both life and non-life insurance products. Although the Philippines is one of the countries in Asia with the highest micro-insurance penetration ratio (Munich Re Foundation 2014), improving access to insurance services remains crucial. Most poor Filipinos live in fishing and farming areas that are vulnerable to severe weather patterns and natural disasters. Thus, micro-insurance is critical to protect their incomes and livelihoods against those risks.

To implement this new initiative, DOF and NCC are planning to develop innovative insurance products for the agriculture sector. Part of the plan is to introduce technology-based platforms such as mobile phones and internet to make insurance products more accessible. To support the market for insurance, DOF and NCC will continue to assess and develop new regulatory policies and laws, as well as advocacy programs to increase awareness and understanding of micro-insurance.

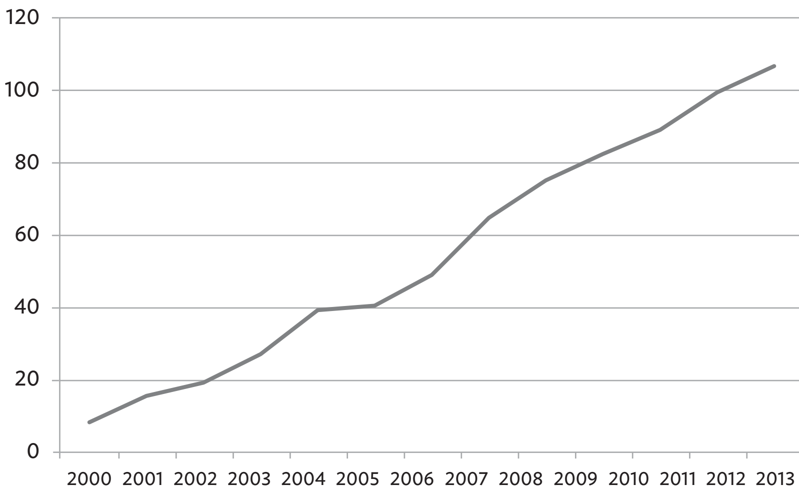
6.3.4 Electronic Money and Mobile Banking

Another area where the Philippines has made significant headway in promoting inclusion is in mobile banking and mobile payments. As one of the pioneers in mobile banking, the Philippine experience is not unique. It highlights how technological innovations, when combined with good policy and a market-oriented business model, can serve as a powerful instrument for accessing financial services. In the case of the Philippines, that formula has worked well.

Three important reasons explain the emergence of the Philippines as an early leader in mobile banking (GSMA 2010). One is wider access to mobile phone technology. Mobile phone subscriptions per 100 inhabitants have been increasing rapidly in the Philippines, from 8.3% in 2000 to 106% in 2013 (Figure 6.4). This translates to a mobile penetration ratio of 110% in the country compared to the bank penetration rate of only 27%. Filipino mobile phone users are also found to be highly literate in using mobile phones, which makes the idea of using mobile money more appealing to them.

According to a 2009 survey conducted by CGAP and McKinsey, around 50% of active mobile users in the Philippines are unbanked. Most of them live outside cities and use mobile money to send and receive domestic remittances. These findings tend to validate why mobile payments and banking have gained support in the Philippines given that the "latent demand for financial services clearly existed" (GSMA 2010).

Figure 6.4 Philippine Mobile Phone Subscriptions per 100 Inhabitants



Source: ITU (2014).

Second is the role of the private sector. In fact, this demand for financial services has enabled mobile operators to design new business models and product offerings in line with the financial needs of their customers. For example, mobile operators first tapped on remittance[15] and payment services as a basis for their initial business experiments. As these experiments became successful, more mobile platforms were used to target other services. Without the private mobile operators taking the risks, those technological innovations would not be possible.

Finally, mobile banking would not be successful without the strong regulatory support by the central bank authorities. The BSP took the challenge of balancing the need to innovate with financial stability and ensuring that the right regulations conducive to mobile banking are created. Through a series of regulations (Table 6.7), the BSP allowed mobile operators "to offer e-money" and nonbanks "to perform cash in/out financial services". The BSP also formalized rules to guide their operations and allowed different business models of financial services to be tested and become more competitive.

The results of these efforts are a successful mobile banking system in the country. As shown in Table 6.8, there were 32 e-money issuers and over 217 million e-money transactions amounting to P348 billion (average of inflow and outflow) by the end of 2013. About 56 rural banks with electronic banking operations were also reported in 2012 from none in 2005. These results further confirm that mobile banking has successfully expanded the financial services network to those traditionally unserved and underserved.

In the meantime, the two leading mobile providers (SMART Communications and Globe Telecom), together with the BSP, tried and tested the waters of technological innovations that are now the models for mobile banking and mobile payments in the world. Although they both provide electronic money (e-money) products, their approaches are quite different. SMART takes a bank-centric approach while Global Telecom uses a telco-led approach.

[15] Remittances are an important financial service since most of the unbanked population uses this service to send money to their families who live far away. This is borne from a survey conducted by CGAP and McKinsey (GSMA 2010).

Table 6.7 Selected BSP Regulations on E-banking

Circulars	Key provisions
No. 240 (5 May 2000)	To require banks to seek prior BSP approval before they can be allowed to provide electronic banking services. Applicant banks must prove that they have in place a risk management process that is adequate to assess, control and monitor any risks arising from the proposed electronic banking activities.
No. 269 (21 Dec 2000)	Banks wishing to provide and/or enhance existing electronic banking services shall submit to the BSP an application describing the services to be offered/enhanced and how it fits the bank's overall strategy. This shall be accompanied by a certification signed by its president or any officer of equivalent rank and function to the effect that the bank has complied with minimum pre-conditions.
No. 511 (3 Feb 2006)	The guidelines contain two main parts. The first outlines the primary risk related to the bank's use of technology and the second describes a risk management process on how banks should manage these risks.
No. 542 (1 Sep 2006)	Govern the implementation of e-banking activities of the bank for purposes of compliance with the requirements to safeguard customer information, prevention of money laundering and terrorist financing, reduction of fraud and theft of sensitive customer information, and promotion of legal enforceability of banks' electronic agreements and transactions.
No. 649 (9 Mar 2009)	Guidelines governing the issuance of electronic money (e-money) and the operations of electronic money issuers in the Philippines.
No. 704 (22 Dec 2010)	Guidelines on Outsourcing of Services by Electronic Money Issuers to Electronic Money Network Service Providers.

Source: BSP (2014c).

SMART launched SMART Money in 2001. It has a partnership with MasterCard and *Banco de Oro* (BDO), the second largest domestic universal bank, which allowed SMART Money to be an e-banking product of BDO. This means that SMART Money is subject to already existing customer networks, regulations, and outsourcing since BDO is an e-money issuer and SMART Communications serves as a cash in-cash out agent and also acts as the e-money platform for BDO. On the other hand, Globe Telecom started GCASH in 2004, and established a subsidiary, called G-Xchange (GXI), which registers with the BSP as a remittance

Table 6.8 E-money in the Philippines: Selected Indicators

	2010	2011	2012	2013
No. of Issuers	21	26	27	32
Banks	20	23	24	27
Nonbank financial institutions	---	---	---	1
Others	1	3	3	4
Volume of Transactions (million)	138	158	188	217
Inflow	30	31	38	45
Outflow	108	127	150	172
Value of Transactions (P billion)	441	535	613	730
Inflow	221	268	308	350
Outflow	220	267	305	346

--- = indicates no data.

Source: BSP (2014b).

agent and actually operates e-banking. For cash-in cash-out, it relies mostly on nonbanks and remittance agents such as pawnshops and moneychangers. Compared to SMART, Globe Telecom took a more challenging approach since it has to deal with consumer protection, anti-money laundering, and combating the financing of terrorism issues by themselves. Table 6.9 gives a summary of the basic features of these two innovative mobile banking products in the Philippines.

Table 6.9 Approaches to Mobile Banking: SMART and Globe

Activity	GCASH	SMART Money
Registration	Anywhere via handset and GCash Money Market	Anywhere via handset and SMART Money Center
Cash In/Cash Out (Descending Priority)	Globe Business Center, pawnshop agents, rural bank partners, non-bank remittance agents, Bancnet, ATMs (linked to mobile banking)	ATM, BDO Bank branch, SMART Money Center, nonbank agents
Use	Money transfer, airtime purchase, retail via mobile, utilities, salary disbursement, donations, payment to schools, internet purchases, loan payments	Money transfer, airtime purchase, retail via card, utilities, international remittance, ATM withdrawals, salary disbursement, donations, internet purchases, loan payments/disbursements, reloading from mobile banking service account, trade settlement

ATM = automated teller machine; BDO = Banco de Oro.

Source: Updated by the authors from GSMA (2010).

6.4 Addressing the Challenges and Way Forward

Although the full impact of the initiatives discussed in Section 6.3 is yet to be fully realized, some results are definitive. There is increasing evidence that more Filipinos, especially those in the low-income levels, are accessing the formal financial system. Micro-deposits have proved to serve well the needs of the poor and to encourage them to become net savers (BSP 2014a). Microfinance services have been fully mainstreamed in the formal financial system, thus enabling better delivery channels and access to more diversified products. Technological innovations have also proved to be an effective and efficient way for increasing financial inclusion in the Philippines as evident in the phenomenal growth of mobile banking.

Still there are challenges to achieve inclusive finance in the Philippines. One key challenge is the relatively low use of financial services in the country. This is a concern because it seems that financial services are still not effectively accessed despite various measures to address it. Evidence suggests (World Bank 2014) that while providing physical access is important, there are other factors that need to be considered in enhancing usage of financial services. For example, increasing the "capacity" of individuals to use a bank account may be an important determinant of usage, rather than simply removing physical barriers like simplifying procedures for opening a bank account.

In the Philippines where one major reason for not accessing a bank account is because of a "lack of money",[16] it seems that reducing those access barriers—such as offering low-fee accounts or simplifying bank account application requirements—is not enough. Instead, greater inclusion should be accompanied by policies to improve the income capacity of the low-income group. This suggests that other targeted policies like income-generation and job creation should be part of the overall strategies for financial inclusion to be effective. Thus, it is time that more meaningful programs for financial inclusion are implemented, especially those that are aimed at targeting the vulnerable groups such as women, youth, and rural people.

Another challenge is ensuring effective and wide access to microfinance services. By the end of 2012, total loan investments in the microfinance sector amounted to $650 million covering 3.2 million clients (Mercado-Bunker 2014). Unfortunately a large unmet demand for microfinance services still exists. It seems that one problem is over saturation of microfinance loans. According to the latest survey report by the Microfinance Council of the Philippines (2012),

[16] Based on the results of the 2009 National Consumer Survey (BSP 2009) where households indicated "lack of money" for their inability to open a bank account. In the same survey, they also indicated that one reason for choosing a bank or institution to maintain an account is because the "bank is used by employer/or my business."

out of 1,634 municipalities in the country, 77% have microfinance clients, and around one third of them were saturated. This means that many clients have loans from two or three MFIs in the same area, thus depriving clients in other areas access to loans. This resulted in many unserved microfinance clients or firms, particularly in remote municipalities and rural areas. Thus, from a policy perspective, regulators need to address this issue of over saturation to ensure a wider group of clients are served.

With a mature microfinance sector, it is also time to assess the sector's relevance and contribution to improving access to finance. There is a perception in some regions that the growth has made the industry over confident (Mercado-Bunker 2014). According to the 2012 Microfinance Banana Skin survey, the microfinance industry has become so involved in commercial activities that it has lost sight of its original social purpose (Center for the Study of Financial Innovation 2012). Instead, the increased commercialization has given way to firms focusing too much on their profit objectives and disregarding the interests of their customers. Interestingly, the same survey results show that the key risks confronting the industry are no longer confined to financing alone. Most of the risks relate to internal management problems of microfinance firms such as over-indebtedness, corporate governance, management quality, and quality of risk management.

Addressing these concerns is not trivial given the strategic role of microfinance in promoting inclusive finance. Thus, policies aimed directly at improving the efficient delivery of microfinance services should remain a priority. For example, regulators should ensure that all MFIs comply with the performance standards for microfinance institutions set by the National Credit Council in 2004. This is important to improve operations of MFIs in the utilization of loans, and ensure that MFIs are indeed a better alternative to informal moneylenders in the country (Jimenez and Roman-Tayag 2011).

With technological innovations holding promise for expanding financial inclusion, another challenge for the Philippines is to make that promise work through better regulations and policies. There is evidence that new technologies such as e-money and mobile banking have led to more competition among remittance service providers and reduced costs. For example, the cost of a domestic remittance using e-money providers is only 7.5%–9.5% of what a bank or remittance agent would charge for the same transaction.[17] Evidence also suggests how mobile banking has allowed the government to make meaningful retail payments for its conditional cash transfer programs, thus enabling the government to expand its reach and coverage of municipalities and beneficiaries (Roman-Tayag 2013).

[17] For example, for a remittance of P1,500 ($34), an e-money provider will charge only P11.50, compared to charges by a bank (P152.50), remittance agent (P120), or a pawnshop (P80) for a similar transaction.

To take advantage of these technological innovations, regulators should continue to provide a better enabling environment. Support should focus primarily on encouraging the private sector to invest in innovative products that align market interests with consumer needs and foster the widespread use of financial services. For example, to further incentivize the mobile operators in the Philippines to expand their mobile money services, regulations should simplify procedures for agents to register new customers and for cash-in/cash-out providers to attain licenses such as for remittance services.[18] While there are financial security issues associated with financial innovation, it is important that regulators remain flexible to adjusting existing policies and regulations with the opportunities that the market can offer for a successful mobile banking in the country.

Related to this is the need to address all market malfunctions that prevent effective financial access. So far public policy in the Philippines has been supportive, with timely interventions focusing on strengthening the legal and regulatory framework, creditor rights, business regulations, competition policy, consumer protection, and other market support mechanisms. All these interventions should continue. But there is a need to prioritize by putting in place interventions that markets require. Evidence shows that successful financial inclusion initiatives are often accompanied by strong private sector support (World Bank 2014).

So far evidence of such market support is encouraging (Gil 2014). A good example is the proposed establishment of a comprehensive credit information system in 2014 to be led by the Securities and Exchange Commission. Initiatives to establish a movable collateral registry by 2015 is also welcome as this will enable small firms to use their movable assets (such as inventories and contracts) as collateral for credit. With so many competing interests, the challenge is how to make these interventions work. The provision of microfinance loans or credit is always good as it spurs firm access to finance. But sometimes delivery can be disrupted by poor implementation and lapses in governance on the part of the implementing agency. For example, in 2012, microfinance firms in the Philippines identified political interference as one major risk affecting their operations. Thus, part of the challenge for achieving inclusive finance in the Philippines is to address problems associated with weak governance and an institutional environment.[19]

Finally, and perhaps the biggest challenge is for financial inclusion "to be achieved responsibly" (World Bank 2014). In as much as financial inclusion is about enabling individuals and firms to be part of the formal system, skills, attitudes, and behaviors matter. It is not enough to improve financial access and usage.

[18] In the Philippines, cash-in and cash-out agents do not need to go to the BSP for their individual registration. SMART and GXI have their own mechanism of accrediting their agents and ensuring their compliance (to anti-money laundering, consumer protection laws, among others). They provide the BSP with their list of accredited agents.

[19] The BSP has issued several regulations to promote a deeper culture of corporate governance in BSP-supervised financial institutions.

It is more important to improve financial capability where individuals and firms commit to more responsible financial inclusion. This implies the ability of the public to "acquire knowledge and develop skills to make well-informed economic and financial decisions" (BSP 2013b). Thus, it is crucial that financial education and literacy[20] continues as an integral part of the country's financial inclusion agenda moving forward.

6.5 Concluding Remarks: Making Financial Inclusion Work

Over the last fifteen years the Philippines has made a strong commitment to embrace the poor segments of the population. This has become more evident since 2000 when microfinance was first mainstreamed in the banking system. Since then financial inclusion has become a national policy agenda, with clear strategies, programs, and plans being implemented over the years. As shown in the discussion in Section 6.3, progress has been made.

Nonetheless, in the Philippines where inclusive growth has remained elusive despite the country's economic development over the years, it is crucial that financial inclusion is responsibly achieved. It has to work. Providing access to finance to everyone, especially to the poor, is not enough. It is a policy objective designed to address other development goals like economic growth and financial stability.

Thus, for financial inclusion to work in the Philippines, all key stakeholders must contribute to make it happen. For the government, policymakers should be clear with the objective of their policies and delivery processes. There is no room for policy mistakes. Instead, policy space has to be built with greater flexibility to accommodate the needs of unbanked individuals and micro and small enterprises. For the private sector, it is important that they are able to create jobs and add value to ensure that the market mechanisms work for the poor. Finally, for the unbanked and underserved sectors, accountability is crucial. They should be willing to educate themselves and acquire the knowledge needed to make them accountable to whatever initiatives on financial inclusion that the government and private sector provide them.

[20] The Philippines is one of the countries in the world that promotes the importance of financial education and literacy for a successful financial inclusion. One key initiative is the Economic and Financial Learning Program (EFLP) being implemented by the BSP. Under the EFLP, special learning sessions are designed for targeted groups such as school children, secondary and tertiary students, employed sectors, overseas Filipino workers, microfinance clients, and the unbanked (BSP 2013c).

References

Asian Development Bank (ADB). 2005. *Microfinance Development Program Loan.* Manila: Asian Development Bank.

Bangko Sentral ng Pilipinas (BSP). 2009. *Consumer Finance Survey.* Manila: Bangko Sentral ng Pilipinas.

———. 2012. Report on the State of Financial Inclusion in the Philippines. Manila: Bangko Sentral ng Pilipinas.

———. 2013a. *Financial Inclusion in the Philippines*. Issue No.1 First Quarter.

———. 2013b. *Financial Inclusion in the Philippines.* Issue No. 3 Third Quarter.

———. 2013c. *Financial Inclusion Initiatives.* Manila: Bangko Sentral ng Pilipinas.

———. 2014a. *The Use of Financial Inclusion Data Country Case Study: Philippines Policy on Micro-deposits*. Manila: Bangko Sentral ng Pilipinas.

———. 2014b. Statistics Database. http://www.bsp.gov.ph/statistics/overview.asp (accessed 16 August 2014).

———. 2014c. List of BSP Circulars Related to Microfinance and Financial Inclusion. http://www.bsp.gov.ph/about/advocacies_micro_circ.asp (accessed 8 August 2014).

Bankable Frontier Associates (BFA). 2010. *Mobile Money Regulation in the Philippines*. July.

Center for the Study of Financial Innovation. 2012. *2012 Microfinance Banana Skins*. New York, US: Center for the Study of Financial Innovation.

Consultative Group to Assist the Poor (CGAP). 2009. *Window on the Unbanked: Mobile Money in the Philippines.* December.

Espenilla, N. 2012. Proportionality in Practice: Bangko Sentral ng Pilipinas Experience. Presentation at GFI Conference on Standard Setting Bodies and Financial Inclusion. Basel, Switzerland. 29 October.

Espenilla, N. and P. Roman-Tayag. 2011. Innovative Solutions to Increase Access to Finance: The Role of Enabling Policy and Regulation. *Bangko Sentral Review 2011.*

Gil, B. 2014. Financial Inclusion for Inclusive Growth—Philippine Case. Presentation at the 2014 Asia-Pacific Financial Inclusion Forum. AFDC, Shanghai. 19 March.

Groupe Speciale Mobile Association (GSMA). 2010. *Mobile Money in the Philippines—The Market, the Models and Regulations*. London: Groupe Speciale Mobile Association.

Global Partnership for Financial Inclusion. 2011. *The Philippines Engagement with the Standard Setting Bodies and the Implications for Financial Inclusion.* Bangkok: Alliance for Financial Inclusion.

Habaradas, R. and M. Umali. 2013. The Microfinance Industry in the Philippines: Striving for Financial Inclusion in the Midst of Growth, Working Paper 2013-05. Center for Business Research and Development, De La Salle University, Manila.

International Monetary Fund (IMF). 2013. Financial Access Survey. http://fas.imf.org (accessed 12 August 2014).

International Telecommunication Union (ITU). 2014. ICT Statistics. http://www.itu.int/en/ITU-D/Statistics/Pages/stat/default.aspx (accessed 8 August 2014).

Jimenez, E. and P. Roman-Tayag. 2005. Electronic Banking: Delivering Microfinance Services to the Poor in the Philippines.

Llanto, G. 2004. Is the Promise Being Fulfilled? Microfinance in the Philippines: Status, Issues and Challenges. Philippine Institute for Development Studies Policy Notes No. 2004-10.

Martin, X. and A. Samarapally. 2014. The Philippines: Marshalling Data, Policy and a Diverse Industry for Financial Inclusion. FINclusion Lab. June.

Mercado-Bunker, M. 2014. Financial Inclusion in the Philippines. Presentation at the 2014 Asia-Pacific Financial Inclusion Forum. Shanghai. 19 March.

Microfinance Council of the Philippines. 2012. *The 2012 Microfinance Client Mapping*: *The State of Market Saturation and Inclusion in the Philippines*. Manila: Microfinance Council of the Philippines.

Milo, M. 2001. Deregulation of Bank Entry and Branching: Impact on Competition. Philippine Institute for Development Studies Discussion Paper Series No. 2001-27.

Munich Re Foundation. 2014. *The Landscape of Microinsurance in Asia and Oceania 2013.* Munich, Germany: Munich Re Foundation and GIZ.

National Economic and Development Authority (NEDA) 2011. *Philippine Development Plan 2011–2016.* Manila: National Economic and Development Authority.

Roman-Tayag, P. 2013. Financial Inclusion: Why Is It Important and How Do We Achieve It? Presentation at the GDN Conference. Asian Development Bank. Manila. 21 June.

World Bank. 2011. The Global Financial Inclusion Database. http://econ.worldbank.org/research (accessed 31 July 2014).

———. 2014. *Global Financial Development Report 2014*. Washington, DC: World Bank.

About the Asian Development Bank Institute

The Asian Development Bank Institute (ADBI), located in Tokyo, is the think tank of the Asian Development Bank (ADB). ADBI's mission is to identify effective development strategies and improve development management in ADB's developing member countries. ADBI has an extensive network of partners in the Asia and Pacific region and globally. ADBI's activities are aligned with ADB's strategic focus, which includes poverty reduction and inclusive economic growth, the environment, regional cooperation and integration, infrastructure development, middle-income countries, and private sector development and operations.

About the Asia–Pacific Finance and Development Center

The Asia–Pacific Finance and Development Center (AFDC), established by the Government of the People's Republic of China (PRC) in 2004, aims to strengthen institutional capacity building in the fields of finance and development and to promote cooperation among the economies in the Asia and Pacific region. AFDC has its headquarters in Shanghai and a branch office in Beijing. AFDC achieves its objectives through training workshops, seminars, high-level forums, and research activities, with support from the PRC government, and partnering with the World Bank, the Asian Development Bank, and many others.