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A Comprehensive Literature Review on Financial Inclusion

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Abstract

Financial inclusion refers to provision of formal financial services namely basic savings bank account, credit facilities, payment services, insurances and so on to the downtrodden and poor people at reasonably priced cost. This article discusses about research reviews of financial inclusion comprehensively in terms of its conceptual framework, nature and causes of financial exclusion, costs and consequences of financial exclusion, measurement of financial inclusion and role of financial inclusion on economic growth.

Keywords: Literature review, financial inclusion, Measurement of financial inclusion, Conceptual framework.

1. Introduction

In most developing countries, a large segment of society, particularly low-income people, has very little access to financial services, both formal and semi-formal. As a consequence, many of them have to necessarily depend either on their own or informal sources of finance and generally at an unreasonably high cost. The situation is worse in least developed countries (LDCs), where more than 90 per cent of the population is excluded from access to the formal financial system.

There has been a growing interest, all over the world, in recent years to study about concept of financial exclusion and financial inclusion, causes and effects of financial exclusion, measurement of financial exclusion, measures taken by the governments to tackle financial exclusion and their effectiveness and different ways and means to achieve the goal of "finance for all". As a result, considerable number of studies has been carried out all over the world by academicians, Central banks, World Bank, United Nations Organization (UNO), Asian Development Bank and leading consultancy groups namely Boston Consulting Group and McKenzie. This article intends to review the available literature on concept of financial exclusion/financial inclusion, nature and causes of financial exclusion, its cost and consequences, measurement and role on economic growth comprehensively.

2. Review of Literature

A growth process which reduces inequality is important in many ways. Empirical evidence suggests that inequality in income and assets has an adverse effect on a wide range of different kinds of socio-economic deprivation (Wilkinson and Pickett, 2007)[1]. Inequality is also associated with unequal opportunities, further leading to wasted productive potential and the inefficient allocation of resources, while also inhibiting sound institutional development (World Bank, 2005)[2]. Financial inclusion drive has been carried out considerably in almost all the countries especially in developing and under developed countries to erase inequality income and to alleviate poverty by providing access to formal financial sectors and financial services.

2.1. Concept of Financial Inclusion

Defining financial inclusion is considered crucial from the viewpoint of developing a conceptual framework and identifying the underlying factors that lead to low level of access to the financial system. A review of literature suggests that there is no generally accepted definition of financial inclusion.

As measuring inclusion is perceived to be difficult, financial inclusion is generally defined in terms of exclusion from the financial system. Early discussion on financial exclusion was preceded by social exclusion and focused predominantly on the issue of geographical access to financial services, in particular banking outlets[3]. However, financial exclusion is not just about physical access caused by the changing topography of financial services. Therefore, the debate has now broadened to include all types of people who make little or no use of financial services and the processes of financial exclusion[4].

2.1.1. Definitional Emphasis of Financial Inclusion across the Countries

The definitional emphasis of financial inclusion varies across countries and geographies, depending on the level of social, economic and financial development; the structure of stake holding in the financial sector; socio-economic characteristics of the financially excluded segments; and also the extent of the recognition of the problem by authorities or governments. Broadly, financial exclusion is construed as the inability to access necessary financial services in an appropriate form due to problems associated with access, conditions, prices, marketing or self-exclusion in response to discouraging experiences or perceptions of individuals/entities.

Definitions of financial exclusion in the literature vary depending on the dimensions such as ‘breadth’, ‘focus’ and ‘degree’ of exclusion. The ‘breadth’ dimension is the broadest of all definitions linking financial exclusion to social exclusion which defines financial exclusion as the processes that prevent poor and disadvantaged social groups from gaining access to the financial system[5].

The ‘focus’ dimension is in the middle of the spectrum that links financial exclusion to other dimensions of exclusion. It defines financial exclusion as the potential difficulties faced by some segments of population in accessing mainstream financial services such as bank accounts/home insurance[6].

2.1.2. Important Definitions of Financial Inclusion/Exclusion

Over the years, several definitions of financial inclusion/exclusion have evolved. Important definitions among them are as follows;

Asian Development Bank (2000) defines financial inclusion as “Provision of a broad range of financial services such as deposits, loans, payment services, money transfers and insurance to poor and low-income households and their micro-enterprises[7]”.

In Stephen P. Sinclair (2001) words, “financial exclusion means the inability to access necessary financial services in an appropriate form. Exclusion can come about as a result of problems with access, conditions, prices, marketing or self-exclusion in response to negative experiences or perceptions[8]”.

Chant Link and Associates, Australia (2004) describes financial exclusion as “lack of access by certain consumers to appropriate low cost, fair and safe financial products and services from mainstream providers. Financial exclusion becomes a concern in the community when it applies to lower income consumers and/or those in financial hardship[9]”.

Treasury Committee, House of Commons, UK (2004) views financial inclusion as “Ability of individuals to access appropriate financial products and services[10]”.

Scottish Government (2005) views financial inclusion as “access for individuals to appropriate financial products and services. This includes having the capacity, skills, knowledge and understanding to make the best use of those products and services. Financial exclusion by contrast, is the converse of this[11]”.

According to United Nations (2006 b), “financial inclusion is a financial sector that provides ‘access’ to credit for all ‘bankable’ people and firms, to insurance for all insurable people and firms and to savings and payments services for everyone. Inclusive finance does not require that everyone who is eligible use each of the services, but they should be able to choose to use them if desired[12]”.

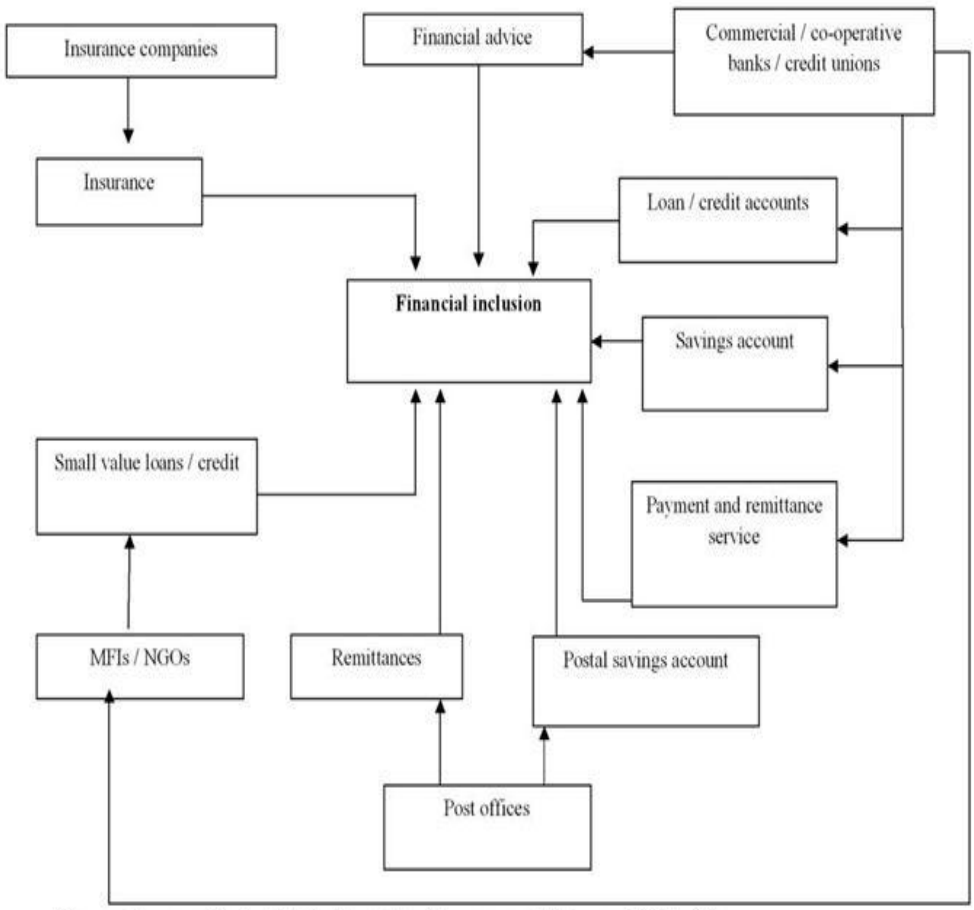
Report of the Committee on Financial Inclusion in India, 2008 views financial inclusion as “the process of ensuring access to financial services and timely and adequate credit where needed by vulnerable groups such as weaker sections and low income groups at an affordable cost[13]”.

World Bank (2008) is of the view about financial inclusion that “broad access to financial services implies an absence of price and non-price barriers in the use of financial services; it is difficult to define and measure because access has many dimensions[14]”.

The working or operational definitions of financial exclusion generally focus on ownership or access to particular financial products and services. The focus narrows down mainly to the products and services provided by the mainstream financial service providers[15]. Such financial products may include money transmission, home insurance, short and long-term credit and savings[16]. Furthermore, the operational definitions have also evolved from the underlying public policy concerns that many people, particularly those living on low income, cannot access mainstream financial products such as bank accounts and low cost loans, which, in turn, imposes real costs on them - often the most vulnerable people[17].

The operational definition of financial inclusion, based on the access to financial products or services, also underscores the role of financial institutions or service providers involved in the process. The anatomy of various financial products or services and the institutional structure influencing financial inclusion is schematically presented in figure – 1.

Figure – 1 Financial products and services and the institutional structure



Source: Reserve Bank of India Report on Currency and Finance, 2007 – 08.

2.2. Nature and Causes of Financial Exclusion

The nature and forms of exclusion and the factors responsible for it are varied and, thus, no single factor could explain the phenomenon. The principal barriers in the expansion of financial services are often identified as physical access, high charges and penalties, conditions attached to products which make them inappropriate or complicated and perceptions of financial service institutions which are thought to be unwelcoming to low income people[18]. These barriers to inclusion have not been constructed deliberately; they are a result of the structural operation of the financial services industry.

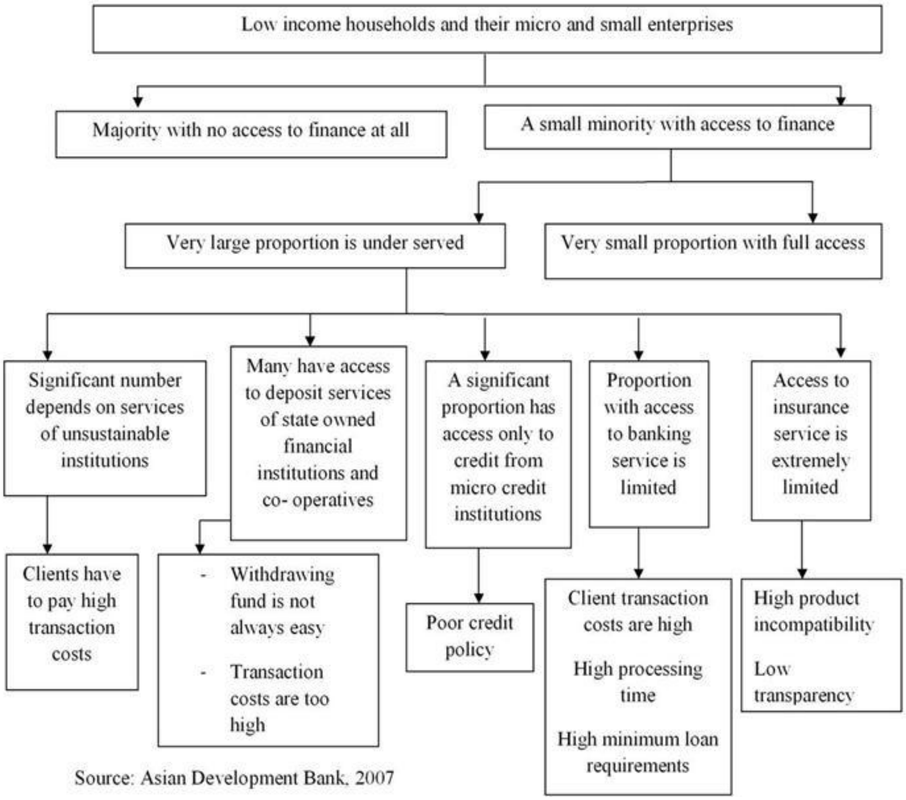
Kempson et al. (2000) analyzed a range of physical and geographical barriers to financial inclusion and a broad range of other factors that can contribute to financial exclusion for different products and individuals under certain circumstances[19].

A number of dimensions or forms of financial exclusion have been identified. The critical dimensions of financial exclusion include: (i) access exclusion- restriction of access through the process of risk management (by financial services providers); (ii) condition exclusion - conditions attached to financial products which make them inappropriate for the needs of some segments of population; (iii) price exclusion- some people can only gain access to financial products at prices they cannot afford; (iv) marketing exclusion - some people are effectively excluded by targeted marketing and sales; and (v) self-exclusion - people decide not to opt for a financial product because of the fear of refusal to access by the service providers[20].

Measuring an individual’s or household’s usage of a particular financial service at a given time may not reveal whether exclusion is short-term or the result of a long-term process, nor whether access is diminishing or improving[21]. Thus, financial exclusion is perceived as an ongoing process in terms of vulnerability to exclusion, rather than simply having access to certain financial services or not. In particular, financial exclusion may be a long-term phenomenon for many consumers or even a life-long process[22]. For families with particular constellations of socioeconomic characteristics, it may extend beyond the lifetime of an individual family member and become inter-generational. It has generally been recognized that it is the poorer sections of the population that do not have access to financial services - formal or informal. However, in many countries, many non-poor individuals, micro, small and medium entrepreneurs also have difficulty in accessing financial services.

The most conspicuous dimension is that many of the low income segments of the population do not have access to even the very basic financial services. Even amongst those who have access to finance, most are underserved in terms of quality and quantity of products and services and significant proportion of low-income households is dependent on unsustainable, subsidy-dependent and poorly performing institutions. Asian Development Bank has identified dimensions of access problems which are displayed in the figure – 2.

Figure – 2 Dimensions of access problems



Source: Asian Development Bank, 2007

2.3. Factors Affecting Access to Financial Services

A number of factors affecting access to financial services have been identified in many countries. Generally accepted factors affecting access to financial services[23] are presented in the following Table – 1.

Table – 1 Factors affecting access to Financial Services

NAME OF THE FACTOR
Gender issues
Age factor
Legal identity
Limited literacy
Place of living
Psychological and Cultural barriers
Social security payments
Bank charges
Terms and Conditions
Level of income
Type of occupation
Attractiveness of the product

Gender Issues: Access to credit is often limited for women who do not have, or cannot hold title to assets such as land and property or must seek male guarantees to borrow.

Age Factor: Financial service providers usually target the middle of the economically active population, often overlooking the design of appropriate products for older or younger potential customers.

Legal Identity: Lack of legal identities like identity cards, birth certificates or written records often exclude women, ethnic minorities, economic and political refugees and migrant workers from accessing financial services.

Limited Literacy: Limited literacy, particularly financial literacy, i.e., basic mathematics, business finance skills as well as lack of understanding often constrains demand for financial services.

Place of Living: Although effective distance is as much about transportation infrastructure as physical distance, factors like density of population, rural and remote areas, mobility of the population (i.e., highly mobile people with no fixed or formal address), insurgency in a location, etc., also affect access to financial services.

Psychological and Cultural Barriers: The feeling that banks are not interested to look into their cause has led to self-exclusion for many of the low income groups. However, cultural and religious barriers to banking have also been observed in some of the countries.

Social Security Payments: In those countries where the social security payment system is not linked to the banking system, banking exclusion has been higher.

Bank Charges: In most of the countries, transaction is free as long as the account has sufficient funds to cover the cost of transactions made. However, there are a range of other charges that have a disproportionate effect on people with low income.

Terms and Conditions: Terms and conditions attached to products such as minimum balance requirements and conditions relating to the use of accounts often dissuade people from using such products/services.

Level of Income: Financial status of people is always important in gaining access to financial services. Extremely poor people find it difficult to access financial services even when the services are tailored for them. Perception barriers and income discrimination among potential members in group-lending programmes may exclude the poorer members of the community.

Type of Occupation: Many banks have not developed the capacity to evaluate loan applications of small borrowers and unorganized enterprises and hence tend to deny such loan requests.

Attractiveness of the Product: Both the financial services/products (savings accounts, credit products, payment services and insurance) and how their availability is marketed are crucial in financial inclusion.

Apart from the supply side factors, demand side factors also have a significant bearing on the extent of financial inclusion. A higher share of population below the poverty line results in lower demand for financial services as the poor may not have savings to place as deposit in savings banks[24].

Thus, low income leads to low demand for financial services, particularly savings products. Likewise, at low levels of development, investment activity may be low and hence, may lead to low demand for credit from banks and other formal financial institutions. However, as poverty levels decline and households move into higher income brackets, their propensity to save increases, which, in turn, leads to higher demand for financial services both for saving and investment purposes.

2.4. Costs and Consequences of Financial Exclusion

Broadly, the issue of cost of financial exclusion may be conceived from two angles, which are intertwined. First, the exclusion may have cost for individuals/entities in terms of loss of opportunities to grow in the absence of access to finance or credit. Second, from the societal or the national perspective, exclusion may lead to aggregate loss of output or welfare and the country may not realize its growth potential. The more tangible outcomes of financial exclusion include cost and security issues in managing cash flow and payments, compromised standard of living resulting from lack of access to short-term credit, higher costs associated with using informal credit, increased exposure to unethical, predatory and unregulated providers, vulnerability to uninsured risks, and long-term or extended dependence on welfare as opposed to savings[25].

2.4.1. Cost of Financial Exclusion

Access to a bank account, credit and insurance are now widely regarded as essential supports for personal financial management and for undertaking transactions in modern societies[26] (Speak and Graham, 1999). According to the Treasury Committee, UK (2006), financial exclusion can impose significant costs on individuals, families and society as a whole. These include (i) barriers to employment as employers may require wages to be paid into a bank account; (ii) opportunities to save and borrow can be difficult to access; (iii) owning or obtaining assets can be difficult; (iv) difficulty in smoothening income to cope with shocks; and (v) exclusion from mainstream society[27].

In terms of cost to the individuals, financial exclusion leads to higher charges for basic financial transactions like money transfer and expensive credit, besides all round impediments in basic/ minimum transactions involved in earning livelihood and day to day living. It could also lead to denial of access to better products or services that may require a bank account. It exposes the individual to the inherent risk in holding and storing money – operating solely on a cash basis increases vulnerability to loss or theft. Individuals/families could get sucked into a cycle of poverty and exclusion and turn to high cost credit from moneylenders, resulting in greater financial strain and unmanageable debt. At the wider level of the society and the nation, financial exclusion leads to social exclusion, poverty as well as all the other associated economic and social problems. Thus, financial exclusion is often a symptom as well as a cause of poverty. Financial exclusion is not evenly distributed throughout society; it is concentrated among the most disadvantaged groups and communities and, as a result, contributes to a much wider problem of social exclusion[28].

A significant portion of demand for credit by rural households arises in order to ease the financial burden of crop failures, illness or death, and health care. In the case of microenterprises, credit may be needed to achieve a reasonable and viable scale of activities. The rising entrepreneurship spanning rural, semi-urban and urban areas, particularly in the unorganized and informal sectors may give rise to large potential demand for credit. The evidence on the demand for credit in India suggests that medical and financial emergencies are the major reasons for household borrowings. Medical emergencies were particularly high for the lowest income quartile[29]. Thus, the difficulty in obtaining finance from formal sources has major social implications.

Another cost of financial exclusion is the loss of business opportunity for banks, particularly in the medium-term. Banks often avoid extending their services to lower income groups because of initial cost of expanding the coverage which may sometimes exceed the revenue generated from such operations[30].

These business related concerns of banks were, however, meaningful when technology development was at a nascent stage and expanding the coverage of financial services required substantial initial investment. The strides in technology have now reduced the required initial investment in a significant manner. What is required is to explore the appropriate technology which is suitable to socio-economic conditions of the region under consideration. Moreover, availability and usage of financial services by the otherwise excluded population groups would lead to increase in their income levels and savings. This, in turn, would have the potential to increase savings deposits as well as credit demand, implying profitable business for banks in the medium-term[31].

2.4.2. Consequences of Financial Exclusion

Two factors have often been cited as the consequences of financial exclusion. First, it complicates day-to-day cash flow management - being financially excluded means households, and micro and small enterprises deal entirely in cash and are susceptible to irregular cash flows. Second, lack of financial planning and security in the absence of access to bank accounts and other saving opportunities for people in the unorganized sector limits their options to make provisions for their old age. From the macroeconomic standpoint, being without formal savings can be problematic in two respects. First, people who save by informal means rarely benefit from the interest rate and tax advantages that people using formal methods of savings enjoy. Second, informal saving channels are much less secure than formal saving facilities. Those who can afford it least, suffer the highest risk. The resultant lack of savings and saving avenues means recourse to non-formal lenders such as moneylenders. This, in turn, could lead to two adverse consequences – (a) exposure to higher interest rates charged by informal lenders; and (b) the inability of customers to service the loans or to repay them. As loans from non-formal lenders are often secured against the borrower’s property, this raises the problem of inter linkage between two apparently separate markets. Judged in this specific context, financial exclusion is a serious concern among low-income households, mainly located in rural areas[32].

2.5. Measurement of Financial Inclusion/Exclusion

While the importance of financial inclusion has been widely accepted, much less is known about how inclusive the financial systems are and who has access to which financial services. It is opt to quote World Bank report statement here which says that "Nobody knows the proportion of people in developing countries that use the services of financial institutions. Too often, that information is not collected by financial institutions or by financial regulators. The latter focus on data pertaining to potential instability in the financial sector and have not been mandated to monitor access of different population groups to financial services. The small deposits and loans of low-income households and small firms are unlikely to cause a financial crisis. Some larger financial institutions might occasionally undertake usage surveys for marketing purposes, but they would not likely make the results public or share results with competitors. When comprehensive data are collected, it is usually by survey research entities gathering them for a public policy reason[33]".

The literature on financial inclusion lacks a comprehensive measure that can be used to indicate the extent of financial inclusion across countries. Though indicators of the depth of banking system, capital markets, and insurance sector are widely available, there is less information available about the degree of financial inclusiveness. Lack of information is more conspicuous in developing countries where there is little systematic information on who is served by the formal financial sector, which financial institutions or services are the most effective at supporting access by poor households and small enterprises, or what practical and policy barriers may be hindering the accessibility[34].

Unlike measures of financial depth—where data from individual institutions (or trades in the case of the capital market) can be aggregated relatively simply to obtain consolidated figures— data on financial use cannot easily be constructed in this way. For instance, the total number of all bank accounts far exceeds the number of customers served, as households and enterprises may have business with several banks (or multiple accounts with a single bank)[35].

Individual indicators, viz., number of bank accounts and number of bank branches that are generally used as measures of financial inclusion, can provide only partial information on the level of financial inclusion in an economy[36]. Financial services or products rendered by banks, postal savings banks, credit unions, finance companies, micro-finance institutions (MFIs), and other formal and quasi-formal non-bank institutions generally form the basis for measuring the financial inclusion[37].

It is often observed that people may have access to financial services, but may not wish to use them. Such voluntarily excluded persons, it is argued, should be included in measures of access even if they do not use financial services. However, even among the 'voluntarily excluded', this may in reality be because such services are unaffordable, unsuited to their needs, or because the potential users fear that they will be declined upon request. Among the 'involuntarily excluded' from services such as credit, some represent high credit risk that lenders are discouraged to prudently serve them[38].

3. Discussions and Conclusion

The definitions of financial inclusion laying emphasis on the 'focus' also vary significantly to include various segments of population such as individuals, households, communities, and businesses. The 'degree' dimension, which is the narrowest of all definitions of financial exclusion, defines financial exclusion as exclusion from particular sources of credit and other financial services including insurance, bill-payment services and accessible and appropriate deposit accounts.

Finally, definitions of financial exclusion vary considerably according to the dimensions such as the concept of relativity, i.e., financial exclusion defined relative to some standard (i.e., inclusion). This line of thinking defines the problem of financial exclusion as that emanating from increased inclusion, leaving a minority of individuals and households behind. Thus, there exists duality of hyper inclusion with some having access to a range of financial products and at the same time a minority lacking even the basic banking services. This phenomenon is observed mostly in developed countries with high degree of financial development.

The review of literature suggests that the most operational definitions of financial inclusion are context-specific, originating from country-specific problems of financial exclusion and socio-economic conditions. Thus, the context specific dimensions of financial exclusion assume importance from the public policy perspective.

Furthermore, the definitions have witnessed a shift in emphasis from the earlier ones, which defined financial inclusion and exclusion largely in terms of physical access, to a wider definition covering access to and use and understanding of products and services. In short, no universally accepted definition of financial inclusion is available. Since measuring inclusion is perceived to be difficult, financial inclusion has generally been defined in terms of exclusion from the financial system. The working or operational definitions of financial exclusion generally focus on ownership or access to particular financial products and services.

Financial exclusion may also have resulted from a variety of structural factors such as unavailability of products suiting their requirements, stringent documentation and collateral requirements and increased competition in financial services. There has also been particular emphasis on socio-cultural factors that matter for an individual to access financial services. Substantial proportion of households, especially those with low income and those living in rural and remote areas, is at present outside the ambit of the formal financial system in many countries. Literature on financial inclusion/exclusion has identified a number of factors that affect efforts to expand access to financial services.

Financial inclusion is also influenced by specific credit needs of various segments of the society. The demand for credit by the people arises for a number of activities such as housing, microenterprises, agricultural operations and consumption needs. Owing to difficulties in accessing formal sources of credit, the poor individuals and small and microenterprises usually rely on their personal savings or internal resources to invest in housing, health and education, and entrepreneurial activities to make use of growth opportunities.

In India, the financially excluded sections comprise largely marginal farmers, landless laborers, oral lessees, self-employed and unorganized sector enterprises, urban slum dwellers, migrants, ethnic minorities and socially excluded groups, senior citizens and women. Some of the important causes of relatively low extension of institutional credit in the rural areas are risk perception of the bankers, cost of its assessment and management, lack of rural infrastructure, and vast geographical spread of the rural areas with more than half a million villages, some sparsely populated.

To sum up, the nature and forms of exclusion and the factors responsible for it are varied and, thus, no single factor could explain the phenomenon. The principal barriers in the expansion of financial services are often identified as physical access, high charges and penalties, conditions attached to products which make them inappropriate or complicated and perceptions of financial service institutions which are thought to be unwelcoming to low income people.

There has also been particular emphasis on socio-cultural factors that matter for an individual to access financial service. The most conspicuous dimension of exclusion is that a majority of the low-income population do not have access to the very basic financial services. Even amongst those who have access to finance, most of them are underserved in terms of quality and quantity of products and services.

The critical dimensions of financial exclusion include access exclusion, condition exclusion (conditions attached to financial products), price exclusion, and self-exclusion because of the fear of refusal to access by the service providers. The financial exclusion process becomes self-reinforcing and can often be an important factor in social exclusion, especially for communities with limited access to financial products, particularly in rural areas. Apart from the above mentioned supply side factors, demand side factors may also significantly affect the extent of financial inclusion. For instance, low level of income and hence low savings would result in lower deposits. Similarly, at low level of income, the ability to borrow is affected because of low repayment capacity and inability to provide collateral. In the Indian context, both demand and supply side factors have an important bearing on the usage of financial/banking services.

The issue of cost of financial exclusion has been conceived from two angles, which are inter-twined. First, the exclusion may have cost on the individuals/entities in terms of loss of opportunities to grow in the absence of access to finance or credit. Second, from the societal or the national perspective, exclusion may lead to aggregate loss of output or welfare and the country may not realize its growth potential. Recognizing the implicit and explicit cost of financial exclusion across the globe, many countries have initiated measures to deal with the same.

There is no single comprehensive measure that can be used to indicate the extent of financial inclusion across economies. Specific indicators such as number of bank accounts, number of bank branches, that are generally used as measures of financial inclusion, can provide only partial information on the level of financial inclusion in an economy.

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