Financial exclusion in Latin America – or the social costs of not banking the urban poor

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ABSTRACT This paper summarizes the findings of research in Bogotá, Colombia and Mexico City on the use of financial services by the urban population. The focus is on the majority of persons who have no relation whatever with a formal bank, cooperative or credit union. The paper identifies the characteristics of those who are "unbanked" and the range of reasons for their exclusion. It also discusses the multiple and considerable costs that this exclusion imposes on the unbanked population, as well as the loss in income that results for formal sector financial institutions. The paper concludes by describing some measures taken to extend financial services to the low-income population, and proposes the importance of linking "financial inclusion" to programmes of urban development and upgrading focused on the poor in developing countries.

KEYWORDS Brazil / Colombia / deposits / electronic transactions / financial institutions / informality / loans / Mexico / micro credits / micro savings / unbanked

I. INTRODUCTION

Economic literature has long stressed the role of financial services in economic development, and the consequent importance of an effective banking industry. But while most experts on finance and development focus on the stability and efficiency of the banking sector, few have looked at the question of access to financial services, or at the microeconomic or household effects of the sector as an issue for developing countries. Although the growth of microcredit programmes has been celebrated, they continue to operate on a miniscule scale. Furthermore, lending to the poor represents only one aspect of financial services, and one that, in the final analysis, leaves the poor in debt. Financial exclusion refers to the limited access low-income groups have to the full range of financial services: to deposit and savings accounts, and to payment systems as well as to credit. Few have looked at the question of how financial exclusion affects economic development, and in particular the development of the urban communities where it is felt. This article summarizes the findings of research in Bogotá, Colombia and in Mexico City that identifies the extent of financial exclusion and the cost it imposes on the "unbanked"[1] population groups, as well as on the formal sector financial institutions. It concludes by describing some measures taken to overcome financial exclusion, and proposes the importance of linking "financial inclusion" to programmes of urban development and upgrading focused on the poor in developing countries.

1. The term "unbanked" refers to individuals who have no relationship with a formal financial institution, including banks, cooperatives and credit unions.

Vol 20(1): 47–66. DOI: 10.1177/0956247808089148 www.sagepublications.com

II. WORLD BANK STUDIES ON FINANCIAL EXCLUSION

Starting in 2002, the World Bank's urban and financial sector operations groups for Latin America joined forces to lead a series of studies on the "unbanked" in Brazil, Colombia and Mexico. Since data on financial services are not generally gathered for the population at large,[2] we carried out household surveys on a representative sample of residents in Bogotá and Mexico City[3] and a range of residents in nine cities and two metropolitan areas in Brazil.[4] To supplement these surveys, focus groups were carried out in Mexico only, and only with unbanked persons. Our objective was to understand what kinds of financial services people use, poor people in particular, their costs and benefits and the choices implied. Although we looked at the range of products under three basic categories of credit, transactions and deposits, we define "financial exclusion" in terms of basic deposit services. Measuring whether or not families have a savings, checking or debit account is easier than looking at their use of bank credit. It also turns out, based on these studies, that deposit services are those most sought after by the unbanked.

III. FINANCIAL EXCLUSION MAINLY AFFECTS THE POOR – AND THE POOR ARE THE MOST AFFECTED BY FINANCIAL EXCLUSION[5]

Data gathered during the past four years in Mexico City (Distrito Federal, Mexico), in Bogotá, Colombia and in several Brazilian cities suggest that in these countries somewhere between 65 and 85 per cent of households do not hold any kind of deposit account in any formal sector financial institution.[6] Figure 1 compares these findings with data from developed countries, and shows the dramatic differences.[7]

Not surprisingly, the unbanked in all the countries studied show other characteristics of marginality: lower incomes and lower educational levels than the population at large; and higher representation among minority and immigrant population groups, and among those dependent on the informal sector and living in informal settlements. Figures 2, 3 and 4 show these relationships in the case of Bogotá, Colombia, but they can be considered typical of the findings for all three countries.

While it is notable that fewer than one quarter of the families in the lowest 40 per cent of income distribution (those earning less than half a minimum wage) are banked, the data also show that even extremely poor households can be interested in holding bank accounts.

Further evidence from Colombia (Figure 3) shows that those in the unbanked group tend to have lower income security than their banked counterparts. Ten per cent of those surveyed are unbanked and unemployed versus 3.6 per cent who are banked and unemployed. The unbanked tend to work in areas with lower job security and beyond the social safety networks. The unbanked are more likely to be self-employed – generally a euphemism for informal sector workers (72 per cent of self-employed are unbanked, as are 81.5 per cent of domestic workers and 78 per cent of unpaid workers in family businesses. That informal, or irregular, workers tend to be unbanked could also be a function of banks' preference for clients with steady employment, reflected in the requirement for references and proof of work.

2. Bankers' associations look at the total number of accounts in relation to overall population, and market studies focus on segments of the population that are likely to have bank accounts.

3. 1,500 households from a representative census group were covered in each survey.

4. As the Brazil study was based on smaller surveys in a range of cities and was not linked to representative census data, most of the following discussion focuses on Mexico City and Bogotá as linked to urban phenomena.

5. The author gratefully acknowledges the arguments of Catherine Mansell Carstens in her pathbreaking book: Carstens, Catherine Mansell (1995), *Las Finanzas Populares en México*, Editorial Milenio SA, Mexico DF.

6. That is, institutions regulated by government for receiving deposits from the public, as in commercial banks, "social interest" banks, cooperatives, credit unions, etc.

7. A recent survey from Africa, undertaken by Sumila Gulyani, suggests a somewhat different experience. A full 30 per cent of the residents of Kibera, a slum community in Nairobi, Kenya, have bank accounts. See Gulyani, Sumila and Debabrata Talukdar (2006), "Slum real estate: the low-quality, high-price puzzle in Nairobi's slum rental market and its implications", Paper presented at the World Bank Urban Forum, Washington DC, 1 December; also Gulyani, Sumila and Ellen Basset (2007), "Retreiving the baby from the bathwater: slum upgrading in sub-Saharan Africa", *Environment and Planning, C: Government and Policy* Vol 25, No 4, London, March, pages 486–515.

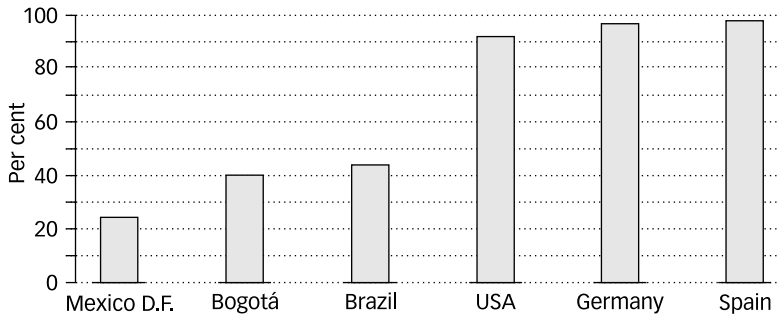

FIGURE 1
Percentage of persons with bank accounts – "bankerization" increases with economic development

SOURCE: **Mexico:** INEGI/World Bank Survey (2002), as quoted in World Bank (2005), "Mexico – broadening access to financial services among the urban population: Mexico City's unbanked", Report No 32418-MX (two voulmes), Washington DC; **Brazil:** World Bank Survey (2002), as quoted in Kumar, Anjali (2004), *Brazil – Access to Financial Services*, The World Bank, Washington, DC, available at http://imagebank.worldbank.org/servlet/WDS_IBank_Servlet?pcont=details&menuPK=64154159&searchMenuPK=64154240&theSitePK=501889&eid=000012009_20040319162949&siteName=IMAGEBANK; **Columbia:** DANE/World Bank Survey (2002), as quoted in Solo, Tova Maria and Astrid Manroth (2006), "Access to financial services in Colombia – the unbanked in Bogotá", World Bank Research Policy Working Paper No 3834, Washington DC, January; **USA:** Federal Reserve Board of the United States (1989), "Consumer finance survey, 1988", Washington DC, available at http://www.federalreserve.gov/pubs/oss/oss2/scfindex.html; **Spain:** Chueca, A (2003), "La experiencia espanola con el sistema de empresas comunitarias de ahorro – SECA", presentation at the Access to Financial Services Conference held jointly by the World Bank, the Colombian Ministry of Finance and the Colombian Association of Banks (Asobancaría), Cartagena, Colombia, April, accessible at www.Asobancaria.com; **Germany:** Langkamp, P (2003), "Sparkassenstiftung für internationale kooperation", presentation at the Access to Financial Services Conference, as above.

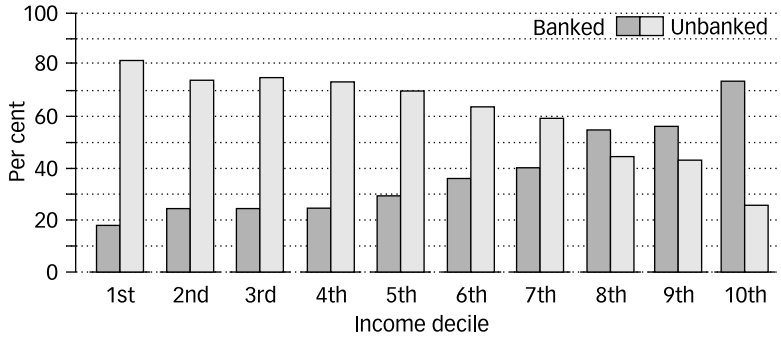

FIGURE 2
Percentage of the population using banking services in Bogotá, Colombia, by income decile

SOURCE: Solo, Tova Maria and Astrid Manroth (2006), "Access to financial services in Colombia – the unbanked in Bogotá", World Bank Research Policy Working Paper No 3834, Washington DC, January.

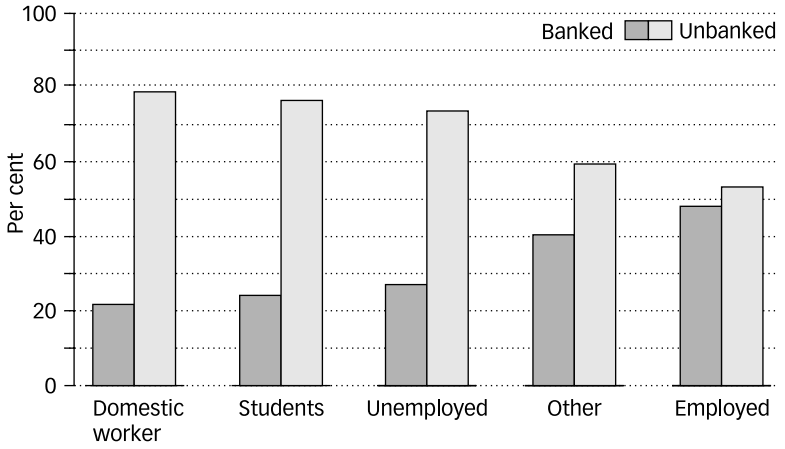

FIGURE 3
Employment status among the "banked" and "unbanked" in Bogotá, Colombia

SOURCE: Solo, Tova Maria and Astrid Manroth (2006), "Access to financial services in Colombia – the unbanked in Bogotá", World Bank Research Policy Working Paper No 3834, Washington DC, January.

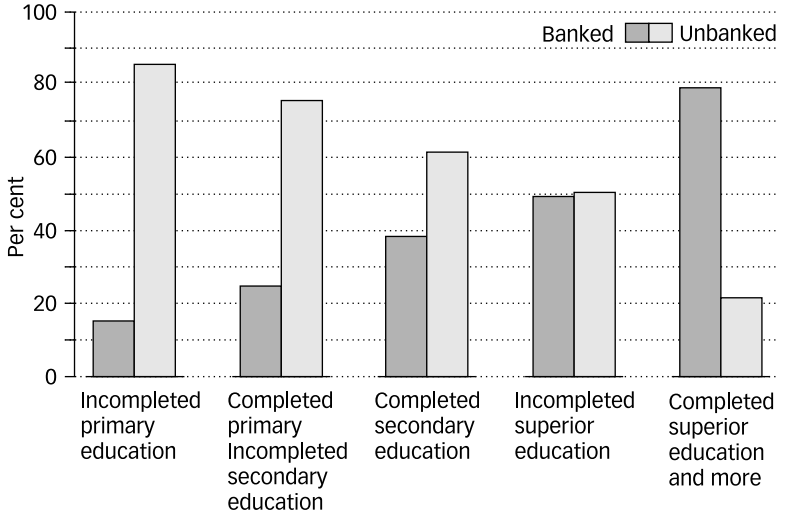

FIGURE 4
Correlation between educational level and the use of formal financial services in Bogotá, Colombia

SOURCE: Solo, Tova Maria and Astrid Manroth (2006), "Access to financial services in Colombia – the unbanked in Bogotá", World Bank Research Policy Working Paper No 3834, Washington DC, January.

In a similar vein, the unbanked have lower incomes and levels of educational attainment than those with bank accounts. Figure 4 clearly shows the relation between education and the use of formal banking products in Bogotá. As educational levels increase, the percentage of unbanked persons falls and the percentage of banked persons rises. Regression analysis shows a significant correlation between educational levels and likelihood of being banked or unbanked. At the same time, it is noteworthy that approximately 15 per cent and 25 per cent, respectively, of those with less than an elementary school education and those with only an elementary school education do have bank accounts in formal sector institutions. This suggests that while educational attainment may be an impediment to accessing formal banking services, other factors can intercede. In the United States, recent programmes in both the public and private sectors provide training in financial literacy to educate the unbanked on the advantages, and in the use, of banking services.

IV. REASONS FOR FINANCIAL EXCLUSION

In both the Colombian and Mexican surveys, the primary reasons given for not using banks or formal sector institutions were insufficient resources, high charges and mistrust of, or discomfort with, banking institutions. Only 3 per cent of the respondents reported that bank location was a barrier. Survey information suggests that access is limited by banking costs, not by poverty. Even low-income families can benefit from banking services. Indeed, data from the surveys suggest that the unbanked do mobilize considerable resources. In Colombia, 66 per cent, and in Mexico, 63 per cent, of the unbanked own their own homes. Granted, the homes may be shanties, without title and in unregistered, unplanned neighbourhoods, but it is nonetheless an impressive indication of capacity for investment. In addition, the surveys show that 22 per cent belong to *tandas* or informal savings circles,[8] and a high but unmeasured percentage buy lottery tickets on a regular basis and use lay-away plans or "savings" clubs at commercial stores.

High initial deposits, minimum balances and documentation requirements. When both banked and unbanked persons were asked to consider banking fees, 70 per cent of the Mexicans and 65 per cent of the Colombians interviewed stated that banking fees, required minimum balances and initial deposits were simply too high for them to pay.[9] Analyses by the Mexican regulatory agency, CONDUSEF,[10] and by the Colombian banking superintendent concurred.[11] In Mexico, the commercial bank savings programmes available in 2003 were not affordable to 75 per cent of the population, based on an initial and minimum deposit equal to half of monthly earnings and maintenance fees of one per cent of monthly earnings.[12] A 2003 survey by the Colombian banking regulator[13] showed that the documentation required by banks in Colombia to open accounts (proof of employment, personal references) was also prohibitive for more than half the population, and all but four banks had costs prohibitive to 75 per cent of the population. Since this 2003 survey, requirements have become more stringent and the obstacles for the poor have grown, largely in response to measures to control money laundering and terrorism.

High maintenance costs for savings. Apart from the costs of opening an account, maintenance costs can eat away at the savings of low-income

8. A quick calculation of amounts saved "at home" and in *tandas*, based on the Mexico survey, suggests that something in the order of $US 0.5 billion is saved outside of formal sector institutions.

9. Bearing in mind that the vast majority of the unbanked surveyed in Colombia and in Mexico have never tried to open a bank account, it might be suggested that claims of high costs are based on perception rather than on fact. Nonetheless, for the small percentage of the unbanked in Mexico who reported trying to open a deposit account but were unable to do so (2.7 per cent), two-thirds lacked the required minimum initial deposit. A further 22 per cent did not have the necessary documents or personal references. (It is likely that many of these individuals work in the informal sector where written documents are rare and where formalities are often avoided to prevent government authorities from tracking business operations.)

10. CONDUSEF – Comisión Nacional en Defensa de los Usuarios de Servicios Financieros, the consumer protection agency for users of banking services.

11. CONDUSEF (2003), "Broadening access to financial services for the urban unbanked. Financial services census results for Mexico", unpublished; also Superintendencia Bancaria de Colombia (2003), "Broadening access to financial services for the urban unbanked. Financial services census results for Colombia", unpublished.

12. Solo, Tova Maria and Astrid Manroth (2006), "Access to financial services in Colombia – the unbanked in Bogotá", World Bank Research Policy Working Paper No 3834, Washington DC, January.

13. See reference 11, Superintendencia Bancaria de Colombia (2003).

or small savers. Further analysis carried out with banking regulators in Mexico and Colombia compared the minimum balance required to generate enough interest to cover bank charges on deposit accounts. Again, on the assumption that a minimum balance could not exceed half a month's salary, data from Mexico's four largest banks (which had 92 per cent of all savings accounts in 2003) showed that no savings products would generate interest for persons below the eightieth percentile of income.[14] In Colombia, data were similar: only 10 out of 25 banks offered savings or checking accounts affordable to families below the thirtieth income percentile, and only 16 offered affordable terms to the poorer 50 per cent of the population.[15]

The poor rarely feel welcome. In Mexico City, where focus groups were carried out to complement the surveys, participants gave the following reasons for not using banks: high commissions; impossible requirements; non-negotiable terms and conditions; low interest rates on deposits; insecurity; and bad treatment. The last point came up repeatedly. A comment made in one focus group may well speak for many of the lower-income unbanked. When the discussion leader asked one group member why he hadn't gone to a bank when he needed a loan, laughter filled the room and one voice spoke up: "*Don't you see how we look, compañera? We just aren't the kind of people the banks would want.*" Many group members made clear that their negative reactions towards banks were a function of the fact that they were anticipating bank rejection before the fact.[16] Why should they consider or wish for what they knew lay beyond their reach? "*I have no proof of my income*" said a street vendor. A plumber corroborated, "*What can I use for a guarantee or a reference?*"[17]

V. THE COSTS OF BEING UNBANKED

The data from Mexico and Colombia begin to shed important light on the flip side of the macroeconomic studies, showing how the "underdeveloped financial sector" – translated into a lack of financial services at the household level – can limit economic growth and poverty alleviation by increasing costs for families who already tend to be in the lower-income brackets. The data show how the unbanked pay more to be paid, to make payments, to save and to borrow than their compatriots who have bank accounts.

The costs of making payments. Our contacts at the Central Bank of Mexico report that cash transactions can cost up to five times more than payments by cheque and up to 15 times more than electronic payments.[18] For the 60 to 80 per cent of urban families in Mexico City and Bogotá who have no choice but to pay with cash, every payment, e.g. the monthly bills for water, electricity, sanitation and telephone, for health insurance (required by law) and for schooling – if they are parents – means a trip downtown with a wad of bills. It's worrisome (pickpockets and muggers abound), costly in terms of transportation and also costly in terms of time. In Mexico City, the focus group participants reported that only two offices will take payments for water bills (in a city of 15 million), and that the wait in line is two to three hours long. Focus group participants seem resigned: "*If it's not raining, I have a good time in line. I catch up with friends from other parts of the city.*" And it beats the alternative, since paying bills for public services at a commercial bank costs US$ 3.50 for non-account holders. In Colombia, the commercial banks will take payment for public

14. It must be acknowledged that Banco Azteca has been created since the study was carried out and has moved aggressively into the low-income market, claiming over one million new accounts in its first year and over one billion dollars in deposits. Banco Azteca offers interest-bearing deposit certificates for a minimum of US$ 50. See World Bank (2005), "Mexico – broadening access to financial services among the urban population: Mexico City's unbanked", Report No 32418-MX (two volumes), Washington DC.

15. See reference 12.

16. The author confirms from experience that it is not uncommon for commercial banks in Latin America to request proof of income as a condition for opening a savings account.

17. Ferrer, Martha (2003), "Ampliar el acceso a los servicios financieros en Mexico", unpublished consultant's report for the World Bank, 2003, as cited in World Bank (2005), see reference 14.

18. Interviews with Rafael Villar, Head of Research Department, Central Bank of Mexico, in 2003.

services from non-account holders at no charge, but they provide only one teller for a limited number of hours per week.

The costs of being paid. Even though fewer than 25 per cent of those surveyed in Mexico have deposit accounts, a full 85 per cent of the unbanked report getting payments by cheque. Another 6.3 per cent are paid through deposits to a third-party account. Turning a paycheck or deposit into usable cash is costly for persons without bank accounts. Most of those interviewed reported that they make the trip to the bank that issued the cheque, as financial institutions will not cash cheques drawn on other banks for non-account holders. Again, the bi-weekly trip to the bank is costly in terms of time and travel, as banking hours and locations are not convenient to low-income earners, and our studies also showed that banks tend to locate in better-off neighbourhoods.[19] About one-third of the unbanked reported changing cheques in commercial stores (in return for purchases) or at money changers (*cajas de cambio*), for a fee. As in the United States, cheque-cashing services charge between 5 and 10 per cent.[20]

The costs of saving. Deposit accounts, even without interest, figured as the "most wanted" financial product among the unbanked in Colombia, Mexico and Brazil. Although families may realize that deposit accounts allow them to greatly reduce the costs of paying for services and cashing cheques, and also help them to save, still about half of the unbanked reported holding liquid savings.[21] But saving outside a formal system can represent opportunity costs as well as insecurity. Savings options reported by the unbanked were, in order of popularity: cash under the proverbial mattress; informal savings clubs (*tandas* in Mexico, *cadenas de ahorro* in Colombia) or savings clubs in commercial stores – something akin to "lay-away plans" linked to specific items; and loans (interest bearing or interest free) to relatives and friends. In Mexico and Colombia, where the passive interest rate on minimum deposits is in the order of 8 per cent per annum, saving in any of these informal systems represents a loss of potential earnings and a potential loss from robbery.

The costs of sending and receiving money. About 5 per cent of those surveyed reported receiving income contributions from remittances. Slightly more than half of the remittances were national, while the remainder were international. While the numbers and percentage of persons affected are low, the remittance costs for an unbanked person are significant. While a bank-to-bank electronic transfer is free, at the time of the study, sending US$ 100 by wire through a bank cost in the order of US$ 9 for a bank account holder. For a non-bank account holder, on the other hand, the same wire cost US$ 19, which constitutes a high proportion of the total remittance for those with lower incomes.

The costs of borrowing. About one-third of those surveyed reported taking out a loan of some kind in the past three years. But costs differ enormously depending on the source of the loan. Currently, active bank interest rates in Mexico and Colombia are capped at around 17 per cent, but credit card charges can reach 36 per cent, even 40 per cent, per annum. On the other hand, loans from commercial stores, moneylenders and pawnshops, the sources of non-bank loans, start at 10 per cent per month and have been reported to go as high as 35 per cent per month (i.e. from 150 per cent to more than 400 per cent per annum). Therefore, it should be no surprise that respondents reported that their preferred source of loans was friends and relatives, the source in about one-third of cases. In

19. Medina, Carlos and Jairo Nunez (2002), "La oferta de servicios del sector financiero formal en Bogota", unpublished.

20. See reference 14, World Bank (2005).

21. Sixty-five per cent own their homes, revealing a capacity and habit for savings in non-liquid form.

surveys, the unbanked and low-income population groups consistently reported a lower propensity to request loans than high-income groups. In Mexico, fewer than 9 per cent of unbanked persons had requested a loan in the past three years, compared with some 20 per cent of banked persons. In Colombia, about one-third of those surveyed reported taking out a loan of some kind in the past three years. The numbers jumped, however, when people were asked about buying on credit.[22] As Figure 5 shows, some 43 per cent of the low-income Mexican group reported buying on credit from commercial stores. If we include the door-to-door salespersons who, our focus group members revealed, sell a wide array of goods on credit, the percentage increases dramatically (Box 1).

At these prices, one may ask, why does a total of 13.5 per cent of the population (20 per cent of the banked population and 10 per cent of the unbanked) seek loans from informal moneylenders each year? The answer

22. To many of those who were interviewed, buying on credit did not seem to be in the same category as borrowing. None of them could report what interest rate they were paying or even the full price of the goods. Instead, they referred to the cost of the weekly payment, or *cuota*.

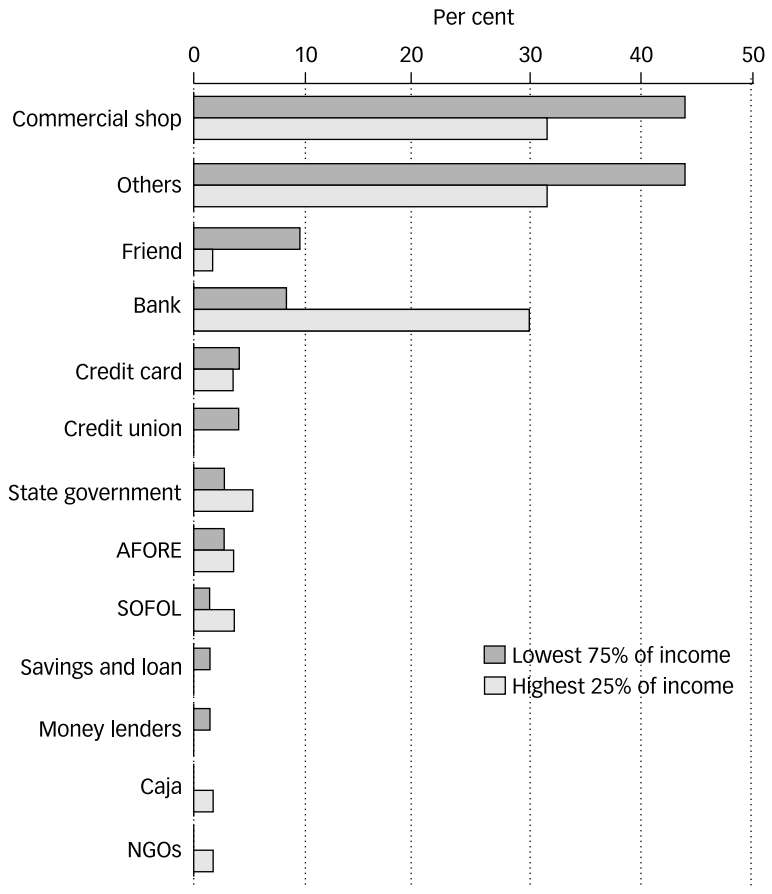

FIGURE 5
Sources of credit in Mexico City according to income

SOURCE: World Bank (2005), "Mexico – Broadening access to financial services among the urban population: Mexico City's unbanked", Report No 32418-MX (two volumes), Washington DC.

BOX 1
Los *Aboneros*

Residents of Mexico City's informal settlements report that they buy kitchenware and household goods, including dishes, mattresses, sheets, towels and sundry, on credit from door to door salesmen called *aboneros*. Although they were unable to report the actual interest rates, the informal households interviewed recognized that there was a mark up of about 30 per cent over the cash price; also, they had to repay the *abonero* within three months, otherwise the price went up.

"*It's how I buy things*" says Sra Fabiola Morelos of Barrio San Juan in Topilejo, in the Tlalpan delegation of Mexico City. "*They bring what I need right to the door of my house and charge me in cuotas (payments) I can afford. Yes, it's more expensive, but with all I have to spend to keep my house going, I could never save up enough money to go out and buy for cash*."

SOURCE: Ferrer, Martha (2003), "Ampliar el acceso a los servicios financieros en Mexico", unpublished consultant's report for the World Bank, Washington DC.

involves the purpose of the loan. Figure 6 shows what people borrowed for and how this varied for banked and unbanked people. The unbanked borrowed primarily to invest in housing or home improvements – something that cannot be bought with commercial credit.[23] Figure 7, which shows the kind of credit service people most want, reinforces the notion that families borrow for what they can, not necessarily for what they would like. Although a little over 20 per cent are interested in credit for consumer purchases, over 75 per cent list their first choices for credit as health, housing and (in third place) education.

23. The banked group, on the other hand, borrowed primarily to buy goods and services, suggesting that they were able to get loans from a *prestamista* at a lower interest rate than that offered by the vendors.

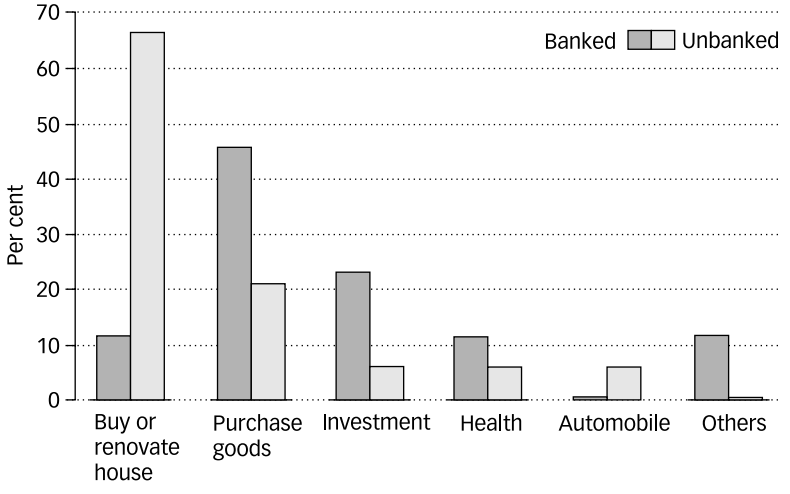

FIGURE 6
Loan purpose

SOURCE: World Bank (2005), "Mexico – Broadening access to financial services among the urban population: Mexico City's unbanked", Report No 32418-MX (two volumes), Washington DC.

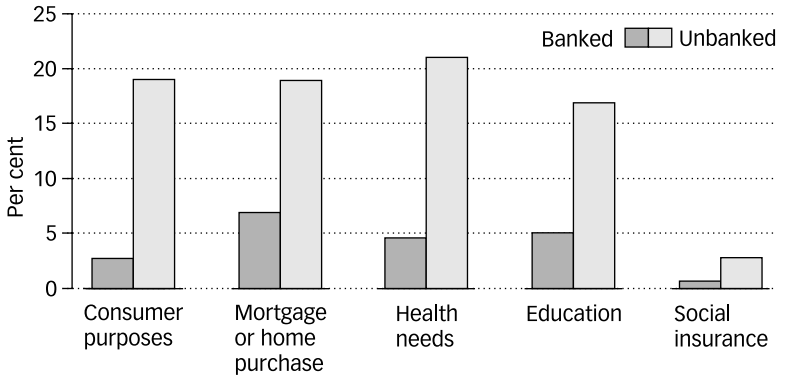

FIGURE 7
Kind of credit service most wanted

SOURCE: World Bank (2005), "Mexico – Broadening access to financial services among the urban population: Mexico City's unbanked", Report No 32418-MX (two volumes), Washington DC.

Financial exclusion makes it harder to break out of urban poverty. To sum up, it is expensive not to have a bank account. Costs vary. For those involved in small businesses – who are saving on the side and are using credit – having to rely on informal financial systems can cost up to 15 per cent of incomes in Mexico and up to 20 per cent in Colombia. Granted, this group represents only about one quarter of the unbanked, but that's close to 20 per cent of the overall population. For the 95 per cent of the unbanked who must make monthly service payments (i.e. about 80 per cent of urban Mexico's population and at least 60 per cent of Bogotá's), not having a bank account can translate into a 1 per cent reduction in income. This might not sound like a lot for middle-class or high-income groups, but for families earning below median incomes,[24] 1 per cent represents medicines for a family, or a day's food. Another group of the unbanked (more than half) have to spend part of their income (up to 10 per cent) merely to cash their paychecks. Ironically, the costs increase as incomes rise and as families move into the formal sector. Financial costs increase for those who save, who have businesses, or who use credit to pay for education, steps recommended for upward mobility. The difficulties of breaking out of the "poverty cycle" have been widely studied along with the high costs of being poor. With new data on the unbanked, we can now begin to understand how financial services figure among these costs and among the keys for building assets.

Bank accounts and security. Surveys in Mexico asked respondents whether their situation had improved in the past five years. When asked: "*How does your economic situation now compare with five years ago?*" the unbanked replied "better" only in 23 per cent of cases and "worse" in 34 per cent. The proportions were reversed for the banked: 36 per cent replied "better" but only 26 per cent "worse". Although this could be a reflection of the fact that banked families tend also to be higher-income earners, no pattern emerged relating income to economic situation.[25] On the

24. Or for the 70 per cent of Colombians who live below the poverty level. See Colombian Ministry of Finance (2005), unpublished survey of costs and use of banking services, 2002.

25. Persons earning more than 10 minimum wages – i.e. those above the 90th percentile – considered that their situation had improved by a factor of 12 to one. Other groups, however, showed no particular pattern: between the 70th and 90th percentiles, the majority considered themselves better off, as did those between the 50th and the 70th percentiles; those between the 40th and 50th percentiles considered themselves worse off; those between the 30th and 40th percentiles better off; those between the 20th and 30th percentiles worse off; and those between 0 and the 20th percentile better off.

other hand, savers, whether higher- or lower-income earners, banked or unbanked, tended to reply that their situation had improved over the past five years. This is consistent with research from the US that shows that savings tend to provide individuals with security, and improve their well-being.[26] To the extent that access to banking services allows for increased savings, this would be solid backing for the claim that financial services provide a form of empowerment and sense of participation in the economy.[27]

VI. FINANCIAL EXCLUSION HAS COSTS FOR URBAN DEVELOPMENT

Literature in developed countries on the subject of financial services frequently presents banking as a public service. While certain public services (water, health, solid waste disposal) are considered key to human survival, financial services are grouped with those considered key to economic upward mobility and community development (along with energy and communications). The links between financial services and personal economic development were articulated in the focus groups in Mexico, where the unbanked described their feelings towards the formal banking sector in terms of exclusion from the mainstream. [28] Insofar as they can see themselves cut off from a basic public service, they also view access to financial services as a form of empowerment. Following on from this perception, community development groups in the United States frequently identify the need for a local bank presence as a priority for economic improvement. Indeed, government-led neighbourhood development programmes in the United States offer incentives to banks that open branches in low-income neighbourhoods and that make loans for community development projects.

The studies in both Mexico and Bogotá analyzed bank location in terms of neighbourhood income levels and found, unsurprisingly, that bank presence diminished with income in both cities. Figure 8, taken from the Mexican study, indicates locational preference in terms of residents per bank office in different neighbourhoods of similar density. It shows the clear tendency for bank presence to decrease on a per capita basis as "neighbourhood informality" increases, or as income decreases. While corollary studies of bank investment levels were not carried out, a certain picture of a vicious circle emerges. Investments in productive and commercial ventures are likely to be low where bank presence is low. Banks tend to lend to their depositors, for projects where their depositors live. The excluded neighbourhoods, with little opportunity to foster savings, are also unlikely to benefit from investments.

Financial exclusion also limits possibilities for government investment. Governments in Mexico and in Colombia have attempted to compensate for the limited commercial lending for low-income housing with housing subsidy programmes. In Colombia, such programmes are channeled through commercial banks. As a result, they often end up excluding the unbanked or their neighbourhoods, although these represent the population groups and neighbourhoods targeted by such programmes.

26. See Stegman, Michael (1999), *Savings for the Poor: Hidden Benefits of Electronic Banking*, Brookings Institution Press, Washington DC; also Stegman, Michael and Robert Faris (2001), "Toward a more performance-driven service test: strengthening basic banking services under the community reinvestment act", Working Paper of the Centre for Community Capitalism at the Kenan Institute of the University of North Carolina, October; Barr, Michael (2001), "Access to financial services in the 21st century: five opportunities for the Bush Administration and the 107th Congress", Centre on Urban and Metropolitan Policy at the Brookings Institution and Harvard University Joint Centre for Housing Studies, Washington DC; and Stegman, Michael (1998), "Electronic benefits' potential to help the poor", Policy Brief Series #32, Brookings Institution, Washington DC, March.

27. See an interesting interpretation in Bernstein, Jared (2003), "Savings incentives for the poor: why the scale doesn't match the promise", *The American Prospect Magazine* Vol 14, No 5, May, accessible at http://www.prospect.org/cs/articles?article=savings_incentives_for_the_poorl

28. See reference 17.

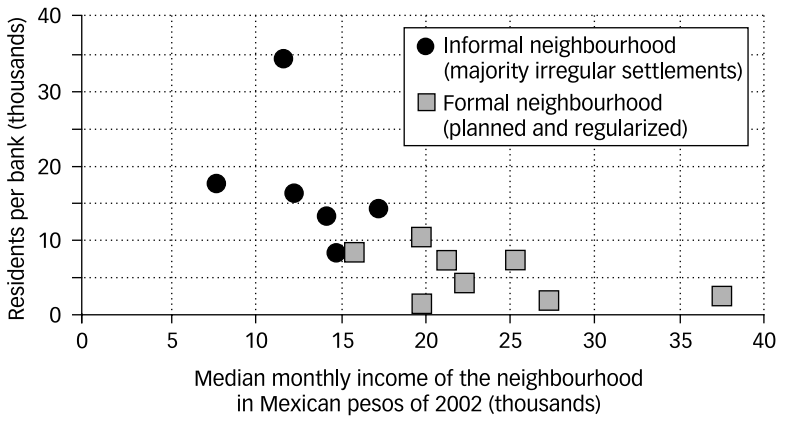

FIGURE 8
Bank location according to type of neighbourhood

SOURCE: World Bank (2005), "Mexico – Broadening access to financial services among the urban population: Mexico City's unbanked", Report No 32418-MX (two volumes), Washington DC.

VII. THE COSTS OF FINANCIAL EXCLUSION FOR BANKS

Can commercial banks afford to ignore 65–80 per cent of the population? Studies show that the low-income groups in developing countries are still good savers and tend to be more, or as, creditworthy as their higher-income compatriots. As we saw earlier, the high rates of home ownership among low- income and unbanked individuals suggest a strong capacity to save and to manage asset building. A rough estimate based on the savings reported by a statistically representative sample of 1,500 Mexican families suggests that the equivalent of between half a billion and a billion US dollars is saved by households in cash, under mattresses and in cookie jars in Mexico City. This doesn't take into account what small businesses are holding in cash and not depositing in banks. The same World Bank report[29] on Mexico cites a review showing that small businesses (up to 250 employees) do not rely on banks for financing but, rather, on family and self-financing. Decidedly, the commercial banks are missing out on a significant business opportunity if they continue to ignore this market segment.

The Mexican case shows a further irony in that commercial banks and mortgage lenders are issuing bonds and seeking finance from global markets at much higher prices than they would pay for deposits at home. Through the SHF (Sociedad Hipotecaria Federal, or Federal Mortgage Corporation), government subsidizes efforts to insure and underwrite mortgage-backed bonds to raise funds from the US market for mortgage financers in Mexico. Average bond rates on mortgage portfolios run at 15.5 per cent[30] in US dollars, including insurance and funding costs. The actual funding rate is 10.25 per cent in US dollars, considerably more

29. See reference 14, World Bank (2005).

30. Information from an SHF (Sociedad Hipotecaria Federal, or Federal Mortgage Corporation) presentation by Guillermo Babbitz to the Housing Programme at Wharton School of Finance, June 2006.

expensive than the domestic savings rates, which run from 6.5 to 8 per cent in Mexican pesos.

Concentrating on the upper 20 per cent – how do the banks make out? Recent bailouts of commercial bank failures represent a high cost to the governments of Mexico, Colombia and Brazil (to name three). Are failures more likely because of bank concentration in higher-income groups? Interviews with the bankers associations of Mexico and Colombia suggest that the bankers themselves are becoming aware of the dangers of their limited markets, particularly since income from service charges is reaching a limit. The bankers associations of both countries have shown interest in promoting *bancarización*, or wider banking policies, as a result. Both have hosted conferences on the subject in recent years. And in Brazil, the issue seems even more pointed. Carlos Ximenes, Vice-President of Brazil's second largest commercial bank, UniBanco, stated: "*…why we bankers have such a terrible reputation, we have had to fight financial exclusion or get lynched*."

Financial exclusion represents high macroeconomic costs as well. Some have suggested that the increased concentration of banking services and the limited access to financial institutions may be related to the fall in aggregate savings. At the same time, it seems likely that the continued downward plunge of domestic credit in relation to GDP could also be linked to the limited breadth of the financial sector. This concentration also has certain implications for income distribution patterns. Government financing of bank bailouts, supervision costs and interest on government papers – one area where commercial bank investments have been growing in developing countries – all rely on taxes applied universally, and are acknowledged to represent a higher burden on the poor. Insofar as they benefit the depositors in commercial banks (a small and upper-income group), the result is a redistribution of income upward – an unhappy effect of present financial sectors and the unbanked in Latin America.

VIII. FIGHTING FINANCIAL EXCLUSION – EMERGING POLICIES AND PROGRAMMES

The positive news is that financial exclusion can be reduced and, furthermore, that government policies can have a measurable positive impact. At a recent meeting with the World Bank, James Carr, Vice-President of the Fannie Mae Foundation, stated: "*No country has achieved widespread financial services, however profitable and sustainable, without some form of government intervention*." While developed countries have most experience in fighting financial exclusion, some developing country governments are also beginning to take measures to increase the possibilities for low-income groups to enjoy full financial services. This section reviews some such government programmes and policies in terms of focus, i.e. those that stimulate savings programmes, payment systems and credit services both in general and in specific approaches – price-based, neighbourhood-based, technological, informational and educational – that foster financial services for low-income groups. While by no means exhaustive,[31] this section aims to formulate some general ideas for future discussion and further development.

31. For example, this section will not deal with the exciting field of microfinance, which has been much discussed and developed elsewhere, as merited.

a. Three focus areas for broadening access to financial services

Savings. Various governments have established popular savings institutions with the objective of encouraging aggregate popular savings. In Germany and Spain, municipal governments established local banks for all citizens well over a century ago, a practice replicated in several Peruvian cities. In the post-war period, the US government encouraged savings programmes through sales of government bonds in the public schools, and the Argentine government installed a postal savings plan. Although the German municipal banks, the *sparkhassen*, have remained local institutions, the *cajas de ahorros* in Spain have developed into major national and international banks. In both cases, government acts as a partner, first directly as an equity investor and second, indirectly by insuring savings deposits and paying returns to small savers.[32] More recently, several European countries have passed legislation requiring banks to receive savings deposits – however small – at no cost. Similar legislation has been enacted in several US states, requiring banks to offer basic services – savings and checking programmes – at prices considered affordable by low-income families.[33] Finally, the US government has offered tax incentives to banks that participate in special programmes to encourage first-time savers. Bank contributions to match savings accumulated in Individual Development Accounts (IDA) can be written off against corporate taxes.

Governments have also funded and backed deposit insurance programmes, which offer limited protection to savers in all participating banks. While there is some debate among experts as to whether such programmes reduce the pressure on banking supervisors to monitor bank management, insurance can help to overcome the reluctance of the unbanked who may distrust the private financial sector.

Payments. How can governments help banks make payment systems more accessible? As mentioned earlier, certain countries require banks to receive payments for public services. Following the idea that payments could be easier for minimum deposit holders, the United States federal government has recently passed legislation requiring all government employees to be paid by electronic transfer. Studies by the Controller of the Currency suggest that payroll cards can actually help the unbanked to develop more sophisticated banking habits.[34] More importantly, the government required that government benefits such as SSI, welfare, including salaries etc. be paid electronically at no extra charge. The change from cash payments to cheques to electronic payments results in savings for government, but also promotes the provision of banking services and the development of debit card accounts for many unbanked government employees. A similar programme has proven successful in Bolivia, facilitating the use of debit cards among government and many formal sector employees.

Taking a different tack on the issue of payments, the Mexican government is financing some 30,000 "points of service" for credit, debit and stored-value cards. It has been observed that public employees and others who are paid by automatic deposit tend to withdraw all income payments and rely on cash. Although some observers question the logic of public subsidies to benefit credit card companies and retailers, the Mexican government argues that its support for the commercial outlets and banks

32. For presentations on these systems, see Chueca, A (2003), "La experiencia española con el sistema de empresas comunitarias de ahorro – SECA", presentation at the Access to Financial Services Conference held jointly by the World Bank, the Colombian Ministry of Finance and the Colombian Association of Banks (Asobancaria), Cartagena, Colombia, April, accessible at www.Asobancaria.com; also Langkamp, P (2003), "Sparkassenstiftung für internationale kooperation", presentation at the Access to Financial Services Conference held jointly by the World Bank, the Colombian Ministry of Finance and the Colombian Association of Banks (Asobancaria), Cartagena, Colombia, April, accessible at www.Asobancaria.com.

33. Some reports claim that such legislation is unnecessary insofar as the banks in "lifeline" states already have "affordable accounts" programmes; others suggest that merely making such programmes available does not guarantee any benefits to low-income or unbanked populations, as the promotion may not be carried out in their communities. See Doyle, Joseph J, Jose A Lopez and Mark R Saidenberg (1999), "How effective is lifeline banking in assisting the 'unbanked'?", *Current Issues in Economics and Finance* Vol 4, No 6, Federal Reserve Bank of New York, June.

34. Frumkin, Samuel, William Reeves and Barry Wides (2003), "Payroll cards: an innovative product for reaching the unbanked and underbanked", Report issued by the Office of the Comptroller of the Currency, United States Federal Government, Washington DC, October.

will reduce overall costs for the financial sector[35] and encourage wider use of debit cards, and thus encourage greater use of savings accounts.

Credit. While microfinance credit programmes are still rooted mainly in specialized institutions, some commercial banks in Latin America are now offering programmes for collateralized credit on the one hand, for credit with "solidarity guarantees" on the other and, at a growing rate, for commercial credit. The scale of such lending continues to be minimal, however, as lending by financial institutions in general has been falling in Latin America over the past decade. In Latin America, the issue of credit is linked to a larger overall question of how to stimulate lending, particularly non-commercial lending, to accelerate economic development.

In the United States, programmes to promote access to financial services have focused on breaking discriminatory practices known as "redlining", by which the banking institutions simply refuse to lend in certain city districts associated with low incomes and/or minority groups. The passage of the Community Reinvestment Act (CRA) in 1977 and other measures (including the creation of the Neighbourhood Reinvestment Corporation) aimed to get commercial banks involved in neighbourhood development by requiring them to make their lending patterns public, including location, race and income levels of borrowers. The legislation further requires banks to demonstrate how the lending reflects the distribution of deposit holders. The CRA supports the notion that savers should not be disqualified from receiving loans because of race, residence or income level. Bank regulators rate financial institutions based on their CRA qualifying activities.[36] While there are no specific legal obligations or consequences attached to these ratings, banks have found enough incentive, based on the attitudes of both the regulators and the public, to try and keep their CRA ratings up.[37] Following the CRA's enactment, the practice of redlining has diminished notably, and lending to low-income households and communities has likewise increased. Studies from the US Federal Reserve Bank assessing the CRA's effect have found that participating banks appear to have realized positive returns overall, in line with or superior to their other investments.[38] Communities also have benefited from stronger community organizations and from increased social infrastructure, business investments, home ownership and home improvements.[39] By the 1990s, community development banking had evolved into an independent sector, trading credits with commercial banks while specializing in providing financial services for low-income neighbourhoods. In the mid-1990s, American bankers began to look downmarket. Several banks have specialized in working with immigrant populations, as the US Federal Reserve Bank has worked with other regulators to develop ways for the unbanked to open accounts without jeopardizing their status as immigrants. Innovations introduced by the Union Pacific Bank of Los Angeles, the Harris Bank of Chicago and the Mitchell Bank of Minnesota are discussed below.

b. Different approaches to broadening access to financial services

Lowering the cost of financial services – the price-based approach. Governments have promoted strategies to make credit more affordable and widespread either by regulating prices and imposing caps, or by

35. Experts from the Central Bank of Mexico estimate that each cash transaction is five times the cost of a cheque transaction and 15 times that of an electronic transaction.

36. These can include specific loans, but also educational programmes and community activities and support, as well as lending to community organizations.

37. According to the National Community Renovation Council (NCRC), the attempts to undo CRA legislation and ensure that it is not replicated in other countries indicate that banks are under pressure from reporting requirements and ratings.

38. For a full discussion of CRA-imputed costs and benefits for banks, see the survey of the performance and profitability of CRA-related lending at http://www.federalreserve.gov/BoardDocs/Surveys/CRAloansurvey.

39. See Bates, Timothy (2001), "Financing the development of urban minority communities: lessons of history", *Economic Development Quarterly* Vol 14, No 3, pages 227–241; also Holyoke, Thomas T (2001), "Community organization and Community Reinvestment Act lending in Washington DC", Paper presented at the Federal Reserve System Conference on Changing Financial Markets and Community Development, Washington DC, April 5–6.

limiting certain service charges. This form of price capping has been used in the United States to control interest rates used by "predatory lenders". As Caskey[40] has pointed out, price controls have their cost. In Texas, for example, pawnshops can charge 240 per cent a year for typical loans and there are almost 1,300 pawnshops in the state. New York has a similar population, but pawnshops there can charge only 36 per cent a year. There are fewer than 150 pawnshops in that state. Price caps, Caskey concludes, can pose a barrier to entry, reducing the effective supply of services. Besides direct legislation, governments have experimented with alternative ways of encouraging lower service charges, such as offering tax incentives, positive ratings and other rewards for institutions that provide services at stipulated prices; or stimulating competition to encourage market forces to lower prices through an information approach (see below).

Promoting bank development in underserved areas – the neighbourhood-based approach. As discussed earlier, the absence of banks in low-income and minority neighbourhoods may contribute to the circle of poverty, or may be the result. To encourage banks to become more active in "underserved" areas, the US government has fostered the creation of "banking development districts". According to this proposal, banks and local governments can file jointly to establish underserved areas, where local government can offer property tax breaks and guarantees of government deposits to banks that set up new branches.[41]

Following similar motivations, the Colombian government has recently changed its regulations to allow commercial banks to open branch offices and install automatic teller machines in public buildings. This regulatory reform aims to help reduce the risks and costs faced by commercial banks offering services to low-income communities, while also helping both banks and their potential customers to overcome cultural and security issues that come into play in low-income neighbourhoods or remote areas. In several countries, the combination of technological advances with such deregulation has already led to "supermarket" and "laundromat" banking, as commercial banks put ATM machines and offices in commercial venues.

Using new technologies to increase access to financial services at lower cost – the technological approach. As US innovators such as the Union and Pacific banks and the recently opened Banco Azteca (Box 2) demonstrate, electronic banking and other new technologies should offer opportunities for lowering costs and for reaching marginal areas.[42] A combination of change machines, payment machines and ATMs could overcome the problems in reaching low-income individuals. "Mobile banking" services such as ATMs (or ATMs in vans) provide a cost-effective way of expanding service and reaching areas where branches may otherwise not locate. Indeed, the electronic technologies have opened the way for commercial banks to offer payroll debit cards. These cards can enable a worker who does not have a traditional deposit account to be paid electronically. The debit card allows the holder to withdraw cash and to make payments from an ATM or, increasingly, to purchase goods at a store that accepts debit cards. The card is linked to an electronic account that keeps track of the remaining balance. The account is not a true bank account, however, since the cardholder cannot make independent deposits into the account or write cheques on the account. Banks began

40. Caskey, John (1992), "Bank representation in low-income and minority urban communities", Research Working Paper, Research Division of the Federal Reserve Bank of Kansas City; also Caskey, John, Clemente Ruiz and Tova Maria Solo (2006), "The urban unbanked in Mexico and the United States", World Bank Policy Research Working Paper No 3835, January.

41. See reference 33, Doyle et al. (1999).

42. See reference 40, Caskey (1992).

BOX 2
Banking moves downmarket in Mexico

Taking advantage of its location in densely populated low-income neighbourhoods, the Mexican department store chain, Elektra, with a largely working-class and informal clientele, has opened a commercial bank, Banco Azteca, with branches in its 800 outlets. Thanks to regulatory reforms that allowed its launch, Banco Azteca has structured its products, both deposit accounts and loans, to meet the needs of middle- and low-income households. It encourages depositors to open accounts with as little as US$ 5, and also offers "deposit certificates" starting at US$ 50-equivalent for six months at interest rates that are competitive with commercial banks. Using advanced technology, Banco Azteca identifies clients through thumbprints, but insists that personal transactions take place in its offices. On the credit side, the bank makes small-value unsecured personal loans at rates comparable to commercial stores, and is developing a mortgage instrument to finance home purchase and construction. Banco Azteca appears to be very successful, which could encourage other banks to start serving this market. It opened its first office in 2002 and by mid-2003, it had over two million deposit accounts and more than one billion US dollars-equivalent in deposits in its 836 branches. Undoubtedly, part of the basis for such rapid growth was that the bank could market to households that had been credit customers of Elektra; and by opening small branches within existing department stores, the bank could keep the costs of its facilities low.

SOURCE: Author's interviews with L Nino, Vice-President of Banco Azteca.

to offer these accounts partly in response to pressure from unions, which demanded the cards as a way of reducing insecurity in payments. Reportedly, payroll debit cards have been quite successful among both white- and blue-collar workers. [43]

43. See reference 40, Caskey et al. (2006).

An informational approach to increasing access. Much of the success of the CRA and the community banking movement in the United States has been attributed to public information sharing. The publication of profitability ratings associated with CRA lending in participating banks undermined the arguments for "redlining" and broke down resistance to working with low-income clients. Bankers began to find advantages in complying with CRA goals.[44]

44. See reference 39, Holyoke (2001).

In another sense, public disclosure and information sharing stimulates competition and leads to reduced costs for consumers, thereby benefiting lower-income consumers. The Mexican CONDUSEF, a public bank regulatory agency established to represent consumers, reports that after it began publishing mortgage rates on its website, rates began to fall.[45] The incentive to financial institutions is, of course, to appear on the list as a low-cost product and thus draw in clients. Similarly, a New York state independent consumer "watchdog" agency follows financial services products offered by commercial banks and publishes information and costs on a monthly basis, claiming that prices have fallen as a result.

45. See reference 14, World Bank (2005). US newspapers frequently cite current interest rates offered by banks and mortgage lenders as part of real estate reporting.

Fighting financial illiteracy to build knowledge and broaden access – the educational approach. Many have pointed to the "financial illiteracy" of the unbanked as a serious obstacle to financial inclusion. Unable to perceive any benefits from financial services, whether savings,

payments or loans, the unbanked resist programmes to increase access. Programmes to educate the unbanked in financial basics have been undertaken by NGOs and community service agencies, frequently with government support. In the United States, the Individual Development Account programme (IDA) described earlier combines financial education with a hands-on programme to encourage savings among the unbanked. The federal government offers tax incentives to banks that open deposit accounts with maximum interest rates for qualified first-time savers. The IDA programme goes further, by linking tax breaks to a programme to "match" accumulated savings for participants who meet the goal of maintaining their deposits and who pass a course in financial management.[46]

46. See Schreiner, Mark, Margaret Clancy and Michael Sherraden (2002), "Saving performance in the American dream demonstration: a national demonstration of individual development accounts", Report issued by the Centre for Social Development, Washington University, October. Evaluations of the IDA programme, which started in 1998, are just becoming available. They tend to reconfirm how difficult it is for the poor to save. Approximately two-thirds of families with IDA accounts were unable to take advantage of the matched funds because they never left enough funds in their account for long enough to qualify for a matched deposit. On the other hand, they did continue to save and maintain their accounts, and one-third did save enough to earn the grant. And as the reports showed, they invested their savings and earnings in home purchase, education, business creation or other long-term projects.

BOX 3
Innovative banks build up their clientele through financial education

PHOTO 1
Mitchell Bank

In the United States, the Spanish language television networks, which cater to an immigrant audience, have woven lessons on banking and the virtues of saving into the telenovelas, or widely watched "soap operas".

The Mitchell Bank of Minnesota has used another educational approach to reach immigrant groups by introducing student-run bank branches into high schools in low-income immigrant neighbourhoods. By teaching young people how to use and benefit from financial services, the Mitchell Bank hopes to earn the trust and the business of their parents and of the community at large.

Mitchell Bank – Cardinal High School Branch

IX. FINANCIAL INCLUSION: ANOTHER ASPECT OF ECONOMIC AND URBAN DEVELOPMENT

In most Latin American countries, the formal sector financial institutions are not responsive to the majority of the population, especially to the poor, who pay a premium for financial services in the informal sector. The resulting phenomenon of financial exclusion hurts the unbanked and reduces opportunities for investment in improving their (low-income) neighbourhoods, thus perpetuating the slum environment. At the same time, financial exclusion adds to the costs and concentrates the risks of formal sector financial institutions – the banks, cooperatives, credit unions and mortgage companies that focus on a very small population segment, foregoing deposits from small savers and consequently seeking liquidity from international money markets at higher costs.

Seen from a macroeconomic perspective, financial exclusion also reduces the capacity for aggregate savings and, in consequence, for aggregate investment, thus jeopardizing economic growth. Finally, in the Latin American countries studied, the increasing tendency of formal sector banks to invest in government papers means that the interest generated from a highly regressive tax system is paid to the high-income holders of savings and deposit accounts. Seen in this light, financial exclusion appears to underpin the redistribution of income from poor to rich, hardly desirable for developing countries with high percentages of population below the poverty level.

On the positive side, both governments and some innovative banks appear to be taking steps to forge financial inclusion. While much has been written in the past about microcredit programmes, this article has intentionally stressed examples that offer a full range of financial services, not just credit, to reach the poor. As microfinance institutions move to expand their services to offer payments and deposit facilities, so it is to be hoped that the traditional banking institutions also move to broaden their clientele, to make full financial inclusion a reality.

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