ADVANCING INCLUSIVE FINANCIAL SYSTEM IN THE NEXT DECADE

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(Project Leader)

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Foreword

Financial inclusion has been recognised as an important tool to promote sustainable economic growth and development. All over the globe, initiatives have been undertaken to ensure widespread financial access and inclusion. In Asian emerging economies, financial inclusion has received greater priority in the development agenda. Various measures and modalities have been developed for advancing higher financial inclusion. New initiatives have been highly benefitted by latest technological development.

The task of financial inclusion is indeed challenging. While considerable advancement has been made, there exist several bottlenecks in achieving higher financial inclusion. Experiences of different economies have identified several sources of friction which vary across economies. These frictions have not only restricted the potential benefits from increased financial inclusion but also reduced the viability of initiatives aimed at this direction. In this regard, it is imperative to identify the barriers for financial inclusion and in turn, design and implement appropriate measures.

Against the above backdrop, this research has been carried out with the objective of reviewing the financial inclusion initiatives undertaken by the SEACEN economies, examining the current status of financial inclusion in these economies and drawing lessons for fine tuning their respective national financial inclusion agenda. In this regard, the research tries to identify successful measures and advocacies as well as bottlenecks impeding progress in financial inclusion.

This collaborative research was led by Dr. Min B. Shrestha, Executive Director of the Research Department of Nepal Rastra Bank and concurrently Visiting Research Economist of The SEACEN Centre (OY 2014) and Project Leader of this research project.

The SEACEN Centre wishes to express its sincere gratitude to the participating member central banks and their researchers for actively participating in this project and preparing the chapters of their respective economies. They are namely, Mr. Ou Sokpanha, Deputy Section Chief, Licensing Department, National Bank of Cambodia; Ms. Woro Widyaningrum, Financial Access and SME Development Department, Bank Indonesia; Ms. Zarina Abd Rahman, Manager, Development Finance and Enterprise Department, and Mr. Wan Mohammad Zainuddin Mohammad Zaini, Analyst, Development Finance and Enterprise Department, Bank Negara Malaysia; Mr. Hem Prasad Neupane, Deputy Director, Bank Supervision Department, Nepal Rastra Bank, Mrs. Williamina Hubert, Senior Research Analyst, Research Department, Bank of Papua New Guinea, Mr. Al Benedict B. Magday, Bank Officer II, Department of Economic Research, Bangko Sentral ng Pilipinas; Dr. R.A. Perera, Deputy Director, Economic Research Department, Central Bank of Sri Lanka; and Ms. Lin Shu-Chen, Senior Specialist, Department of Economic Research, and Ms. Chen Tzu-Hsien, Junior Specialist, Department of Banking, Central Bank, Chinese Taipei.

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Hookyu Rhu
Executive Director
The SEACEN Centre

April 2015

TABLE OF CONTENTS

Chapter 4
ADVANCING INCLUSIVE FINANCIAL SYSTEM IN THE NEXT DECADE IN MALAYSIA
By Zarina Abd. Rahman and Wan Mohammad Zainuddin Mohammad Zaini

Chapter 5
ADVANCING INCLUSIVE FINANCIAL SYSTEM IN THE NEXT DECADE: A CASE OF NEPAL
By Hem Prasad Neupane

Chapter 6
ADVANCING INCLUSIVE FINANCIAL SYSTEM IN THE NEXT DECADE: THE CASE OF MOBILE BANKING IN PAPUA NEW GUINEA
By Williamina Hubert

Chapter 7
ADVANCING INCLUSIVE FINANCIAL SYSTEM IN THE NEXT DECADE: MICROFINANCE IN THE PHILIPPINES
By Al Benedict B. Magday

Chapter 8
ADVANCING FINANCIAL INCLUSIVE SYSTEMS FOR THE NEXT DECADE: THE CASE FOR SRI LANKA
By Roshan Perera

Chapter 9
ADVANCING INCLUSIVE FINANCIAL SYSTEM IN THE NEXT DECADE: ASSISTING THE SMES AND UNDERPRIVILEGED MINORITIES IN ACCESSING FINANCIAL RESOURCES IN CHINESE TAIPEI
By Shu-Chen Lin and Tzu-Hsien Chen

Executive Summary

Financial inclusion has received greater priority in the development agenda for many countries across the globe. Several individual as well as collective initiatives have been undertaken by economies aimed at achieving greater financial inclusion. Financial inclusion is often considered more important for developing economies for its role in reducing poverty, increasing employment and uplifting the economic status of the general public. Well-calibrated financial inclusion may also help the achievement of greater financial stability as it can broaden business opportunities and profitability of banks and financial institutions in the medium- and long-term.

While considerable advancement has been made, the progress towards achieving greater financial inclusion has been uneven across economies mainly due to their respective socioeconomic backgrounds, plans and policies implemented and intermediary institutions and infrastructures. Different economies have identified several bottlenecks and sources of friction which continue to impede progress. In many cases, banks and financial institutions have yet to develop sustainable delivery models to meaningfully carry out financial inclusion initiatives.

Against the above backdrop, this research has been carried out with the objective of reviewing the financial inclusion initiatives undertaken by the SEACEN economies, examining the current status of financial inclusion in these economies and drawing lessons for fine tuning their respective national financial inclusion agenda. In this regard, the research tries to identify successful measures and advocacies as well as bottlenecks impeding progress in financial inclusion. This collaborative research covers eight SEACEN economies, namely, Cambodia, Indonesia, Malaysia, Nepal, Papua New Guinea, Philippines, Sri Lanka and Chinese Taipei.

The team project papers in this research project show that financial sector development in terms of the number and types of banks and financial institutions has been achieved in most of the economies covered in this study. Banking services have been modernised and efficient payments systems have been put in place. However, the level of development in the insurance industry and capital markets varies among the economies. Financial inclusion focused plans and policies have been implemented in some of the economies with the setting up of dedicated institutional frameworks. The level of urbanisation, economic

advancement and geographical access in certain economies such as Chinese Taipei and Malaysia may have also helped in achieving a higher level of financial inclusion in these economies.

Increasing the level of financial inclusion is a challenging but needed task in economically underdeveloped and geographically challenged economies. Economies such as the Philippines, Sri Lanka and Indonesia have consolidated their plans, policies and institutions to focus on the achievement of financial inclusion. Papua New Guinea has also implemented focused plans and established a specialised institution for financial inclusion. Cambodia and Nepal seem to be concentrating mainly on increasing financial access although financial inclusion is also in their policy agenda.

Despite the various efforts made, the progress toward achieving greater financial inclusion has been uneven in the SEACEN economies due to country-specific challenges. In Cambodia, the low level of financial literacy, high rate of interest charged by microfinance institutions, collateral- based lending and presence of shadow banking are major bottlenecks for financial inclusion. In the case of Papua New Guinea, consumer protection, proper regulation of new financial products, high security threats, low population density and high operating costs pose major challenges to financial inclusion.

Similarly, Nepal faces challenges such as high interest rates, duplication in microfinance service, weak coordination among agencies and poor infrastructure. Challenges experienced by Indonesia are a low level of financial literacy, high interest rate on credit and unwillingness of banks and financial institutions to cater for services to excluded segments due to high operating costs. In the Philippines, the archipelagic nature of the country imposes geographical and physical barriers to financial access. There is also a lack of authority with the explicit mandate to lead financial inclusion initiatives.

A challenging geographical structure is the common physical barrier to financial inclusion in Nepal, Papua New Guinea and the Philippines as well as the high interest rate charged by the institutions involved in increasing financial access and inclusion and the low level of financial literacy.

Constraints to inclusive finance exist at both the demand and supply sides. Major demand-side constraints include physical access, higher interest rates, documentation, lack of collateral, higher transaction costs, mistrust in financial institutions, etc. Major supply-side constraints are unwillingness of banks to do retail banking, financial viability of micro-finance institutions, real and perceived risk in micro-lending, high operating costs, wider competition and lack of capital.

Evidence suggests that the financial sector, if left alone to the free market, may leave large sections of society out of reach for financial services and heighten inequality by adversely affecting the quality of economic growth. A balanced role that the state plays in the financial market and coordination among regulators are essential for promoting inclusive finance.

All the eight SEACEN economies covered in this study have recognised the need for financial inclusion and are implementing various policies. Indonesia and PNG have formulated national financial inclusion strategies. Cambodia and Malaysia are implementing financial sector development strategies with the incorporation of financial inclusion as an intrinsic portion. The Philippines is planning to draft a National Financial Inclusion Strategy while Nepal is drafting a Financial Sector Development Strategy with financial inclusion incorporated as a separate pillar. In other economies, the policy focus is on financial access, which also addresses financial inclusion issues to some extent.

Most of the banks and financial institutions are involved in financial inclusion activities directly or indirectly in the SEACEN economies. However, microfinance institutions are the major institutions involved in financial inclusion while in some economies, specialised institutions for financial inclusion have been set up.

The experiences of Chinese Taipei and Malaysia show that well-crafted plans, policies and programmes that are persistent with a longer term vision are the basic foundations for achieving higher levels of financial inclusion. Similarly, dedicated institutions which work in a coordinated manner to implement such plans, policies and programmes are crucial. Involvement of dedicated institutions in Chinese Taipei for credit supply, credit guarantee and micro-insurance to farmers, fishermen, aborigines, the physically challenged and families suffering unexpected hardship is one example in this context.

While appropriate measures and models are important in achieving financial inclusion targets, it may not mean that measures that have been effective in some economies will be as successful in others, due to differentiations in, for example, the level of economic advancement and geographical uniqueness. For this reason, financial inclusion plans, policies, institutions, measures and models should be tailored or modified appropriately to suit the specific context and environment. It can also be gleaned from the participating economies that measures targeted to achieve higher financial inclusion may benefit significantly from the use of technology such as mobile phones and other electronic devices or systems.

Chapter 1

INTEGRATIVE PAPER ON ADVANCING INCLUSIVE FINANCIAL SYSTEM IN THE NEXT DECADE

By
Dr. Min B. Shrestha[1]
(Project Leader)

1. Introduction

Financial inclusion has received greater priority in the development agenda for many countries across the globe. Several individual as well as collective initiatives have been undertaken by economies aimed at achieving greater financial inclusion. Financial inclusion is often considered more important for developing economies for its role in reducing poverty, increasing employment and uplifting the economic status of the general public. Well-calibrated financial inclusion may also help the achievement of greater financial stability as it can broaden business opportunities and profitability of banks and financial institutions in the medium- and long-term.

While considerable advancement has been made, the progress towards achieving greater financial inclusion has been uneven across economies mainly due to their respective socio-economic backgrounds, plans and policies implemented and intermediary institutions and infrastructures. Different economies have identified several bottlenecks and sources of friction which continue to impede progress. In many cases, banks and financial institutions have yet to develop sustainable delivery models to meaningfully carry out financial inclusion initiatives.

Against the above backdrop, this research has been carried out with the objective of reviewing the financial inclusion initiatives undertaken by the SEACEN economies, examining the current status of financial inclusion in these economies and drawing lessons for fine tuning their respective national financial inclusion agenda. In this regard, the research tries to identify successful measures and advocacies as well as bottlenecks impeding progress in financial inclusion.

1. Executive Director of the Research Department of Nepal Rastra Bank and concurrently Visiting Research Economist (VRE) of The SEACEN Centre for FY 2014.

This collaborative research covers eight SEACEN economies, namely, Cambodia, Chinese Taipei, Indonesia, Malaysia, Nepal, Papua New Guinea, Philippines and Sri Lanka. This integrative paper is mainly based on the reports prepared by project team members from the respective economies, which appear subsequently as separate chapters in this Volume.

The rest of this integrative paper is organised as follows. Section 2 conducts a literature survey on financial inclusion. Section 3 reviews the financial inclusion initiatives implemented in the SEACEN economies covered in this study. Section 4 examines the current level of financial inclusion in these economies. Section 5 discusses major issues and challenges in increasing financial inclusion while Section 6 concludes.

2. Literature Survey

2.1 Definition of Financial Inclusion

The Center for Financial Inclusion (2015) defines full financial inclusion as a state in which everyone who can use them has access to a full suite of quality financial services, provided at affordable prices, in a convenient manner, with respect and dignity. According to the Word Bank (2014), financial inclusion is the proportion of individuals and firms that use financial services. The lack of use does not necessarily mean a lack of access. The key issue is the degree to which the lack of inclusion derives from a lack of demand for financial services or from barriers that impede individuals and firms from accessing the services.

Financial inclusion encompasses the range, quality, and availability of financial services to the underserved and the financially excluded. It is important that efforts to improve financial inclusion focus not only on the financially excluded but also on the underserved population and firms in developing countries (Stein et al., 2011).

According to GIZ (2011), interventions aimed at financial inclusion may impede the development of the banking system or reduce the efficiency of financial intermediation. Such an attempt to bring about financial inclusion may not necessarily lead to inclusive financial development. Instead, it may have negative effects on economic growth and poverty reduction. Thus, inclusive financial development will occur when the inclusiveness of the financial sector does not retard its growth possibilities.

2.2 Rationale for Financial Inclusion

Financial services are an essential part of everyday life. People who face difficulties accessing and using financial services experience real detriment, not only in terms of the monetary costs of financial exclusion, but also the social and psychological costs of feeling excluded from mainstream society (Kempson et al., 2012).

According to the World Bank (2014), financial inclusion can play a critical role in reducing extreme poverty, boosting shared prosperity, and supporting inclusive and sustainable development. Demirguc-Kunt and Klapper (2012) argue that there is a strong correlation between inequality in the use of formal accounts and general income inequality as measured by the Gini coefficient. They opine that inclusive financial systems are especially likely to benefit poor and other disadvantaged groups. A study conducted in Kenya finds that people with access to savings accounts or simple informal savings technologies are more likely to increase productivity and income, increase investment in preventive health, and reduce vulnerability to illness and other unexpected events (Dupas and Robinson, 2013a; 2013b).

Evidence shows that access to loans, savings accounts, insurance and other financial services is crucial in enabling the poor to invest in homes, education and small businesses, withstand the impact of economic shocks and manage uneven cash flows and seasonal incomes (GIZ, 2011).

Financial inclusion also can enhance financial stability by providing more diverse loan assets and a more stable deposit base. Morgan and Pontines (2014) argue that an increased share of lending to small- and medium-sized enterprises aids financial stability, mainly by reducing non-performing loans and the probability of default by financial institutions.

2.3 Barriers to Financial Inclusions

Worldwide, only 50% of adults have accounts at formal financial institutions. While account penetration is nearly universal in high-income economies, with 89% of adults reporting that they have an account at a formal financial institution, it is only 41% in developing economies. Globally, more than 2.5 billion adults do not have a formal account, most of whom are in developing economies. More than 75% of the world's poor are excluded from formal financial services. About 60% of the population in East Asia and 80% of that in South Asia do not have access to the formal financial system. Similarly, the differences in account ownership by individual characteristics are particularly large in developing economies. While 46% of men have a formal account, only 37% of women do (Demirguc-Kunt and Klapper, 2012).

Half of the world's adult population which does not have an account at a formal financial institution report high cost, physical distance, and lack of proper documentation as the common barriers to finance access although there are significant differences across regions and individual characteristics (Demirguc-Kunt and Klapper, 2012). Constraints exist at both the demand and supply sides of financial inclusion. United Nations (2006) list cultural factors, mistrust of financial institutions, transaction costs, financial literacy and skill capacity and access to basic infrastructure as the demand-side constraints. On the other hand, supply-side constraints include unwillingness of banks to perform retail banking, financial viability of microfinance institutions, real and perceived risks in micro-lending, high operating costs, wider competition and lack of capital (Nepal Rastra Bank, 2013).

2.4 The Promise of Technology

Technological innovations can lower the cost and inconvenience of accessing financial services. The last decade has been marked by a rapid growth in new technologies, such as mobile payments, mobile banking, Internet banking, and biometric identification technologies. These technological innovations allow for a significant reduction in transaction costs, leading to greater financial inclusion (World Bank, 2014).

The development of information and communications technology is creating opportunities for the provision of essential financial services to the population at large. When the more disadvantaged segments of society are informed about new attractive possibilities, they normally would want to test the new products. When they become reassured that these products work and are reliable, they would usually embrace them. However, technology-based schemes or products can only be sustainable if they are built on a commercially viable business model. Moreover, such products can also give rise to fraud. Hence, the challenge is to harvest the potential benefits that technological innovation and new business models can create, while ensuring that the risks are understood and managed (Dittus and Klein, 2011).

2.5 Way Forward

Inclusive financial systems are the only way to reach large numbers of the poor and low-income groups. To get there, various approaches and channels are needed to get the diverse financial services into the hands of a wide range of groups who are currently excluded (Helms, 2006). For inclusion to have positive effects, it needs to be achieved responsibly. Creating many bank accounts that lie dormant makes little sense. The objective of financial inclusion policy certainly cannot be to make everybody borrow (World Bank, 2014).

Key elements for enhancing financial inclusion include a supportive policy environment, strong institutions, innovative products and delivery channels and financial awareness. The public sector can promote financial inclusion by developing the appropriate legal and regulatory framework as well as by educating and protecting the users of financial services. Many of the public sector interventions are more effective if the private sector is involved (World Bank, 2014).

Dittus and Klein (2011) argue that regulation should be designed by type of service and it should take systemic dimensions into account. If conditions for a full banking license are to be met, many of the financial services addressing inclusion will not emerge. In developing the regulatory framework for basic financial services to the poor, regulation should be calibrated according to the risks incurred for the overall financial system. The danger of systemic repercussion coming from the basic financial services to the poor that may impose large financial costs seems to be not so apparent.

Direct government interventions tend to be politicised and less successful, particularly in environments with weak institutions. Hence, existing institutions should be strengthened while new dynamic ones should be established in both the public as well as private sector. Wider use of financial services can be fostered by innovative product designs that address market failures, meet consumer needs, and overcome behavioural problems (World Bank, 2014).

Financial literacy is crucial for enhancing financial inclusion. The evidence demonstrates that financial education is especially beneficial among people with below-average education and limited financial skills. However, research also indicates that standard, classroom-based financial education aimed at the general population does not have much of an impact for financial inclusion. Hence, well-designed and targeted interventions should be implemented such as those that use teachable moments, such as starting a job or purchasing a major financial product. Education focusing on rules of thumb is particularly helpful because it avoids information overload (World Bank, 2014).

The implementation of global financial inclusion initiatives will require an integrated and concerted effort leveraging on four key drivers of the global development community, the financial services industry, national governments, and centers for knowledge sharing and standard setting bodies (Stein et al., 2011).

2.6 Global Initiatives

The United Nations Committee on Building Inclusive Financial Sectors, set up in 2006, has urged central banks and governments to include the goal of universal financial inclusion to the two traditional goals of prudential regulation of depositors' funds and the stability of the financial system (United Nations, 2006). The G-20 Summit held in Toronto in June 2010 subsequently announced the "Principles for Innovative Financial Inclusion" (Stein et al., 2011).

The Alliance for Financial Inclusion issued the Maya Declaration in September 2011 during its Third Global Policy Forum. The declaration recognises the critical importance of financial inclusion for empowering and transforming the lives of people all over the world and reaffirms the value of peer-to-peer knowledge exchange and learning among financial regulators and policymakers for the design and implementation of innovative financial inclusion policy solutions. Up to November 2014, more than 100 institutions from 95 countries have adopted the Maya Declaration principles (Alliance for Financial Inclusion, 2015).

The Center for Financial Inclusion aims to build a movement that mobilises stakeholders around the globe to achieve full inclusion by 2020 through the Financial Inclusion 2020 Project (Center for Financial Inclusion, 2015). This global effort in financial inclusion will be driven by setting global targets, focused not only on credit, which is only part of the needed portfolio of financial services and products, but on a range of financial products and instruments including payments, remittances, savings, and insurance (Stein et al., 2011). In recent years, some 50 countries have set formal targets and goals for financial inclusion (World Bank, 2014).

3. Financial Inclusion Initiatives Implemented in the SEACEN Economies

3.1 Cambodia

In Cambodia, financial inclusion policies were implemented mainly through the microfinance projects carried out by donor agencies, non-governmental organisations and other institutions in the early 1990s. The Financial Sector Blueprint 2001-2010 recognised the need of a viable, proper and effective rural financial system for providing affordable financial services to enable the poor to increase their income and reduce poverty. In this regard, the government developed a National Microfinance Strategy, adopted the rural credit policy, initiated the rural credit and savings project, encouraged banks to establish branches in rural areas, and promoted innovative pilot microfinance projects.

Microfinance still remains the main channel for implementing financial inclusion policies in Cambodia. The Financial Sector Development Strategy 2011-2020 which has the objective, among others, of increasing poor people's access to finance, has emphasised the reform of the microfinance sector for achieving the end goal. Various development areas have been identified in the Strategy while short-, medium- and long-term targets have been set.

Major development policy areas outlined in the Strategy for the reform of the microfinance sector include allowing microfinance institutions to expand direct access to savings, increasing financial inclusion, deepening financial services, expanding access to financial products and services to individual in hard-to-reach-areas as well as developing a strong consumer protection mechanism and promoting financial literacy. The Ministry of Economy and Finance, National Bank of Cambodia and Cambodia's Microfinance Association are the main agencies responsible for implementing the short-, medium- and long-term financial inclusion targets.

As of 2013, the banking system in Cambodia comprise of 35 commercial banks, 9 specialised banks, 38 microfinance institutions 33, registered microfinance operators, 2 financial leasing companies, and 1 credit bureau company. Among the 38 microfinance institutions, 7 are microfinance deposit-taking institutions. Banking and financial institutions are continuing to broaden their branch networks, products and services to capture new segments of the market.

New banking products and services are being developed for the financial market to serve the needs of the public such as cash management, gold investment account, trade finance, dual currency investment, swap contract, real estate brokerage, internet banking, mobile banking, SMS banking, debit card and credit card. Since 2006, the number of offices has expanded gradually, especially for MFI offices that have been located mostly outside the city in order to reach people living in rural areas. As of December 2013, the total number of offices for both banks and MFIs reached 2,713 in total.

3.2 Indonesia

In Indonesia, the national strategy of financial inclusion was announced in June 2012 which has a vision of achieving a financial system that is accessible by all layers of the community, to promote economic growth, poverty reduction and income equality in Indonesia. The Strategy aims at broadening access to financial services for all segments of the population and unlocking opportunities for small businesses.

The Strategy has inclusive finance as one of its main objectives. Financial inclusion is defined as the "right of every individual to have access to a full range of quality financial services in a timely, convenient, informed manner and at an affordable cost in full respect of his/her personal dignity." The focus is on providing financial services to all segments of the society, with particular attention to the low-income poor, productive poor, migrant workers and people living in remote areas.

The Strategy gives prominence to the concept of providing financial services based on the different needs of specific categories of the population. While the Strategy covers all segments of the population, it explicitly targets three segments with the greatest need or unmet demand for financial services, which include the low income poor, working poor and near poor. The low income poor group consists the extremely poor who receive social assistance. The working poor are the self-employed poor comprising small and marginal farmers, fishermen, artisans and craftsmen, petty traders and micro entrepreneurs. The near poor category includes low income or working poor who have the ability to accumulate substantial savings and have access to formal banks.

Building an inclusive financial system requires efforts from all the relevant stakeholders, in particular the policymakers and regulators. Various institutions are engaged in the formulation and implementation of financial inclusion policies and programmes. Several Ministries manage programmes that are directly related to the financial inclusion strategy. The Ministry of National Education and the Ministry of Religious Affairs work as counterparts to Bank Indonesia for the financial education initiative. The Ministry of Manpower and Transmigration manage initiatives related to migrant workers. The Ministry of Communication and Information is the relevant body for initiatives related to ICT. The Ministry of State-Owned Enterprise manages the State-Owned Enterprise (SOE) and issues the requirement for SOEs to allocate part of their profit for social activities.

Similarly, the Ministry of Home Affairs manages the National Program for Community Empowerment (PNPM), of which one component is the establishment of microfinance institutions at the local level. Under the joint decree, this Ministry is responsible for overseeing MFIs that are legal entities such as village-owned enterprises. The main role of the Ministry of Cooperatives and MSMEs (Micro, Small and Medium Enterprises) is to supervise and develop cooperatives and MSMEs, including issuing the relevant policies. The joint decree mandates the Ministry to oversee financial sector cooperatives.

The Coordinating Ministry of Economic Affairs manages the Credit for People's Enterprise (KUR) Program while the Financial Service Authority (FSA) oversees non-bank financial institutions (insurance, capital market). Under the joint decree, the FSA also has oversight of venture capital entities. The Ministry of Social Affairs takes charge of the government's conditional cash transfer (PKH).

3.3 Malaysia

The Central Bank of Malaysia Act 2009 explicitly provides that a primary function of Bank Negara Malaysia (BNM) is to develop and promote an inclusive financial system. Supported by a clear mandate, BNM has been the leading agency responsible for the policies and initiatives aimed at promoting financial inclusion in Malaysia.

Increasing access to basic banking services and products such as financing and savings accounts is essential to bring more businesses and households into the formal financial system. In 2005, BNM issued a Guideline for Basic Banking Services which require all commercial banks to provide basic banking services. This is to ensure that all segments of society have access to basic deposit and transaction services at a reasonable cost.

Malaysia has created a facilitative business environment that supports the creation of a diverse range of institutions to thrive and compete. In 2006, commercial banks were encouraged to play a key role in the expansion of access to financing for micro enterprises through the "Pembiayaan Mikro" framework.

Under this framework, micro enterprises can access uncollateralised business financing in a fast, easy and convenient manner.

In order to empower the consumers with the knowledge and skills to make good financial decisions, BNM in collaboration with “Agensi Kaunseling and Pengurusan Kredit” ((AKPK) Credit Counselling and Debt Management Agency) and the industry has implemented financial education programmes which include the POWER! Programme introduced in 2011, specifically targeting young individuals and new borrowers to help them to effectively manage their finances.

The development of a strong and dynamic SME sector is a high priority on the national development agenda as SMEs account for 97% of the total business establishments in Malaysia. In this regard, the SME Master Plan 2012-2020 has been implemented to create a conducive ecosystem to accelerate the growth of SMEs. The Master Plan is an inclusive plan for all SMEs, across sectors, regions and strategic areas which translates bold measures into strategies across 6 different focus areas.

BNM has also encourages the growth of Islamic banks in parallel with conventional banks to ensure that all segments of society are served. Islamic financing products and services provide financing options that are aligned with the principles and economic requirements of the underserved. At the same time, development finance institutions (DFIs), cooperatives and MFIs also have an important role in serving niche groups of customers in Malaysia. With a wide distribution of networks across the nation including the rural areas, DFIs and cooperatives complement the other financial institutions in providing businesses and consumers with an alternative source to access financial services. There are currently more than 10,000 cooperatives nationwide.

In addition, MFIs such as “Amanah Ikhtiar Malaysia” (AIM) and “Tabung Ekonomi Kumpulan Usaha Niaga” (TEKUN), were established to further the microfinance agenda. AIM is a private trust that was established in 1987 with the objective of assisting the hard core poor to rise out of the poverty trap. This is done through the provision of microfinancing for various income generating activities through its 123 branches nationwide. AIM adopts the Grameen Bank model where financing is given to groups of borrowers, primarily women. Similarly, TEKUN established in 1994, provides microfinancing, especially to the rural communities, for income generating activities as well as to support entrepreneurs, mainly in agriculture and agricultural-based sectors.

The Credit Guarantee Corporation (CGC) is another key institutional arrangement facilitating greater access to financing by the small and medium enterprises (SMEs). By providing credit guarantees to business loans, CGC addresses the issue of the lack of collaterals, which is one of the main constraints faced by small businesses.

There are six Development Finance Institutions that provide financial services to the targeted groups. The “Bank Simpanan Nasional”, ((BSN), National Savings Bank) is mandated to mobilise savings in the underserved areas and promote microcredit. The Agricultural Bank (Agrobank) serves the agricultural sector in a sustainable way while the SME Bank serves the SME sector.

In January 2008, the “Suruhanjaya Koperasi Malaysia” ((SKM) Cooperatives Commission of Malaysia) was set up to regulate the development of cooperatives. Apart from exercising a supervisory role over all cooperatives in Malaysia, SKM also aims to create an ecosystem that is conducive to the development of competitive cooperatives through the provision of grants and financing.

In 2001, the Central Credit Reference Information System (CCRIS) was established to collect credit information from all regulated financial institutions. In addition to supporting BNM’s assessment of credit risk in the financial system, the database provides important information on a borrower’s credit history to FIs to enable them to perform better credit assessments.

The Credit Bureau Malaysia (CBM) was established in 2008 to assist SMEs to build credible and comprehensive credit records. CBM credit records include transactions from outside the regulated financial system such as transactions with suppliers, landlords and utility companies. This more comprehensive credit record improves access to finance for businesses that utilise the formal financial system for the first time.

The Consumer and Market Conduct Department was established at BNM in 2006 to formulate and implement policies that promote fair and responsible treatment of consumers and to supervise and enforce compliance with such policies. These policies cover, among other things, obligations of financial intermediaries to observe fair practices in complaints handling, debt collection, responsible financing, imposition of fees and charges, and provision of credit cards.

In ensuring that consumers have access to advisory and resolution facilities, BNMLINK was established as a centralised point of contact for members of the public and businesses including small and medium enterprises (SMEs) to address their inquiries and complaints in relation to the financial sector. The public can interact directly with the FIs or BNM to obtain information and financial advisory services, or resolve any complaints against FIs. TELELINK allows the public to access these services by telephone while MobileLINK extends BNMLINK's advisory services nationwide using a custom made coach equipped with the supporting facilities and technologies.

For dispute resolutions, the Financial Mediation Bureau was established in 2005 to ensure consumers of all FIs have recourse to an independent, fair and impartial dispute resolution mechanism. Meanwhile, the AKPK or Credit Counseling and Debt Management Agency was established in 2006 to provide counseling on financial matters and assist over-indebted individuals to work out loan repayments with FIs.

Malaysia also established the "Perbadanan Insurans Deposit Malaysia" ((PIDM) Malaysia Deposit Insurance Corporation) 2005 as a key component of the financial safety net with the mandate of insuring deposits and benefit payments under insurance and takaful (shariah-compliant insurance) policies against the failure of banks or insurance and takaful providers. PIDM protects deposits up to RM250,000 (US$78,125) per depositor per bank and up to RM500,000 (US$156,250) per policyholder in insurance and takaful benefits. The protection is provided automatically at no charge to the consumers.

3.4 Nepal

Nepal Bank Ltd. established in 1937 was the first bank of Nepal while Nepal Rastra Bank, the Central bank of Nepal, was established in 1956. Government-owned commercial bank, Rastriya Banijya Bank and the Agricultural Development Bank were established in 1966 and 1968, respectively. To increase banking access for all districts of the country, NRB initiated a Banking Development Program in late 1960s that encouraged commercial banks to open branches in the specified areas by providing incentives for the first five years of operation.

Agriculture-based cooperatives established in the 1950s were the first institutions to develop microfinance services in Nepal. These cooperatives were established under the Small Farmers' Development Project which was transformed into the Small Farmers Cooperatives Limited later. Until the 1970s, government-owned banks were directly involved in implementing various programmes, aimed at increasing financial access as there were no private sector banks. After the implementation of financial liberalisation policies in the early 1980s, private banks and financial institutions were established. The increased number of banks and financial institutions helped in extending financial services in the country.

The Government of Nepal in its Seventh Five Year Plan (1985-90) has put in place an ambitious plan of establishing at least one bank branch for every 30 thousand people in the country. To meet this target, Nepal Rastra Bank (NRB) implemented various banking development measures.

In the 1990s, several measures were undertaken to expand financial services to the rural population of the country. These measures included the establishment of five government-owned regional rural development banks based on the Grameen Bank model of Bangladesh, permission to carry out limited banking transactions to financial cooperatives and non-governmental organisations, and opening up of licensing for the private sector to establish microfinance development banks. As of mid-January 2014, microfinance development banks have established more than 50,000 centres in the country.

The Rural Self Reliance Fund (RSRF) was established by the government to provide credit to the rural poor. The Fund provides wholesale loans to cooperatives and NGOs, which will then further extend loans to the targeted poor. The Rural Microfinance Development Centre and Sanakisan Bikas Bank are other wholesale lenders that provide funding for microfinance institutions including cooperatives.

The Banking Promotion Board was formed in 1968 to promote banking services and educate the population. The Sub-committee of the Board regularly publishes information to create awareness and has been airing a radio programme for the last 40 years. A number of audio-visual programmes have been broadcasted in television channels. The Board is currently under the Nepal Bankers' Association.

Various donor supported micro-credit programmes were implemented in the country since 1980s, which have included the Production Credit for Rural Women, Micro-credit Program for Women, Poverty Alleviation Project in Western Terai, Third Livestock Development Project, Rural Microfinance Program, Community Ground Water Irrigation Service Project and Enhancing Access to Financial Services. Presently, programmes such as Mobile Money for the Poor (MM4P) supported by UNCDF, Access to Finance Program for Inclusive Growth supported by the Danish Government and Raising Income of Small and Medium Farmers supported by the Asian Development Bank are under implementation.

Currently, commercial banks are required to lend 4.5% of their total deposit liabilities to the deprived sector while for development banks, it is 3.5% and 3.0% for finance companies. Similarly, NRB provides direct financial support to banks and financial institutions (BFIs) that wish to open a branch where financial access is low. BFIs opening a branch in the specified 14 remote district headquarters would obtain Rs. 5 million interest free loans and Rs. 10 million if the branch is located outside the district headquarters. For micro-finance institutions, opening a branch in the specified 22 remote districts having low banking access will obtain Rs. 2 million interest free loans.

The cooperative sector is considered the third pillar of the national economy in Nepal. There are more than 28,000 cooperatives in the country of which about 13,000 are savings and credit cooperatives. These cooperatives are expanding their financial services into the rural areas where banks and financial institutions are absent.

To provide investment opportunities for the population at large, BFIs are required to allocate a minimum of 30% of their share offerings to the public. Likewise, a mandatory provision has been implemented for the allocation of a certain percentage of shares of hydropower generating companies to the local population who may be directly affected by the project.

Under the financial literacy programme, NRB has launched the “NRB with the Student” programme targeted at school children. Similarly, coordination with universities and the Ministry of Education is ongoing in order to incorporate financial education into academic curriculum.

A comprehensive Financial Sector Development Strategy (FSDS) is being drafted which is expected to include financial inclusion as a separate pillar.

3.5 Papua New Guinea

During the early 2000’s, the Microfinance Expansion Project (MEP1) was implemented with the support of the ADB and AusAid playing an instrumental role in providing financial services to the disadvantaged and low-income sections of society in Papua New Guinea. Two microfinance banks, namely, PNG Nationwide Micro-bank (formerly Wau Microbank) and PNG Microfinance Limited (PML), were established in 2004 under the MEP1 programme. These institutions were instrumental in providing access to financial services to SMEs and rural farmers.

In 2004, the Government of Papua New Guinea formally recognised financial inclusion as an important component for economic growth particularly for rural dwellers and the urban unemployed. In this regard, the government enacted the Informal Sector Development and Control Act in 2004.

The Development Strategic Plan (DSP) 2010-2030 of Papua New Guinea reiterated the importance of an efficient financial and banking sector. The Medium-Term Development Plan (MTDP) 2011-2015, released to complement the DSP, aimed at achieving financial and banking sector development in order to expand financial products and services to private sector small and medium enterprises (SMEs), develop affordable and financial products to meet the needs of these customers and others, and encourage financial services in rural areas. National Budgets since 2010, have started to make explicit budget allocations for financial inclusion related projects.

PNG conducted the Financial Diaries and Financial Competency Surveys covering low-income households in December 2013. The Survey catalyzed the formulation of the Financial Inclusion and Financial Literacy Strategy 2014-2015, the main aim of which is to reach one million more unbanked low-income people and SMEs with a diverse range of financial services by end- 2015. Additionally, it targets 50% of those reached to be women.

As an extension of the MEP1, the Microfinance Expansion Project (MEP2) has been launched with the support of ADB and AusAid. This project is expected to be completed in 2017. Building on the experience of MEP1, MEP2 has focused on programmes for financial literacy to encourage the unbanked population to become part of the monetised sector; continual work with MFIs to develop management and technical capacity whilst also developing appropriate regulatory framework for their supervision. Additionally MEP2 aims to increase lending to SMEs.

PNG signed the 2020 Money Pacific Goals (MPG), an initiative of the Pacific Island Countries that contains four main goals - the first is for all school children to receive financial education through core curricula; the second is to ensure that adults have access to financial education, the third is to establish simple and transparent consumer protection while the fourth and final goal is to halve the number of households without financial access to basic financial services.

The Financial Inclusion Sub-Committee was established under the Consultative Implementation and Monitoring Council (CIMC) to specifically assist, facilitate, promote and encourage dialogue among the relevant stakeholders. Similarly, the Centre for Excellence in Financial Inclusion (CEFI) was established in April 2013 to coordinate all the financial inclusion initiatives in the country, bring together stakeholders involved in financial inclusion and monitor targets and report progress outlined in the National Financial Inclusion and Financial Literacy Strategy 2014-2015.

CEFI's coordination efforts are channeled through the 6 main working groups in the area of Consumer Protection, Financial Education and Financial Literacy, Electronic Banking, Data and Measurement, Inclusive Insurance, and Government Coordination as part of financial inclusion development at all levels of government. Meanwhile, the advocacy efforts of CEFI are focused on developing products that are captured by evidence-based data, providing quarterly industry trend analysis and disseminating information pertaining to best practices and industry standards to all relevant stakeholders.

3.6 Philippines

In 2000, Bangko Sentral ng Pilipinas (BSP) was mandated by the General Banking Law to recognise microfinance as a legitimate banking activity and to set the rules and regulations for its practice within the banking sector. Since 2000, the BSP has been proactive in the development of microfinance as its flagship programme. Through the BSP's advocacy, 2005 was declared as the Philippine Year of Microfinance in line with the United Nations declaration of 2005 as the International Year of Microcredit.

In 2006, the BSP focused its microfinance initiatives on increasing the scale and scope of microfinance in the country, specifically within the banking sector. In 2007, the microfinance industry was characterised by innovation, dynamism and continued growth. The BSP remained responsive to these changes while maintaining the focus of its microfinance initiatives on increasing the scale and scope of microfinance in the country, specifically within the banking sector. In 2008, the microfinance industry saw continuous growth and dynamism within the framework of an enabling policy and regulatory environment.

In 2011, there was mainstreaming of financial inclusion in the domestic and international policy agendas, in light of growing recognition of the importance of financial inclusion as a policy objective. Along with this, the Philippine Development Plan (PDP 2011-2016) laid out its vision for the financial sector as a “regionally responsive, development-oriented and inclusive financial system which provides for the evolving needs of its diverse public”.

A wider range of products, expanded network of financial service providers, extended virtual reach through innovative delivery channels, lower barriers to access and use of financial services and consumer protection, are necessary for increasing financial inclusion. The BSP has issued various circulars that provide incentives for banks to engage in microfinance as well as ensure that its practice is done in a viable, sustainable and prudential manner.

Considering the importance of the support of and partnership with other agencies and organisations, the BSP is planning to champion financial inclusion across various sectors by convening relevant stakeholders to draft a National Strategy for Financial Inclusion. This Strategy is consistent with what is envisioned in the PDP. The proposed financial inclusion strategy aims to provide a framework to enable government and the private sector to take a coordinated and systematic approach for a clear vision of building a financial system that is accessible and responsive to the needs of the entire population and which will lead to broad-based and inclusive growth.

Meanwhile, the BSP created a Data and Measurement Working Group within the Inclusive Finance Steering Committee (IFSC), a bank-wide committee that was constituted to ensure a coordinated focus in pursuing programmes supportive of financial inclusion. There is also institutionalised information sharing with other departments within the BSP as well as with other agencies that are handling inclusion-relevant data (e.g., non-banks, e-money, cooperatives, microfinance NGOs).

3.7 Sri Lanka

At the time of independence, the financial sector was dominated by foreign commercial banks that mainly served the foreign trade and plantations sectors in the country. The establishment of the Central Bank in 1950, nationalisation of the Bank of Ceylon in the 1960s and establishment of the People’s Bank in 1961 are the major policy initiatives that led the rapid development of the financial sector in terms of institutions, instruments, services and geographical coverage. With the liberalisation of economic activity in 1977, there has been greater participation of the private sector in financial activities.

Despite the expansion of the branches of commercial banks, there was still a lack of services offered in rural areas. To address this concern, the Central

Bank established 17 Regional Rural Development Banks in 1985. To improve financial inclusion, a credit and debt management counseling centre was set up by the Central Bank to provide advice to individuals and companies on their credit problems and address issues relating to the denial of access to finance.

Microfinance has played a significant role in providing funds to the low-income segments of the population and has helped to develop a more inclusive financial service for the poor. The microfinance sector in Sri Lanka commenced in 1906 with the establishment of the Thrift and Credit Cooperative Societies under the Cooperative Societies Ordinance. The Central Bank initiated various microfinance schemes such as the Small Farmers and Landless Credit Programme ("Isuru") launched in conjunction with the Regional Rural Development Banks (RRDBs) in 1991, Poverty Alleviation Microfinance Project (PAMP I) in 2000, and PAMP II initiated in 2009. These schemes were aimed at improving income levels and social conditions of the poor in targeted project areas. Similarly, the Government also played a major role in the promoting microcredit through the Samurdhi Development Programme which commenced in 1995.

The Central Bank has initiated special credit facilities in the event of major disasters. These include the "Susahana" a refinance scheme for those affected by the tsunami in 2004, loan schemes with 100% refinance for development activities in the Eastern Province in 2007 and for the resumption of economic activities in the Northern Province in 2009, and the "Saubhagya" initiated for new entrepreneurs and small- and medium-scale enterprises affected by natural disasters. A credit guarantee scheme covering all short-term loans given for cultivation of crops called the New Comprehensive Rural Credit Scheme (NCRCS) was introduced in 1986.

The government in its budget for 2006, designated the agriculture sector as a priority sector for lending. Accordingly, all licensed banks were mandated to ensure that 10% of their credit portfolio was made to the agriculture sector. If a bank was not able to meet this target, they were to transfer the funds to the Central Bank to be re-loaned to designated sectors. In the Government's budget for 2012, banks were encouraged to set up dedicated SME centres in each district. To encourage the opening of bank branches in the regions, the Central Bank issued guidelines in 2007, mandating that for every bank branch that is opened in the Western Province, two branches need to be opened in the other regions.

The Sri Lanka Deposit Insurance Scheme was implemented in October 2010, replacing the voluntary scheme that had been in operation since 1987. All licensed banks and registered finance companies were enlisted as members of the scheme. Compensation of up to a maximum of Rs.200, 000 per depositor would be paid under the scheme. Similarly, the Secured Transactions Act which provides for the establishment of a registry for moveable collateral such as machinery and equipment was passed in September 2009.

The Central Bank established the Rural Credit Department in 1981 to promote lending to the rural sector, mainly for agricultural activities. With the expansion of the branch network of commercial banks particularly during the 1960s and 1970s, the Central Bank opened three regional offices to facilitate economic activities in the regions. With the end of the conflict in 2009, two more regional offices were set up in the Northern and Eastern provinces in 2010.

Another initiative of the Central Bank of Sri Lanka to improve financial inclusion has been the setting up of a credit and debt management counseling centre to provide advice to individuals and companies on their credit problems and to address issues relating to the denial of access to finance.

3.8 Chinese Taipei

In Chinese Taipei, the financial sector has achieved a relatively higher degree of inclusion in comparison with other SEACEN economies. However, there still exist some gaps between men and women, and the low-income and high-income groups with regard to their access to financial services. In this context, the focus of financial inclusion initiatives has been on farmers, fishermen and small- and medium-sized enterprises (SMEs). Many of the farmers and fishermen are economically disadvantaged and require access to financial resources. SMEs which are playing an important role in Chinese Taipei's economy and society, face difficulties in acquiring loans from financial institutions as they often lack sufficient collaterals, a transparent accounting system and financial knowledge. In this regard, the Additional Articles of Constitution of Chinese Taipei promulgated in 1997 has declared that the State shall assist and protect the survival and development of private SMEs.

The Council of Agriculture started to offer agricultural loans to farmers and fishermen since 1973 under schemes such as "The Business Start-Up Loans for the Youth Engaged in Agriculture" and "Loan for Fishery Industry in Guidance and Assistance of Management" in order to help them obtain funds to sustain their businesses as well as reducing their financial burden. To address the credit needs of SMEs, the Financial Supervisory Commission (FSC) launched the "Plan for Increasing Loans to SMEs by Domestic Banks" in July 2005, aimed at encouraging domestic banks to provide assistance to SMEs in need of working capital. Under the Plan, the FSC set an annual target of loan increment for SMEs.

The government has also introduced several programmes offering loans and micro-insurance, to assist various underprivileged segments of the population such as the youth, women, the low-income and the elderly. The Civil Bank Scheme which was started in July 2012 based on Grameen Bank model, aims to help disadvantaged minorities cultivate the savings habit and enhance their credit conditions by providing them with easier access to funds to start businesses.

To raise the willingness of financial institutions to extend loans, the policy loan programmes have been implemented with the credit guarantee system. The loans are typically small amounts with lower interest rates and higher coverage ratio of credit guarantee. On the insurance front, the FSC and the Life Insurance Association have encouraged insurance companies to provide micro-insurance with lower rates and insurance coverage for small amounts for low-income families and the underprivileged minorities since July 2009.

Credit Departments of Farmers' and Fishermen's Associations (CDFFAs) established in 1944 are the primary channels through which farmers and fishermen access financial services. The main objective of the CDFFAs is to provide loans to farmers and fishermen and facilitate the development of the local economy in rural areas and fishing villages. As of the end of 2013, there were 303 head offices and 867 branches of CDFFAs.

While SMEs constitute 99% of the industries in Chinese Taipei, they, nonetheless, face difficulties in getting loans from financial institutions. To address this problem, the Small and Medium Enterprise Credit Guarantee Fund of Taiwan (Taiwan SMEG) was established in 1974 for the credit guarantee of SMEs. The primary function of the credit guarantee system is to share credit risks with financial institutions, thereby strengthening their willingness to extend loans to SMEs. This agency provides two types of credit guarantee services - indirect guarantee and direct guarantee. The indirect guarantee is a process by which SMEs make loan applications to financial institutions, and the financial institutions in turn request the Taiwan SMEG to provide guarantee thereon. Meanwhile, the direct guarantee is a process where SMEs, with positive business potentials but higher risk concerns, require the credit guarantee commitment from the Taiwan SMEG directly before they can apply for loans from financial institutions.

In order to help farmers and fishermen obtain loans from financial institutions, the government founded the Agricultural Credit Guarantee Fund (ACGF) in 1983 to assist those who lack collaterals to obtain working capital. The source of the Fund is from the government, financial institutions and members of the CDFFAs, which contribute to 65%, 30% and 5% of total funds, respectively. To help enhance the credit conditions of farmers and fishermen who pay the guarantee fees, the Fund shares the credit risk with financial institutions especially the CDFFAs when financial institutions extend loans to farmers and fishermen.

The FSC and the Life Insurance Association have encouraged insurance companies to provide micro-insurance with lower rates and insurance coverage for small amounts for low-income families and underprivileged minorities since July 2009. Moreover, the Ministry of the Interior started an experimental scheme of civilian banks in July 2012 based on the Grameen Bank spirit, aimed at helping disadvantaged minorities cultivate a savings habit, enhance their credit conditions, providing them with easier access to funds to start businesses and ultimately lift them from poverty.

4. Current Level of Financial Inclusion in the SEACEN Economies

4.1 Access Points and Accounts

As discussed in the previous sections, various efforts have been made by the respective governments to increase financial inclusion. However, the level of financial inclusion achieved so far varies widely among the SEACEN economies covered in this study. The bank branch to population ratio is quite high in Chinese Taipei, Malaysia and Sri Lanka while it very low in Papua New Guinea. In terms of ATMs to population ratio, Chinese Taipei, Malaysia and Indonesia have the better access in comparison Cambodia, Nepal and Papua New Guinea (Table 1).

The population holding bank accounts at formal financial institutions is another key indicator of financial access and inclusion. Data shows that the population ratio having an account at a financial institution in Chinese Taipei, Sri Lanka and Malaysia are above the world average. Accounts held by female and population with the bottom 40% income also are at higher levels in these economies. Meanwhile, the ratios are shown to be low in Philippines, Indonesia and Nepal and very low in Cambodia. It can be seen from the Table that a greater number of the female population hold accounts at formal financial institutions compared to the male population in Chinese Taipei and the Philippines.

Table 1
Access Points and Accounts

SEACEN Economies	Number of Bank Branches per 100,000 Adults	ATMs per 100,000 Adults	Account at a Formal Financial Institution, Total	Account at a Formal Financial Institution, Female	Account at a Formal Financial Institution, Income bottom 40%
Cambodia	4.4	6.7	3.7	3.7	1.7
Indonesia	9.6	36.5	19.6	19.2	10.3
Malaysia	19.9	52.9	66.2	63.1	50.1
Nepal	8.4	7.5	25.3	21.2	16.0
Papua New Guinea	1.9	8.5	-	-	-
Philippines	8.1	19.3	26.6	33.7	10.4
Sri Lanka	17.5	15.4	68.5	67.2	58.3
Chinese Taipei	22.0	165.0	87.3	88.4	82.4
World	-	-	50.5	46.6	40.7

Source: World Bank Financial Inclusion Database, 2015; World Bank, 2011.

4.2 Usage of Accounts and Savings

The usage of accounts at financial institutions for receiving government payments is high in Chinese Taipei, standing far above the world average. In terms of accounts used to receive wages, Chinese Taipei, Philippines and Malaysia are above the world average. More than 40% and 25% of the population in Chinese Taipei and Malaysia respectively, use accounts to receive their wages compared to the world average of 21%.

In terms of savings at financial institutions, Sri Lanka also stands above the world average besides Chinese Taipei and Malaysia. The proportion of female savers and savers from the bottom 40% income group are also high in these economies. In terms of usage of accounts and savings at formal financial institutions, the current level is very low in Cambodia and Nepal. The low levels of the usage of accounts to receive government payments and wages in these economies may be due to low government payments and small number of wage earners.

Table 2
Usage of Accounts for Payments and Savings

SEACEN Economies	Account Used to Receive Government Payments	Account Used to Receive Remittances	Account Used to Receive Wages	Saved at a Financial Institution in the Past Year, Total	Saved at a Financial Institution in the Past Year, Female	Saved at a Financial Institution in the Past Year, Income Bottom 40%
Cambodia	0.1	1.2	1.1	0.8	0.2	0.2
Indonesia	2.6	6.1	7.7	15.3	15.9	7.8
Malaysia	7.5	9.6	26.3	35.4	30.2	22.3
Nepal	1.2	4.6	3.6	9.9	7.1	6.2
Papua New Guinea	-	-	-	-	-	-
Philippines	5.5	12.2	8.5	14.7	18.0	3.0
Sri Lanka	2.9	5.4	7.4	28.1	26.2	19.0
Chinese Taipei	24.5	12.3	41.8	45.7	47.7	32.9
World	12.9	7.2	20.9	22.4	21.0	15.3

Source: World Bank Financial Inclusion Database, 2015.

4.3 Use of Credit

Credit is one of the vital financial services that can help increase employment and income of the households. In the absence of access to credit from financial institutions, the general public are compelled to borrow from family, friends and other money lenders often at a higher interest rate. In Table 3, it is shown that more than one third of the population still depends on loans from family and friends in Indonesia, Philippines, Cambodia and Nepal while the share of such borrowings are low in Chinese Taipei, Sri Lanka and Malaysia.

The level of credit used from a financial institution by the female population is higher than the world average in all the eight economies covered in this study. Credit used by the bottom 40% income group is higher than the world average for Sri Lanka, Cambodia and Chinese Taipei but lower than the world average in Nepal, Indonesia, Philippines and Malaysia.

Table 3
Loan Facilities

SEACEN Economies	Loan from a Financial Institution in the Past Year, Total	Loan from a Financial Institution in the Past Year, Female	Loan from a Financial Institution in the Past Year, Income Bottom 40%	Loan from Family and Friend in the Past Year, Total	Loan from Family or Friend in the Past Year, Female	Loan from Family and Friend in the Past Year, Income Bottom 40%
Cambodia	19.5	20.1	18.4	38.9	38.5	38.3
Indonesia	8.5	8.2	6.4	42.3	42.6	43.8
Malaysia	11.2	10.3	1.8	19.9	16.8	25.1
Nepal	10.8	9.6	7.8	33.2	30.6	34.0
Papua New Guinea	-	-	-	-	-	-
Philippines	10.5	12.8	5.1	39.0	36.5	43.7
Sri Lanka	17.7	19.4	19.1	12.7	9.0	15.8
Chinese Taipei	9.6	9.2	8.6	6.9	6.6	10.4
World	9.1	8.1	8.3	22.7	21.6	24.0

Source: World Bank Financial Inclusion Database, 2015.

4.4 Use of Electronic Cards

According to the data presented in Table 4, more than one-third of the adult population possess debit and credit cards in Chinese Taipei whereas it is less than 4% and less than 1% in Nepal and Cambodia respectively. The proportion of female population possessing debit and credit cards are greater than for the male population in Chinese Taipei and the Philippines. Except for Chinese Taipei, all the other economies fall below the world average in terms of debit and credit cards possession.

Table 4
Electronic Cards

SEACEN Economies	Debit Card, Total	Debit Card, Female	Debit Card, Income Bottom 40%	Credit Card, Total	Credit Card, Female	Credit Card, Income Bottom 40%
Cambodia	2.9	3.2	1.4	0.1	0.0	0.0
Indonesia	10.5	9.5	3.5	0.5	0.3	0.0
Malaysia	23.1	20.6	6.8	11.9	9.9	2.4
Nepal	3.7	2.0	0.7	0.6	0.0	0.7
Papua New Guinea	-	-	-	-	-	-
Philippines	13.2	16.4	5.2	3.2	4.0	1.0
Sri Lanka	10.0	8.1	5.7	3.5	2.1	2.4
Chinese Taipei	37.0	40.1	26.0	45.9	48.9	34.6
World	30.4	27.9	21.2	14.8	13.4	10.2

Source: World Bank Financial Inclusion Database, 2015.

4.5 Electronic Payment and Mobile Banking

In Chinese Taipei, about 29% of the population use the electronic payment system, which is above the world average (Table 5). The use of electronic payment is comparatively high in Malaysia but very low in Cambodia, Nepal, Sri Lanka, Philippines and Indonesia.

Mobile banking has become popular in the Philippines, Sri Lanka and Malaysia. The use of mobile phone to pay bills is above the world average in these economies while it is low in Nepal, Cambodia and Indonesia.

Data on use of mobile phone to pay bills is not available for Chinese Taipei and Papua New Guinea. However, the dramatic growth in e-money accounts for mobile payments indicates that the mobile banking is rapidly gaining popularity in Papua New Guinea[2].

2. See Papua New Guinea Team Project Paper for details on data.

Table 5
Electronic Payment and Mobile Banking

SEACEN Economies	Electronic Payments Used to Make Payment	Mobile Phone Used to Pay Bills, Total	Mobile Phone Used to Pay Bills, Female	Mobile Phone Used to Pay Bills, Income Bottom 40%
Cambodia	0.5	0.1	0.1	0.0
Indonesia	3.1	0.2	0.3	0.2
Malaysia	12.6	2.4	2.1	0.4
Nepal	0.5	0.3	0.0	0.0
Papua New Guinea	-	-	-	-
Philippines	2.1	2.1	2.5	2.6
Sri Lanka	0.5	2.4	2.1	1.1
Chinese Taipei	29.2	-	-	-
World	14.5	2.0	1.5	1.0

Source: World Bank Financial Inclusion Database, 2015.

4.6 Insurance Penetration

Insurance is another important component of financial services. About 16% of the population have personal health insurance in Malaysia, albeit still below the world average. Such insurance is very low in Indonesia, Nepal, Cambodia, Philippines and Sri Lanka. On the other hand, agriculture insurance purchase is higher than the world average for Cambodia, Sri Lanka and Malaysia but very low for Nepal, Indonesia and Philippines. Data on health insurance and agriculture insurance purchases are not available for Chinese Taipei and Papua New Guinea. However, in the case of Chinese Taipei, it can be inferred that such insurance purchases should be fairly high as there is in place, a well-established credit guarantee and micro insurance system.

Table 6
Insurance Penetration

SEACEN Economies	Personal Health Insurance	Purchased Agriculture Insurance, % Working in Agriculture
Cambodia	2.6	14.3
Indonesia	0.9	0.0
Malaysia	16.4	7.2
Nepal	1.8	2.2
Papua New Guinea	-	-
Philippines	5.5	0.0
Sri Lanka	7.5	8.1
Chinese Taipei	-	-
World	17.1	6.5

Source: World Bank Financial Inclusion Database, 2015.

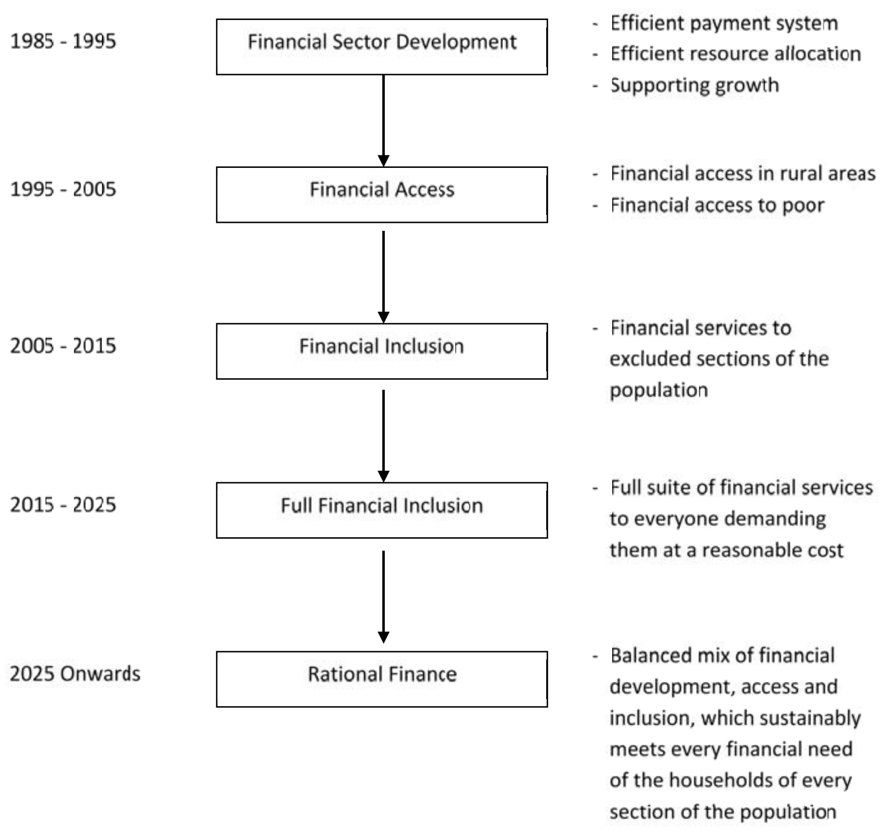
5. Major Issues and Challenges

5.1 Gaps and Shifting Focus of Financial Sector Policies

The focus of financial sector policies has shifted in the last three decades to address the gaps which occurred as a consequence of the implementation of such policies. The development of the financial sector was the main focus of financial sector policies in developing economies during 1980s. The objective then was to establish efficient payment and resource allocation systems to support economic growth. Financial liberalisation policies adopted by these economies led to the removal of entry barriers, deregulation of interest rates and setting up of new institutions, among others. As a result, most developing economies witnessed the mushrooming in the number of banks and financial institutions as well as the initiation of modern banking services. Economic activities were boosted along with the increased efficiency in financial intermediation and resource allocation. However, the banks and financial institutions were concentrated in urban areas. As a result, despite the development of the financial sector, financial access was limited to urban areas and the well-to-do, which exacerbated the gap between the urban and rural population and between the rich and poor.

During the 1990s, financial sector policies in developing economies shifted their focus to increasing financial access. Various plans, programmes and policies were implemented in this regard which produced mixed results. Microfinance institutions were successful in increasing financial access in rural areas in most developing economies but they were often limited to microcredit and not the full suite of financial services. While financial access has increased in terms of bank branches, ATMs and bank accounts, a large segment of the population is still financially excluded. To address this gap, developing economies have started to focus on financial inclusion.

Chart 1
Shifting Focus of Financial Sector Policies



The team project papers in this research project show that financial sector development in terms of the number and types of banks and financial institutions has been achieved in most of the economies covered in this study. Banking services have been modernised and efficient payments systems have been put in place. However, the level of development in the insurance industry and capital markets varies among the economies. In terms of financial access and inclusion, Chinese Taipei and Malaysia have made significant progress and are moving toward full financial inclusion. Financial inclusion focused plans and policies have been implemented in these economies with the setting up of dedicated institutional frameworks. The level of urbanisation, economic advancement and geographical access may have also helped in achieving a higher level of financial inclusion in these two economies. Almost all the financial inclusion indicators of Chinese Taipei are far above the world average while many are above world average in Malaysia's case.

Increasing the level of financial inclusion is a challenging but needed task in economically underdeveloped and geographically challenged economies. The Philippines, Sri Lanka and Indonesia have consolidated their plans, policies and institutions to focus on the achievement of financial inclusion. Papua New Guinea has also implemented focused plans and established a specialised institution for financial inclusion. Cambodia and Nepal seem to be concentrating mainly on increasing financial access although financial inclusion is also in their policy agenda.

5.2 Slower Achievement

Despite the various efforts made to increase financial access and inclusion, the achievement has been slow and insufficient in the majority of the economies covered in this research report. While financial access programmes and policies have been successful in expanding bank branches and financial institutions as well as establishing new microfinance institutions with the number of accounts at formal financial institution to population ratio increasing, a significant number of such accounts are not used for transactions. Moreover, the interest charged on microcredit has often been very high, mainly attributable to the high service costs. As a result, the scenario is such that only the well-to-do in urban areas are able to obtain credit from banks at a lower interest rate while rural poor have to pay very high rates of interest for small loans from microfinance institutions.

The commitment of the government and plans, policies and programmes implemented in the respective economies are commendable. However, despite the efforts, available data show that the progress made in achieving financial inclusion is not encouraging in some of the economies. This indicates that the plans and policies may have been only perfunctory and token in nature. Nonetheless, available indicators show that Chinese Taipei has made significant progress in achieving fuller financial inclusion. Malaysia also seems to be heading towards full financial inclusion. The Philippines, Sri Lanka and Indonesia have transitioned from the financial access phase to the financial inclusion phase. However, Nepal, Papua New Guinea and Cambodia may need to revisit and consolidate their efforts to make further inroads toward financial inclusion.

5.3 Country-specific Challenges

Despite the various efforts made, the progress toward achieving greater financial inclusion has been uneven in the SEACEN economies due to country-specific challenges. In Cambodia, the low level of financial literacy, high rate of interest charged by microfinance institutions, collateral- based lending and presence of shadow banking are major bottlenecks for financial inclusion. In the case of Papua New Guinea, consumer protection, proper regulation of new financial products, high security threats, low population density and high operating costs pose major challenges to financial inclusion.

Similarly, Nepal faces challenges such as high interest rates, duplication in microfinance service, weak coordination among agencies and poor infrastructure. Challenges experienced by Indonesia are a low level of financial literacy, high interest rate on credit and unwillingness of banks and financial institutions to cater for services to excluded segments due to high operating costs. In the Philippines, the archipelagic nature of the country imposes geographical and physical barriers to financial access. There is also a lack of authority with the explicit mandate to lead financial inclusion initiatives.

A challenging geographical structure is the common physical barrier to financial inclusion in Nepal, Papua New Guinea and the Philippines as well as the high interest rate charged by the institutions involved in increasing financial access and inclusion and the low level of financial literacy.

6. Conclusion

Inclusive finance is defined as a state in which all people of working age have access to a full suite of quality financial services, provided at affordable prices, in a convenient manner, and with dignity for the clients. Inclusive finance normally encompasses the access of financial services, at reasonable cost, especially to low-income groups, to people excluded by location or geography. Safe savings, appropriately designed loans for the poor and micro-, small- and medium-sized enterprises, and appropriate insurance and payments services can help people to work their way out of poverty.

Constraints to inclusive finance exist at both the demand and supply sides. Major demand-side constraints include physical access, higher interest rates, documentation, lack of collateral, higher transaction costs, mistrust in financial institutions, etc. Major supply-side constraints are unwillingness of banks to do retail banking, financial viability of micro-finance institutions, real and perceived risk in micro-lending, high operating costs, wider competition and lack of capital.

Evidence suggests that the financial sector, if left alone to the free market, may leave large sections of society out of reach for financial services and heighten inequality by adversely affecting the quality of economic growth. A balanced role that the state plays in the financial market and coordination among regulators are essential for promoting inclusive finance.

All the eight SEACEN economies covered in this study have recognised the need for financial inclusion and are implementing various policies. Indonesia and PNG have formulated national financial inclusion strategies. Cambodia and Malaysia are implementing financial sector development strategies with the incorporation of financial inclusion as an intrinsic portion. The Philippines is planning to draft a National Financial Inclusion Strategy while Nepal is drafting a Financial Sector Development Strategy with financial inclusion incorporated as a separate pillar. In other economies, the policy focus is on financial access, which also addresses financial inclusion issues to some extent.

Most of the banks and financial institutions are involved in financial inclusion activities directly or indirectly in the SEACEN economies. However, microfinance institutions are the major institutions involved in financial inclusion while in some economies, specialised institutions for financial inclusion have been set up.

The experiences of Chinese Taipei and Malaysia show that well-crafted plans, policies and programmes that are persistent with a longer term vision are the basic foundations for achieving higher levels of financial inclusion. Similarly, dedicated institutions which work in a coordinated manner to implement such plans, policies and programmes are crucial. Involvement of dedicated institutions in Chinese Taipei for credit supply, credit guarantee and micro-insurance to farmers, fishermen, aborigines, the physically challenged and families suffering unexpected hardship is one example in this context.

While appropriate measures and models are important in achieving financial inclusion targets, it may not mean that measures that have been effective in some economies will be as successful in others, due to differentiations in, for example, the level of economic advancement and geographical uniqueness. For this reason, financial inclusion plans, policies, institutions, measures and models should be tailored or modified appropriately to suit the specific context and environment. It can also be gleaned from the participating economies that measures targeted to achieve higher financial inclusion may benefit significantly from the use of technology such as mobile phones and other electronic devices or systems.

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Chapter 2

ADVANCING INCLUSIVE FINANCIAL SYSTEM IN THE NEXT DECADE: A PERSPECTIVE FROM CAMBODIA'S BANKING SECTOR

By
Ou Sokpanha[1]

1. Background of Cambodia

1.1 Geographical and Economic Background

Cambodia, known as the Kingdom of Cambodia, is one of the ASEAN member economies located in the southern portion of the Indochina Peninsula in Southeast Asia. Cambodia is described as a unitary parliamentary constitutional monarchy. Cambodia has gone through many historic turns, including French colonisation from 1867 to 1953 and the infamous Khmer Rouge regime, just to name a few, where almost everything was demolished. Cambodia is presently considered as a low income country in which 80% of its total population of 14.8 million is engaged in agricultural sector. The total land mass of the nation is 181,035 square kilometers, which is divided into 25 provinces and municipalities and bordered by Laos, Vietnam, Thailand and the Gulf of Thailand. As at December 2013, Cambodia's GDP was US$15,251 million, while the per capita GDP stood to US$1,043. Cambodia's economy has expanded remarkably over the past few years as reflected by the rapid increase of its GDP as well as its per capita income. However, these increases still remain relatively low compared to other countries in the region. As mentioned earlier, the majority of the Cambodian people are presently engaged in the agricultural sector which is the prioritised sector recognised by the Royal Government of Cambodia. In addition to this, Cambodia's economy has also relied heavily on its tourism industry which earns huge revenues for the nation. Rice, fish, timber, garments and rubber are the major exports.. Unlike many of the ASEAN member economies, Cambodia's economy is cash-based and highly dollarised. Huge amounts of US dollars are being circulated within the banking and financial system as well as within the economy as a whole. Dollarisation has a long history in Cambodia. Although there is no administrative action against the use of US dollars in the economy,

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the relevant regulatory authorities have been trying to contain dollarisation, while promoting the use of the local currency, Khmer Riel (KHR).

1.2 Banking and Financial Development

The National Bank of Cambodia (NBC) was established in 1954, a year after Cambodia's independence as a former French colony and together with the closure of the Indochina Printing Institution. The local banking system was also established thereafter in the country in which privately-owned banks operated alongside state-owned banks under the supervision of the NBC.

The entire banking system as well as the economy were destroyed in early 1975 due to the civil war. It was not until 1979 that the Central Bank was re-established and the banking system was restored from ground zero. From the lack of physical infrastructure to the loss of human resource, Cambodia's banking system regressed far behind its neighboring countries. It was a long and arduous process for the Cambodian government to revive the banking system. The development of Cambodia's banking system in this context is nascent. Before achieving its current status, Cambodia's banking system has gone through many transitional periods, including a shift from a mono-banking system to two-tiered banking system in 1991, bank restructuring in 2000, and new capital requirement scheme in 2008, etc. The reforms have brought about remarkable improvements. The number of banking and financial institutions is increasing gradually over the years, while Cambodia's banking system is integrating into the international financial markets. Although it is challenging for the NBC to maintain financial stability and bring more development to Cambodia's banking system, the performance of the banking institutions as a whole has been satisfactory, and Cambodia's banking system keeps growing in many aspects.

1.3 The Need for Inclusive Financial System

Financial inclusion has become more important and relevant in the current context. Mahendra (2006) defined financial inclusion as the availability of banking services at an affordable rate to the large segment of the vulnerable and low-income groups. According to Khan (2011), financial inclusion, especially when viewed in the context of overall economic inclusion has the ability to improve the financial status and standards of living of the poor and the vulnerable class of the society. In addition, the access to basic financial services will lead to increased economic activities and employment opportunities for the rural households. He also remarked that this has a multiplier effect on the economy that will lead to higher disposable income for the rural households which will in turn result in more savings and a robust deposit base for the banks and other financial institutions. Based on the study by Hariharan and Marktanner (2012), financial inclusion is a huge source of economic growth and development. It is a strong and significant correlate of a country's total factor productivity and, therefore, possesses the ability to create capital. The study also concluded that financial inclusion has the potential to increase the financial sector savings portfolio, the efficiency of financial intermediation, and allows for tapping of new business opportunities.

Among the total population of 14.8 million, there is a huge gap between the people who get access to banking and financial services and those who don't. More importantly, there is also a constraint on public awareness and confidence with regard to the banking and financial sector that makes the majority of the people reluctant to access formal banking and financial services. Therefore, financial inclusion has become one of the significant development policy areas for the Royal Government of Cambodia that is being addressed in the latest "Financial Sector Development Strategy 2011-2020." Inclusive financial system will help the general public, especially the disadvantaged and low-income groups, to equally benefit from the formal banking and financial services at affordable costs that can significantly contribute to the poverty alleviation, as stated in the Rectangular Strategy by the Royal Government of Cambodia. Cambodia's financial inclusion aims at these low-income strata in the rural and hard-to-reach areas who constitute the majority of the population. As recognised by the NBC, rural finance is one of the important ingredients for sustainable economic development. Therefore, widening access to inclusive finance will help in enhancing the economic growth for the whole nation.

1.3.1 Objectives of the Study

Besides discussing the significance, issues and challenges that Cambodia's banking sector faces in promoting an inclusive financial system, this research paper aims to present the available data related to the current situation of banking and financial development, particularly financial inclusion, including the action plans to be implemented for the next decade that will contribute to advancing financial inclusion in Cambodia.

2. Financial Inclusion Policies and Institutions

In Cambodia's banking sector, financial inclusion policies were initiated mainly through the channel of microfinance institutions (MFIs) which first started as projects by non-governmental organisations (NGOs) since the early 1990s. Microfinance plays a very important role as a supplementary banking service in broadening financial access of the rural population. The main activities of these microfinance institutions involve social rehabilitation, health care, and humanitarian assistance related-sector, particularly for disadvantaged and poor people. Many years ago, the MFIs were not able to reach people in the rural and remote areas. Therefore, those poor and low-income people had no choice but to rely entirely on informal sources of finance which were available at considerably high interest rates. A number of constraints contributed to the low level of financial inclusion in the rural and hard-to-reach areas, including lack of physical infrastructure, hard-to-reach areas which pose greater security problems for the MFIs, limited economic activities, lack of income-generating activities and vocational training, lack of financial literacy and business knowledge, unavailable formal loans, high credit risks, and so forth.

The role of the MFIs in economic development is assuming greater significance over the years. To date, the Royal Government as well as the NBC acknowledge microfinance and its stakeholders as having a crucial role in contributing to the alleviation of poverty under the Cambodian Millenium Development goal to halve the proportion of people living below the national poverty line between 1993 and 2015. The development of the microfinance sector and advancement of an inclusive financial system have been addressed by the Royal Government in its financial blueprint since 2001. Once again, the Royal Government of Cambodia has included financial inclusion into its action plan for the Financial Sector Development 2011-2020 under the future reforms of the Microfinance Sector. The development policy areas related to financial inclusion were specifically addressed and divided into 3 phases, notably short-term, medium-term, and long-term. The agencies concerned include the Ministry of Economy and Finance (MEF), NBC and Cambodia's Microfinance Association (CMA). The development policy areas include the expansion of financial inclusion, deepening of financial services, expansion of access to financial products and services to individuals in hard-to-reach-areas (particularly the poor and the hard-core poor), strong consumer protection, MFI consumer protection and financial literacy, and so forth. Although the financial blueprint does not stipulate specific or detailed measures to implement in the action plans, it does provide clear direction and targets for the banking and financial sector to achieve within its timeframe.

Table 1
Financial Inclusion in Future Reforms for Microfinance Sector

Development Policy Area	Short-term Target 2011-2014	Medium-term Target 2014-2017	Long-term Target 2017-2020	Agencies Concerned
Permission for MFIs to expand direct access to savings	Enhance savings mobilisation by MDIs: • Review barriers to savings mobilisation. • Study how to accelerate the establishment of more MDIs consistent with supervisory capacity.	Present the means for promoting savings: • MDIs should be assisted to promote innovative schemes that will enhance savings generation from the general public. • Study ways by which savings-led NGOs can be made strong, safe savings generators.	Extend support to MDIs and other savings organisations: • Continue assisting MDIs and savings-led NGOs.	MEF, NBC, CMA Lead agency: NBC
Increase in Financial Inclusion **Deepening of Financial Services** **Expansion of access to financial products and services to individuals in hard-to-reach-areas (particularly the poor and the most poor)**	Consider ways to encourage people living in hard-to-reach areas to access bank services: • Study the needs for supply and demand of microfinance among the most poor and people in hard to-reach areas. • Based on the above study, identify constraints to reaching these clients and provide recommendations to address these issues through both financial and non-financial services. • Link the strategy to financial education and business development training strategies set forth in the strategy.	Develop programmes or provide incentives that help the poor and individuals in hard to-reach areas access financial services: • Consider fiscal or regulatory incentives for MFIs to expand operations to the most poor and people in hard-to-reach areas. • Design and implement programmes that will promote access to a range of financial services (micro leasing, microcredit, and micro savings) by the most poor to enable them to improve their welfare. • Encourage linkage of microfinance	Expand financial services to the rural poor and individuals in hard-to reach areas: • Track the progress of and scale up services to the poor, people in hard-to-reach areas, and individuals who were formerly excluded from microfinance services.	NBC, CMA Lead agency: NBC

		operations of MFIs to NGOs and local governments in a prudent manner. • Replicate successful pilots in other hard-to-reach areas.		
Strong consumer protection **MFI consumer protection and financial literacy**	• Design a common framework to guide disclosures of loan terms and conditions and other relevant matters that will protect consumers. • Design a programme for promoting financial literacy not only for the present clients of MFIs, but also for the most poor in both urban and rural areas. • Study the issue of over-indebtedness. • Disseminate the results of the study to various stakeholders and map a strategy and a plan to further address the study's findings.	• Implement the guidelines for MFI consumer protection. • Implement the programme for promoting financial literacy.	• Improve the guidelines for consumer protection based on experience and best practices. • Promote offering financial literacy to other sectors.	MEF, NBC, CMA Lead agency: NBC
Reliable and accurate information	• Establish a credit bureau. • With the implementation of risk-based supervision, ensure that data accuracy becomes a key concern of the supervisory processes and that the reports accurately reflect the MFIs' operations and their risk profiles.	• Monitor or control the process of assessing customers' solvency and creditworthiness for decision-making purposes. • Steadily promote the adoption of best accounting and financial disclosure practices with the aim of onverging with the standards applicable to the banking sector.	• Assess the progress achieved and the gaps to be filled and, where applicable, define an appropriate action plan to enhance reliability and accuracy of information and data disclosed and quality of supervisory reports.	MEF, NBC Lead agency: NBC

Redress of grievances	• Establish a mechanism for redress of grievances for MFIs. Consider establishment of a consumer protection agency to receive, follow up, and act on complaints.	• Monitor effectiveness and make necessary improvements in the mechanism for addressing client grievances.	• Strengthen the mechanism for addressing client grievances.	MEF, NBC, CMA Lead agency: MEF

Source: Financial Sector Development Strategy 2011-2020.

2.1 Credit Bureau Company

The launch of a private Credit Bureau company (CBC) back in early 2012 was a very important milestone and a big achievement for the NBC in promoting the quality of lending and transparency, and especially in preventing credit risk resulting from excessive lending to one single borrower by different institutions. Meanwhile, the establishment of CBC also contributes significantly to the enhancement of access to finance, especially for the borrowers in the rural and remote areas. Assuring sound credit worthiness of the borrowers in addition to, or in the absence of, collaterals facilitates the expansion of credit in the banking system. The credit reports help in reducing the transaction costs of processing and assessing loan applications and they can be used by individual borrowers for easy and quick access to credits from the banking and financial institutions, especially for loan applicants who have good credit profiles. According to the Prakas[2] on Credit Reporting, the CBC acts as the intermediary to collect and distribute information to member institutions based on rules of reciprocity. Institutions under the supervision and regulations of the NBC are required to disclose their customer's credit information, with customers' consent, to the CBC and to check customers' credit information at every stage of the loan cycle. By the end of 2013, the CBC's database contained data of 1,920,176 borrowers from 35 commercial banks, 9 specialised banks, 36 microfinance institutions and 2 financial leasing companies.

2.2 Third-Party Processor and Mobile Banking

In year 2010, the NBC issued the Prakas on Third-Party Processors allowing bank to outsource one or more parts of their payment transaction services through

2. Prakas: written legal announcement issued by the National Bank of Cambodia for regulated institutions to follow.

one or more third-party processors, as may be agreed between the bank and those third-party processors, and subject to prior approval from the NBC, in conformity with Article 204 of the Law on Negotiable Instrument and Payment Transactions. The major products and services offered by the third-party processors include balance enquiry, fund transfer, bill payment, mobile phone top up, money transfer within Cambodia, and large-scale payrolls, etc. The majority of these transactions are carried out through mobile phone which is one of the most popular devices among the Cambodian people. Over the past few years, the products and services offered by third-party processors have contributed substantially to increasing the level of access to finance by both city dwellers and even those living in the rural and remote areas of Cambodia. In the meantime, due to the increasing popularity of the Internet and mobile banking, the NBC is in the process of drafting the guideline on mobile banking which will help in strengthening the safety and soundness of the mobile banking operation as well as in expanding access to finance.

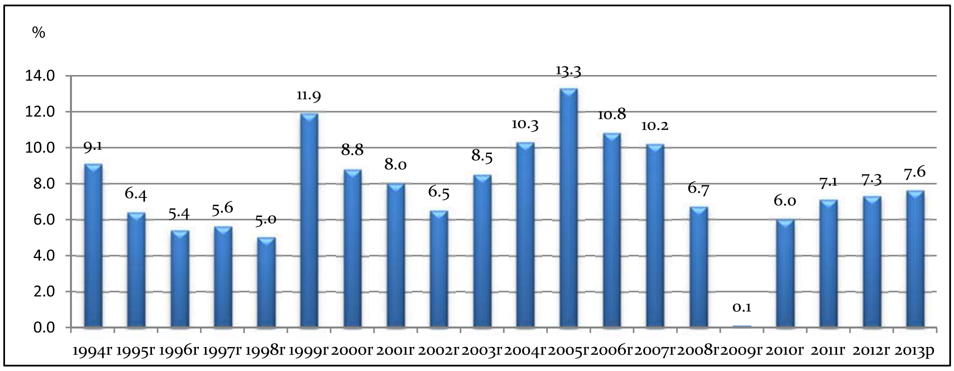
2.3 Cambodia Securities Exchange (CSX)

To take one step further in the implementation of the Financial Sector Development Strategy 2006-2015, the Royal Government of Cambodia decided to establish the Cambodia Securities Exchange (CSX) as a public enterprise with government shareholding of 55% and with the remaining stake held by the Korea Exchange, a well-known securities exchange operator of the Republic of Korea. The CSX was launched on 18th of April 2012 with its mandate aimed at establishing and operating a securities market, a clearing and settlement facility, and a depository, in accordance with the Law on the Issuance and Trading of Non-Government Securities and its subsequent regulations. Currently, the CSX is in the early stage of development, with only one listed company which is the Phnom Penh Water Supply Authority.

3. Current Status of Cambodia's Financial Inclusion

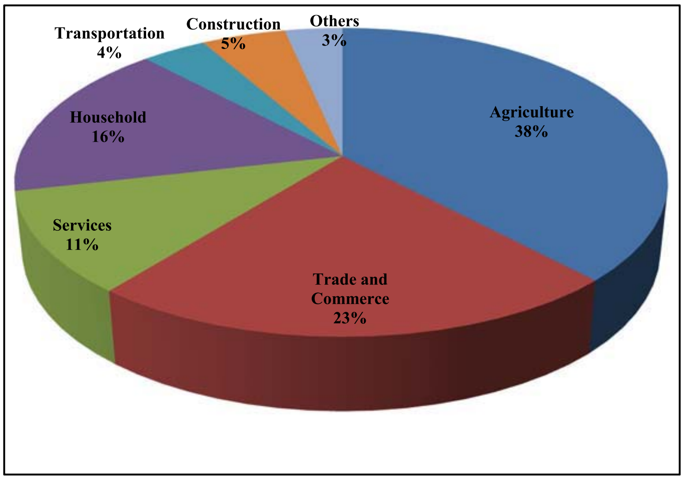
Cambodia's economy has developed gradually over the past 4 years as reflected by the steady growth of real GDP by 7.6% as at December 2013, while the per capita GDP reached US$1,043. Based on the UNDP's data in Cambodia, the rural population accounted for 80% and the majority of the inhabitants are engaged in the agricultural sector. Life expectancy rate at birth was 63.6 and Cambodia's human development index was 0.543, ranking at number 138 as at 2013.

Figure 1
Real GDP Growth



The banking system of Cambodia has witnessed remarkable development. The number of banking and financial institutions has increased significantly during 2013. Three commercial banks and 2 specialised banks were licensed, one of which was upgraded from a microfinance institution. In addition, the NBC issued 2 new licences for MFIs, and 1 for a financial leasing company. As at 2013, Cambodia's banking system consisted of 35 commercial banks, 9 specialised banks, 38 MFIs, of which 7 are microfinance deposit-taking institutions (MDIs), 33 registered microfinance operators, 2 financial leasing companies, and 1 credit bureau company. Total assets, customers' loans and deposits keep growing at a remarkable pace. By the end of 2013, the total assets of the whole banking system were US$12,748.11 million. Customers' loans and deposits grew by 26% and 12%, respectively, compared to the same period of 2012. By December 2013, customers' loans and deposits reached US$7,351.78 million and US$7,560.44 million, respectively. Credits have been extended to different sectors to accommodate the development in the economy. Over the past few years, the credit growth has increased around 30% on a yearly basis. The NBC has been paying close attention over this development, and measures have also been taken in response to this credit expansion in order to maintain the safe and sound performance of the banking system.

Figure 2
Microfinance
Credit Classified by Sectors, December 2013



Credit facilities are extended to many key sectors of the economy, including wholesale trade, retail trade, construction and real estate, manufacturing, other non-financial services, and agriculture. As at December 2013, the banks' lending is largely concentrated on the wholesale trade sector which accounted for 18.1% of the total loan portfolio, while the agricultural sector is the dominant sector for MFIs which constituted for 38% of the total lending. The weighted average lending rate of banks in KHR and US$ is 15.9% and 11.4%, respectively, while deposit rate in KHR and US$ is 5.8% and 4.3%, respectively. The number of depositors and borrowers within the whole banking system has also increased to 2.6 and 1.9 million people, respectively.

Over the years, Cambodia's banking sector has been shifting away from traditional or conventional banking to a modern banking system as a part of its regional and global integration into the world market. To keep pace with the expansion of the banking and financial market as well as market competition in Cambodia, the banking and financial institutions continue to broaden their branch networks and products and services to capture new segments of the market which also means bringing banking products and services to the people. New banking products and services are being developed and launched to serve the need of the public, such as cash management, gold investment account, trade finance, dual currency investment, swap contract, real estate brokerage, internet banking, mobile banking, SMS banking, debit card and credit card. Since 2006, the number of offices has been expanded gradually, especially among MFIs' offices that have been located mostly outside the city in order to reach out to the people living in the rural areas. By December 2013, the total number of offices for both banks and MFIs reached 2,713. This is quite a small number in comparison to the increasing population and demand for banking products and services which indicates a need for more banks and MFIs' offices. The number of ATM terminals has been increased to facilitate cash withdrawal transactions by the customers. Currently, the ATM terminals are still mostly located in the city and downtown neighborhoods. In this regard, there is still a need to broaden the number of ATM terminals, especially in the rural areas. Banking products, such as debit and credit cards are also getting popularity as reflected by the increasing number of cards issued.

Figure 3
Number of Offices & ATM Terminals

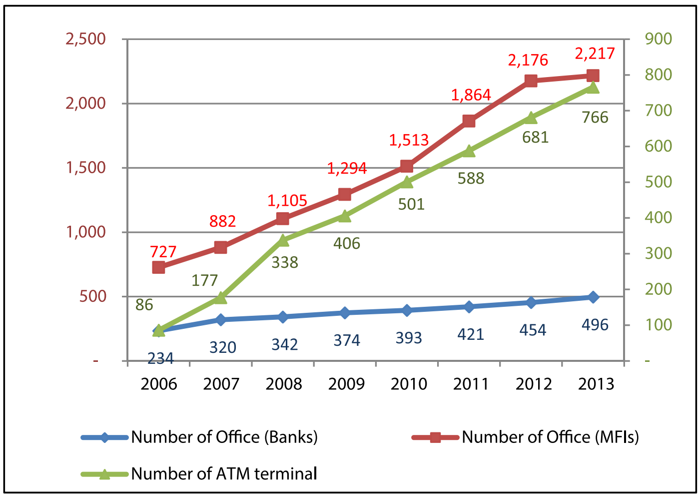
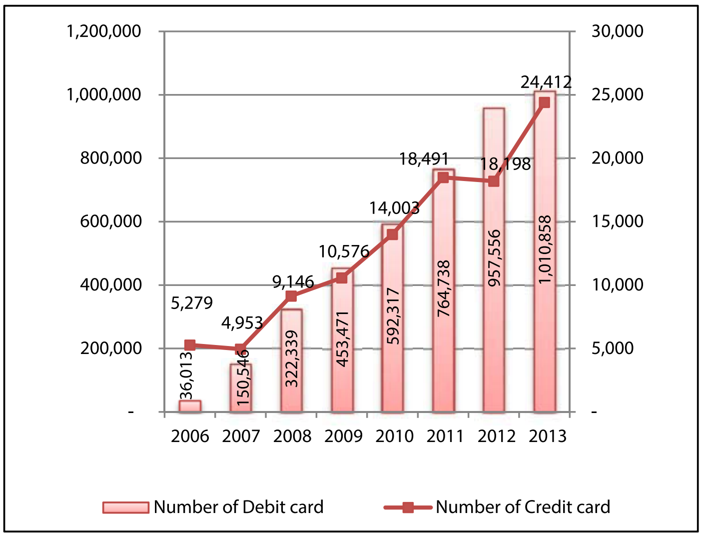


Figure 4
Number of Debit & Credit Cards



By December 2013, credit cards grew by 34.1% compared to the same period in 2012, while debit cards grew by 5.5%. Credit cards are more popular in the city that is crowded with business centers, while debit cards are more frequently used in provinces and rural areas. The use of banking products such as debit and credit cards are still limited owing to the factors, such as lack of financial awareness among consumers as well as lack of information about their usefulness, usage, and security. Cambodia's banking and financial market has been expanding year by year as reflected by the increasing size of capital and assets. Meanwhile, the number of borrowers and depositors also keep increasing steadily. By December 2013, borrowers from banks and MFIs increased by 8.9% and 19.1%, respectively, while banks' and MFIs' depositors also grew by 18.5% and 20.7%, respectively, compared to the same period in 2012. Although the reach of inclusive financial system gets better over time as seen through the increasing number of borrowers and depositors, the on-going efforts in promoting and enhancing financial inclusion are still needed as a large part of the population still lie beyond the ambit of the formal banking and financial system.

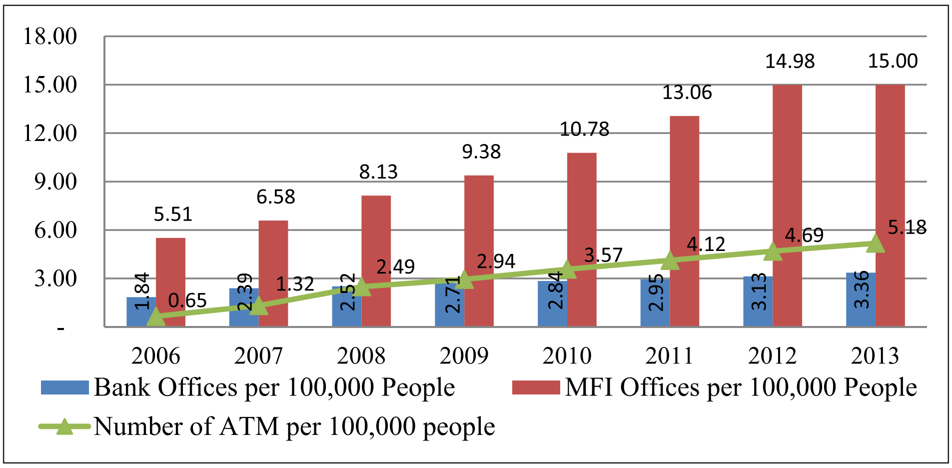
4. Data Presentation and Analysis

Cambodia's banking system is in the early stage of development. Data on banking and financial institutions as well as financial inclusion is very limited.

Data constraint has become one of the big challenges for conducting research study on financial inclusion in Cambodia. In this section, the selected indicators and relevant data are illustrated and analysed so that an overall picture of Cambodia's financial inclusion can be adequately captured and presented.

Overall, Cambodia is moving forward to achieve an inclusive financial system in the long term. By the end of 2013, Cambodia's banking system has expanded to capture more segments of the population. Total loan accounts of both banks and MFIs reached 1.9 million, while deposit accounts stood at 2.6 million. Due to the expansion of the network of banks and MFIs, access to banking and financial services is broadening. As illustrated in Figure 5, from 2006 to 2013, the number of bank offices per 100,000 people increased from 1.8 to 3.4, respectively, while the number of MFI offices also grew from 5.5 to 15.0. In comparison to banks, the MFIs have extended their services on a broader scale and rapidly went beyond the city limits and reach out mostly to the middle classes and poor households who are in need of financial services.[3]

Figure 5
Number of Bank Offices & ATM Terminals per 100,000 People



3. Data on population is calculated by taking base-year census population in 2004, extracted from Cambodia Statistical Yearbook by National Institute of Statistics, multiplying by population growth rate.

The general public have more access to financial services offered by MFIs compared to banks as reflected by the number of loan accounts held by banks which is one fourth the loan account portfolio held by MFIs. In addition, the growth rate of deposit and loan accounts held by MFIs within the last 4 years is also relatively higher compared to banks. Along with the increasing number of loan accounts, the deposit accounts have also been increasing remarkably within the last few years, especially among MFIs since 2007 due to the establishment of Microfinance Deposit Taking Institutions (MDI). To accommodate the demand of the public, the number of ATM terminals, the majority of which are owned by commercial banks, have also increased gradually up to 5.2 units per 100,000 people as at December 2013. The expansion of offices and ATM terminals has contributed largely to the increasing awareness and access to financial services.

The growth rate of credits has also been noticeable for the last several years. By December 2013, the annual growth rate of credits by banks was 25.8%, while MFIs' credits grew by 48.7%. Since 2005, the growth rate of credits for both banks and MFIs is above two digits. It was only in 2009 that the growth rate for both banks and MFIs fell to its lowest point so far at 5.2% and 7.8%, respectively, under the impact of asset price bubble at the time. As the supervisory authority, the NBC introduced two remarkable measures, such as the increase of reserved requirement rate on foreign currency deposits and the adoption of credit ceiling on the real estate sector. Credits as percentage of GDP for both banks and MFIs kept growing gradually that indicated the extent of openness as well as access to banking and financial services by the public, especially the rural populace.

Figure 6
Trend of Credits % of GDP

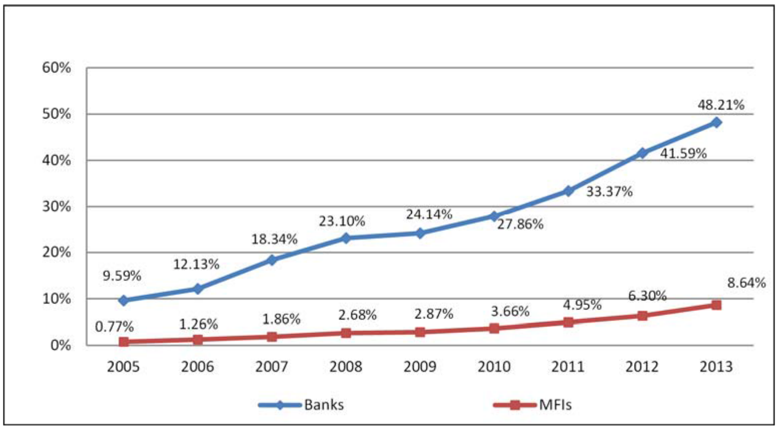
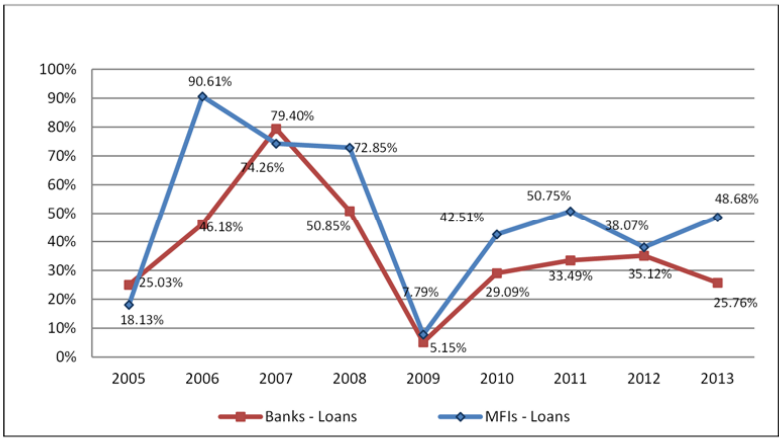


Figure 7
Credit Growth of Banks & MFIs



Credit facilities were extended to many key sectors supporting the growth and development of the economy. For many years, the banks' lending remained concentrated on retail and wholesale trade as well as other commercial sectors, such as manufacturing, construction, hotel and restaurant, and real estate activities, etc. Meanwhile, the agricultural sector which is prioritised by the Royal Government of Cambodia also showed an increasing trend over the years. In parallel with the improvement of the living standard, modern technology, business centres, shopping malls, the demand and supply for housing, personal lending, mortgaged and credit card loans also continued to grow. The credit expansion in these sectors may reflect increasing credit risks. On the other hand, it also reflects increasing access to banking and financial services by the public.

Table 1
Banks' Credit by Industry and Economic Sectors

Millions of US$

	2008	2009	2010	2011	2012	2013
Retail Trade	305.11	461.04	584.62	789.15	925.42	1,109.26
Wholesale Trade	396.46	324.47	571.50	630.11	1,048.65	1,348.44
Hotels and Restaurants	312.81	302.61	317.76	324.90	354.54	462.94
Manufacturing	241.04	220.77	283.71	401.50	552.40	819.67
Other Non-Financial Services	161.41	210.74	323.05	402.18	594.97	752.91
Construction	189.61	216.95	229.62	326.05	446.82	577.37
Personal Lending	143.09	179.63	168.68	216.27	245.84	310.18
Agriculture, Forestry and Fishing	126.51	170.03	218.03	388.56	572.73	723.47
Real Estate Activities	180.70	158.98	151.33	139.84	183.58	250.53
Information Media and Telecommunications	59.90	73.89	87.76	130.72	196.44	117.34
Owner-occupied Housing only	175.50	90.28	117.48	271.40	329.98	398.94
Transport and Storage	33.67	42.18	62.14	67.32	77.55	97.43
Financial Institutions	33.17	34.71	43.72	80.07	134.44	117.59
Utilities	18.77	13.37	17.98	51.67	56.04	47.84
Other Lending	19.92	10.94	40.83	73.55	121.45	197.40
Rental and Operational Leasing Activities	5.95	11.02	24.32	72.64	77.06	86.62
Credit Cards	3.92	4.06	5.80	8.08	9.00	11.86
Mining and Quarrying	1.83	2.60	13.67	3.30	20.93	39.57
Total	**2,409.38**	**2,528.28**	**3,248.34**	**4,377.29**	**5,947.83**	**7,469.37**

Unlike banks, MFI's credits were largely channeled to the agricultural sector, which is one of the top prioritised sectors for the Royal Government of Cambodia, trade and commerce, and household/family. By December 2013, credits to agriculture, trade and commerce, and household accounted for 38%, 23%, and 16%, respectively. As 80% of the total population are engaged in agricultural activities, the increasing injection of credits into this sector helps to enhance the living standard of the rural populace as well as uplift economic welfare as a whole by extending access to financial services. Rural households have become more aware of formal financial products and services offered by the MFIs as indicated by the increase of borrowers and depositors.

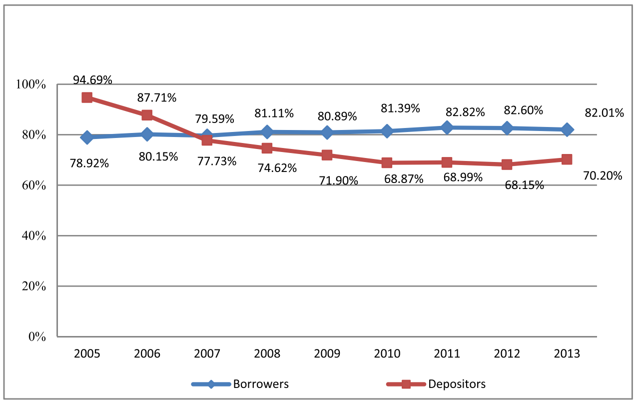
Table 2
MFIs' Credit Classified by Sectors

Millions of US$

	2005	2006	2007	2008	2009	2010	2011	2012	2013
Agriculture	28.49	46.46	69.73	121.36	126.00	180.25	264.09	349.32	500.14
Trade and Commerce	13.32	24.97	50.09	92.33	105.79	122.64	165.08	214.58	300.08
Services	4.12	3.81	10.51	20.57	23.26	40.19	66.52	91.22	140.15
Transportation	1.12	3.49	5.81	11.03	10.67	15.57	18.93	39.55	49.39
Construction	0.34	1.52	2.84	5.00	7.00	10.97	18.19	33.14	64.47
Household/Family	1.35	6.59	12.89	21.39	22.46	45.85	92.27	129.78	218.74
Other Categories	1.02	1.17	2.50	5.36	3.43	10.10	16.47	28.24	44.12
Total	**49.75**	**88.01**	**154.36**	**277.04**	**298.63**	**425.57**	**641.56**	**885.83**	**1,317.08**

Gender plays a very important role in financial inclusion. Notably, the majority of account holders at MFIs are females. By the end of 2013, female borrowers and depositors at MFIs remain at 82% and 70.2%, respectively. In the microfinance sector, women play a very important role in accessing financial services from the MFIs, including borrowing and making deposits. In most cases, the MFIs feel more secure in lending to female borrowers as they are the major income earners among the poor households and are more capable in cash-flow management.

Figure 8
Numbers of MFIs' Female Borrowers & Depositors



Among other key indicators, the interest rate remains crucial for accessing financial inclusion. Due to the absence of the interbank market, the NBC has little influence on the fluctuation of the market's interest rate. At the moment, each banking and financial institution is given discretion to set its own interest rate as appropriate. By December 2013, the bank's interest rate on USD and KHR loans was 11.4% and 15.9%, respectively, while interest rate on a one-year fixed deposit for USD and KHR was 4.3% and 5.8%, respectively. As observed, the spread of the bank's interest rate was relatively high in the past and fluctuated over the course of the years. However, the increase in the number of banks as well as intense competition among the banks pushed down the spread of interest rate over the last few years.

Figure 9
Bank's Interest Rates in USD

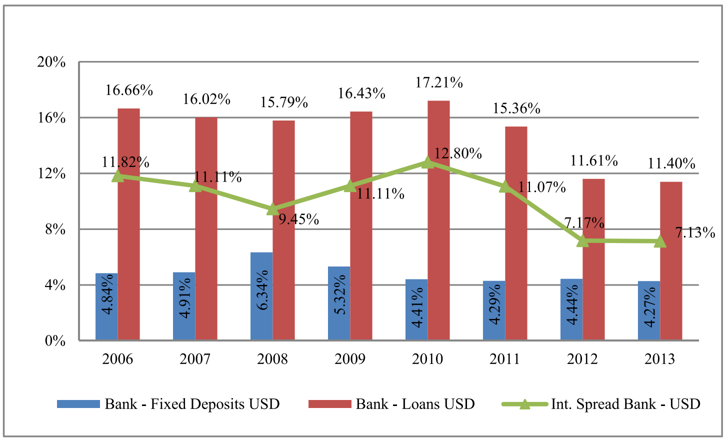
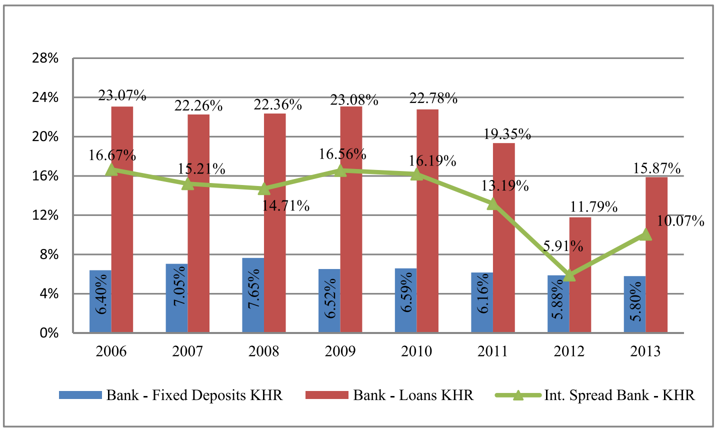


Figure 10
Bank's Interest Rate in KHR



The NBC permitted the establishment of MDIs in 2007. Presently there are 7 institutions, formerly MFIs, which were converted and licensed to operate as MDIs. Therefore, the majority of the MFIs still rely heavily on the contribution from shareholders and borrowed funds from abroad that are usually denominated in foreign currencies and came with a high cost. In addition, the loans offered by the MFIs are normally small in amount. As the result, the MFIs maintain relatively high interest rate on their lending, especially on loans in KHR compared to loans in USD. In most cases, the banks and MFIs will pass on the burden to their clients by increasing the interest rate on loans along with the increase in their cost of funds. By December 2013, MFI's interest rate on loans in USD and KHR remained as high at 28.7% and 36%, respectively. So far, the high interest rate on loans placed a heavy burden on rural borrowing and will eventually impact on access to financial services.

Figure 11
MFI's Interest Rate in USD

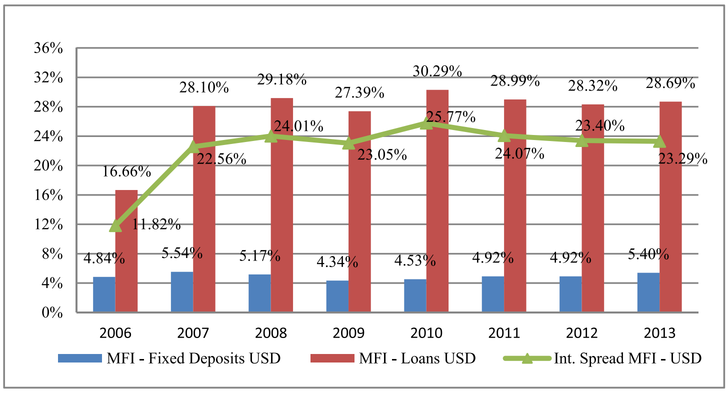
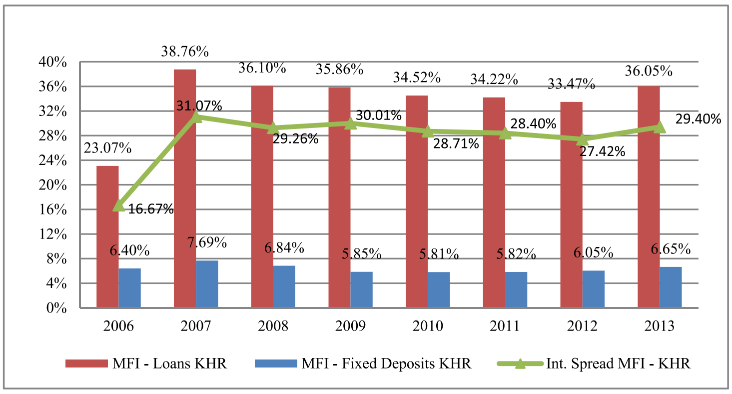


Figure 12
MFI's Interest Rate in KHR



Shadow banking remains one of the big challenges for Cambodia's banking sector in promoting inclusive financial system. Currently, a large part of the population is accessing shadow banking instead of formal financial services offered by the regulated institutions. For years, the shadow banking business remains largely unregulated but popular among the city dwellers and rural populace. Data and information regarding shadow banking is hard to come by and in most cases unavailable. As of now, it is hard to capture the risks of shadow banking and it is also unclear how to measure its impacts on the formal banking system as well as on financial inclusion as the necessary data and information are still missing. However, shadow banking and its risks are now being taken into consideration by the regulatory authorities and soon regulations and measures will be put in place for implementation.

5. Plan for the Next Decade

By complying with the vision and action plan for Financial Sector Development 2011-2020, much has been accomplished by the banking and microfinance sector, and many issues and challenges have been successfully addressed. Cambodia is now in the next phase of achieving its medium-term target (2014-2017) as well as long-term target (2017-2020). In this regard, the other remaining issues and challenges will be addressed and taken into account.

5.1 Major Issues and Challenges

Cambodia faces many challenges that hinder the advancement of an inclusive financial system in the next decade. The constraints, issues and challenges that need to be addressed are lack of financial literacy, high lending rate from MFIs, collateral-based lending, shadow banking, and lack of SME accounting documents. For many years, education remains one of the top priorities for the Royal Government of Cambodia, while raising financial literacy among the people is still a challenge. Owing to the lack of understanding on the use and benefits of banking and financial products, a large part of the population are still reluctant to access formal banking and financial services which limits the development of financial inclusion. Interest rate on loans from MFIs is another constraint to be taken into account. In comparison, MFIs offer much higher interest rate on loans compared to banks due to the reasons that MFIs usually lend micro-loans in local currency (KHR). Therefore, they tend to impose higher interest rate on borrowers owing to high cost of funds and credit risk. The general practice of collateral-based lending is just another issue that prevents many potential borrowers from accessing formal banking services. In lending, banks and MFIs generally will require hard title deed of property, such as land and building, as collaterals. In many cases, this requirement becomes a big challenge for borrowers, especially people living in the rural areas because they usually hold soft title deed over their property which is not acceptable by many banks and MFIs. Shadow banking has spread across the country which put a threat on the safety of the public and soundness of the formal banking system. Many rural borrowers and even retail businessmen in the city have turned to shadow banking for the source of funds that comes with a very high interest rate. Shadow banking induced a very negative impact on financial inclusion as well as many other risks for Cambodia's banking system as a whole. Another challenge for financial inclusion that is often raised by the SMEs is the lack of accounting document. Many SMEs, especially family business, do not practise proper bookkeeping that reflects negatively on their credit standing, which is the second most important requirement after collaterals. This makes it difficult for many SMEs to acquire loans since banks and MFIs cannot appropriately access their repayment capacity in addition to their pledged collaterals.

5.2 Policies and Targets

Development policy and action plans for promoting the development of the microfinance sector as well as advancing inclusive financial system have already been included in the Financial Sector Development Strategy 2011-2020 which was adopted by the Royal Government of Cambodia since 2011. Pursuant to the vision and action plans of the Financial Sector Development Strategy, the policies addressed many key areas, such as strengthening the regulatory and supervisory framework and capacity, expanding services and outreach of MFIs, increasing consumer protection, enhancing operational efficiency, strengthening industry support for MFIs, improving access to credit information, promoting market transparency and disclosure, enhancing institution's management information systems, promoting saving mobilization and, building capacity for competition as well as expanding access to credit. The action plans covered many development policy areas, while their targets to be achieved in the next decade are categorised under medium-term targets (2014-2017) and long-term targets (2017-2020).

5.2.1 Permission for MFIs to Expand Direct Access to Savings

Recognising the role of MFIs in supporting economic development and in promoting the welfare of the rural households, the NBC allowed the establishment of MDIs in the late 2007 through its Prakas on Licensing of Microfinance Deposit Taking Institutions. At the time, MFIs had a strong reliance on external borrowing from abroad in funding their operations. The new Prakas enabled eligible MFIs to become MDIs that allowed them to collect deposits from the public and also to reduce the cost of funds for borrowers. There are 7 MDIs operating alongside with another 36 MFIs and they have contributed substantially to financial inclusion through saving mobilisation. As a result, the volume of MFIs' depositors has recorded remarkable growth. As medium- and long-term targets, the MDIs will be given assistance to promote innovative schemes that will enhance savings generation from the general public, particularly among the poor households and rural populace.

5.2.2 Deepening of Financial Services and Expansion of Access

Financial inclusion can be expanded through deepening of financial services and extension of access to financial products and services to the inhabitants in the hard-to-reach-areas, particularly the poor and the most poor. Over the years, the banks and MFIs have continued expanding their branch networks across the country. More financial products and services, such as mobile banking and financial leasing, have been introduced into the market and are gaining popularity among the users. The number of ATMs keeps soaring over the years along with the number of issued debit and credit cards. For medium-term target, the concerned agencies such as the NBC and CMA, may consider developing programmes or provide incentives to help the poor in the hard-to-reach areas to access financial services. This includes developing fiscal or regulatory incentives for the MFIs to expand operations to the hard-to-reach areas, and designing and implementing programmes that will facilitate the poor to gain access to a range of financial services (micro leasing, micro credit, and micro savings) to improve their welfare. Furthermore, the agencies will encourage linkage of microfinance operations of MFIs with NGOs and local governments in a prudent manner and replicate successful pilots in other hard-to-reach areas. As for the long-term target, financial services will be expanded to the rural poor and individuals in hard-to-reach areas by tracking the progress of and scaling up services to the inhabitants in the hard-to-reach areas, who were formerly excluded from microfinance services.

5.2.3 Strong Consumer Protection and Financial Literacy

Financial education is essential in building financially competent consumers that eventually contributes to the increase in financial inclusion. Financial literacy has been one of the priorities in developing the banking and financial sector. So far, financial education programme has been designed for promoting financial literacy not only for the present clients of banks and MFIs, but also for the most poor in both the urban and rural areas. In this regard, the NBC produced a short documentary film titled “I Love Riel,” which was purposed to enhance the understanding of the general public on the roles and significance of the banking and financial sector as well as promote the use of the local currency. Together with financial literacy, a strong consumer protection framework is very important and essential for the success of financial development. As a part of the consumer protection framework and to promote the credit facilities of banks and financial institutions with transparent, fair, reasonable and responsible manner, the NBC issued Prakas on the Calculation of Interest Rate on Microfinance Loans in 2001 and Prakas on Transparency in Granting Credit Facilities by Banks and Financial Institutions in 2011. In the meantime, the NBC is working toward establishing a guideline for consumer protection. In the medium term, the concerned agencies will design and implement the guideline for consumer protection as well as programme for promoting financial literacy. As for the long-term target, the guideline for consumer protection will be improved based on experience and best practices, while financial literacy to other sectors will be promoted.

5.2.4 Reliable and Accurate Information

The NBC has been paying more attention and effort in the implementation of risk-based supervision ensuring that data accuracy becomes a key concern of the supervisory processes and that the reports accurately reflect the MFI’s operations and their risk profiles. The establishment of a CBC in 2012 was also a significant achievement contributing to the maintenance of reliable and accurate information of borrowers as well as to the prevention of credit risk resulting from the excessive lending to one single borrower by different institutions. In the medium term, the concerned agencies will monitor or control the process of assessing customers’ solvency and creditworthiness for decision-making purposes. Furthermore, they should steadily promote the adoption of best accounting and financial disclosure practices with the aim of converging with the standards applicable to the banking sector. As for the long-term target, the concerned agencies will assess the progress achieved and the gap to be filled and, where applicable, define an appropriate action plan to enhance the reliability and accuracy of information and data disclosed and quality of supervisory reports.

5.2.5 Redress of Grievances

As a part of the consumer protection framework, market conduct supervision is very crucial and is being taken into consideration. In the meantime, the legal and institutional framework regarding market conduct supervision is being discussed by the relevant agencies. The mechanism for redress of grievances and consumer protection agency will be established to receive, follow up and act on complaints. For the medium-term target, the concerned agencies will monitor the effectiveness of and make necessary improvements to the mechanism for addressing client grievances, while the said mechanism will continue to be strengthened as a long-term target.

6. Conclusion

This paper aims to present all the available data related to the current situation of financial inclusion and also the action plans that will contribute to the advancement of financial inclusion in Cambodia for the next decade. As seen, many important indicators for assessment of financial inclusion are still missing which do not allow for further in-depth analysis or empirical studies. However, this paper pieces together, from the available data, an overall picture of financial inclusion as well as the progress achieved thus far by Cambodia in the development of an inclusive financial system. Advancing financial inclusion is not an easy task that can be accomplished within a short time frame. It requires sound action plans together with the cooperation from the concerned ministries or agencies. Fortunately, the Royal Government of Cambodia has already put in place its "Financial Sector Development Strategy 2011-2020" which is an important blueprint for the implementation of future reform nationwide. This strategic plan covers largely the banking and non-banking financial sector and includes the enhancement of inclusive financial system. Many policy areas have been identified and targeted for development. The concerned agencies have also been assigned their functional responsibilities, including the NBC, MEF, CMA and SEC of Cambodia. Therefore, cooperation among the relevant agencies and effective implementation of the action plans will assure the success of the development strategy.

So far, Cambodia's banking system has achieved many major milestones and is progressing toward becoming a fully-developed banking system. In this regard, the expansion of financial inclusion is very much needed and it plays a crucial role in contributing to the future success of the banking system in Cambodia. Inclusive financial system will enable the low-income Cambodians living in rural and hard-to-reach areas to get equal benefit from formal banking and financial services at affordable costs. It will substantially contribute to the alleviation of poverty as well as to economic growth of the nation as a whole.

Through the implementation of development policy areas on financial inclusion as stated in Financial Sector Development Strategy 2011-2020, Cambodia has largely accomplished its short-term targets, while moving forward to achieving the medium and long-term targets in the next decade. The banking system has expanded both in scope and scale. Meanwhile, the number of depositors and borrowers keep growing phenomenally, while public confidence toward the banking system continues to grow over the years. However, many challenges remain that need to be addressed in advancing inclusive financial system, including the lack of financial literacy and high interest rate from MFIs, collateral-based lending, shadow banking, and lack of SME accounting documents.

Cambodia is in the process of accomplishing not only the medium-term targets, but is also moving forward to achieving the long-term targets by 2020 having set the development policies and targets. From deepening of financial services to promoting strong consumer protection, the policies and targets aim in promoting inclusive financial system that will benefit all the stakeholders. Besides, there are also initiatives to overcome the challenges by the concerned agencies. For example, “The Law on Secured Transactions” is being discussed among the major government agencies. This initiative is crucial as it will enable the SMEs that have no proper accounting documents to have better access to formal loan services offered by the banks and financial institutions. Cambodia is moving forward in the right direction in promoting inclusive financial system. With the continued cooperation among the various concerned agencies coupled with the progress gained thus far, the prospects for Cambodia of advancing inclusive financial system in the next decade is bright.

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Chapter 3

STRATEGY OF FINANCIAL INCLUSION: THE CASE OF INDONESIA

By
Woro Widyaningrum[1]

1. Background

Indonesia is a country in Southeast Asia and Oceania, an archipelago comprising approximately 17,508 islands. It encompasses 33 provinces and 1 Special Administrative Region (governed by a pre-colonial monarchy) with over 238 million people, making it the world's fourth most populous country. According to the 2010 national census, the population of Indonesia is 237.6 million, with high population growth at 1.9%. 58% of the population live in Java, the world's most populous island.

Indonesia's republican form of government comprises an elected legislature and president. The nation's capital city is Jakarta. Indonesia is a founding member of ASEAN and a member of the G-20 major economies.

In the year 2013, which was not exactly easy, the inflation rate was recorded at 8.38% (yoy) to the end of 2013. The pressure from the global and domestic sources contributed to the performance of the 2013 economy. First, global financial market uncertainty increased with the negative sentiment towards the reduction of the monetary stimulus plan, e.g., tapering off in the U.S. The second shock was the pressure on the balance of payments (BoP) in 2013. The surplus on the capital and financial account declined. In addition, the exchange rate in 2013 also continued to depreciate with increased volatility. The weakening of the rupiah was in line with the weakening of currencies in countries in the region.

In Q4 2013, the BoP improved and sustained decline in the current account deficit diminished. By 2014, the BoP is expected to improve with the decline in the current account deficit. The trade balance on Q1 2014 recorded a surplus. Inflation in 2014 and 2015 is expected to be controlled in the range of 4.5 ± 1% and 4.0 ± 1%, respectively. The current condition indicates that the stability of the economy is back under control.

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The financial system in Indonesia is dominated by banks. Of the total formal financial assets in Indonesia, banks manage about 79%. In addition, there exist a variety of Micro Finance Institutions (MFIs), of which 45% are saving and loans cooperatives and 33% are unregulated informal MFIs, including deposit-taking entities.

Based on a World Bank survey to determine the level of financial literacy in Indonesia, it was found that “only” 20% of the adults have access to formal financial institution, while comparing to other ASEAN countries such as the Philippines 27%, Malaysia 66%, Thailand 73%, and Singapore 98%. A total of 15% of the Indonesian population have savings in formal financial institutions in the past year, as many as 9% of the Indonesian population borrowed loans from formal financial institutions in the past year, and as many as 42% of the Indonesian population borrowed from family or owed friends in the past year.

Based on a survey of BI, 99.9% of all businesses in Indonesia are classified into micro, small and medium enterprises (SMEs), while 60-70% of the 51.3 million micro, small and medium enterprises (SMEs) in Indonesia are not connected with banking services.

Until now, a sizeable majority of the population, especially the poor and vulnerable, have no access to financial services. This is due to limited availability and accessibility of financial services. The dimension of “access” then becomes a fundamental issue, that is, financial exclusion precludes people from the opportunities of managing income fluctuations, mitigating risks and investing in health, education and income generating activities.

Therefore, designing and promoting an inclusive financial system means contributing to remove the causes of inequality and directly influencing the processes and mechanisms that prevent segments of the population from fully participating in the economy. The economic literature recognises that among the main causes of poverty and vulnerability is the lack of access to various forms of capital: physical, natural, human, social and financial. Thus, a financial inclusion strategy cannot represent an isolated initiative.

2. Financial Inclusion Policies and Institution

2.1 Financial Inclusion Policies

2.1.1 National Strategy of Financial Inclusion (NSFI)

The Financial Inclusion Programme (FIP) is an effort to encourage the financial system to be accessible to all levels of society in order to encourage quality economic growth and overcome poverty. The background of the FIP was initiated by surveys from the various stakeholders, such as the World Bank and Bank Indonesia (BI), which identified a low level of public accessibility to formal financial institutions Indonesia.

The national strategy of financial inclusion was announced by the Vice President of Republic Indonesia in June 2012. This strategy which is designed to focus on people or individuals, is aimed at broadening access to financial services for all segments of the population and unlocking financial and small business opportunities. The strategy aims to address all layers of the population, but with a clear understanding that different layers have different social and financial needs.

Definition

In the NSFI, inclusive finance is defined as:

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

The definition and the strategy more generally represents a mutually reinforcing link between three key concepts: poverty reduction, financial stability and economic growth. The first component of poverty reduction is achieved by promoting a graduated process of substantial segments of the population from the "low-income poor" to the "non-poor" category, as well as paying attention to the special needs categories like domestic and international migrant workers and people living in the remote areas. The second component of financial stability is achieved through the promotion of an enabling regulatory environment and consumer protection practices. The last component of economic growth is achieved through the promotion of initiatives aimed at fostering and empowering local economic development.

Vision

The national vision of financial inclusion is formulated as follows:

To achieve a financial system that is accessible by all layers of the community to promote economic growth, poverty reduction and income equality in Indonesia.

Objectives

The vision of financial inclusion is translated into several objectives as follows:

Objective 1 : Make financial inclusion part of the grand strategy of economic development and poverty reduction. Financial Inclusion is ultimately a strategy aimed at achieving broader economic development goals, in this case poverty reduction and improvement of public welfare. A poor and marginalized group is also a group that has limited access to financial services. Financial inclusion goals is to provide access to the wider financial services for each resident, but there is a need to give greater focus to the poor.

Objective 2 : Provide financial services and products tailored to the needs of the community. The provision of financial services and products must be tailored to the specific needs of different segments of the population.

Objective 3 : Improve people's knowledge of financial services. A large proportion of the community, particulary the poor and marginalized groups, have limited knowledge regarding financial services and products. This remains one of the major obstacle faced in achieving financial inclusion. This knowledge is important so that people feel more secure interacting with financial institutions.

Objective 4 : Improve people's access to financial services. Barriers to the poor accessing financial services are generally due to, among others, geographical isolation and legal obstacles. Overcoming these barriers will create a fundamental breakthrough in simplifying access to financial services. Such improvement in access, however, needs to be done without compromising the principles of stability and prudent banking.

Objective 5 : Strengthen the synergies between banks, microfinance institutions, and non-bank financial institutions. In order to fill the gap of the underserved consumers, the synergy between the banks, MFIs and non-bank financial institutions becomes crucial and should be encouraged.

Objective 6 : Optimize the role of information and communication technology (ICT) to expand the scope of financial services. Technology can reduce transaction costs and extend beyond mere formal financial system of savings and credit services. However, clear guidelines and rules need to be set to balance the expansion of coverage and risk.

Target Groups

The Financial Inclusion Strategy (FIS) gives prominence to the concept of providing financial services based on the different needs of specific categories of the population. While the financial inclusion strategy covers all segments of the population, it explicitly targets those groups with the greatest need or unmet demand for financial services. Therefore, it is particularly important to understand the different segments of the population, making sure that all key segments are taken into consideration.

The strategy distinguishes three segments of population (low-income poor, working poor and near-poor) and three cross-cutting categories (migrant workers, women and people living in remote areas). These categories are consistent with those used by Central of Statistics (CBS). Figure 1 below describes the different features distinguishing low-income poor, working poor and near-poor, based on their financial capacity and in relation to each of the main financial services considered in the strategy.

Figure 1
Characteristics of Targeted Groups

Financial capacity /Target	Low-income poor	Working poor	Near-poor
Ability to Save	No ability to save at all or just very small amounts but with no access to any saving services	Have ability to save part of the income generated through their activities. Saving mostly informally	Some ability to save with access to formal banks
Access to credit	Not able to repay	Access to informal credit. Able to repay with non-traditional collateral	Some access to both formal and informal sources. Able to repay with collateral
Need for insurance	Highly exposed to personal and community-level shocks	Have some buffers but still might be heavily affected by shocks	Have wider range of instruments to cope with risk
Money transfer needs	Receiving remittances from MW family members	Need for remittances as well as possibility of transfer money through mobile devices	May need to operate bank transfers, bill payments etc.
Financial literacy	None	Moderate	Moderate
Financial identity	None	Limited	Limited

Low-lncome Poor: This category includes all those with very limited or no access to any type of financial service. This category refers to the extremely poor who receive social assistance, as well as those segments of the poor who are part of community empowerment programmes. In terms of financial capacities, the low-income poor belonging to this category, usually have little or no capacity to save and have no access to any saving services. Finally, they often lack basic financial literacy and rarely have any form of financial identity.

The Working Poor: This category includes the self-employed poor, which consists of small and marginal farmers, fishermen, artisans and craftsmen, petty traders and micro entrepreneurs in the urban and rural informal sector. The lack of resources restricts their ability to expand production or undertake improvements in productivity and/or income. More specifically, in terms of financial capacity, the poor belonging to this category have the ability to save part of their income that they generate, but do so mostly through informal means. This group usually has a moderate level of financial literacy but often lack any sort of financial identity number.

Near-poor: This is a residual category, including all those who do not meet the definitions of low-income or working poor. The near-poor category consists of those people who have the ability to accumulate substantial savings and have access to formal banks. In terms of credit, they have access to both formal and informal sources and are generally able to meet their repayment obligations. They have a good level of financial literacy and possess financial identity linked to their bank accounts.

2.2 Financial Inclusion Institutions

Building an inclusive financial system, requires effort from all the relevant stakeholders, but in particular from policymakers and regulators. The key role of financial inclusion for poverty allevation, economic growth and financial stability requires clear leadership and ownership of the issue by the policymakers. It is therefore crucial that the government assigns to specific institutions the explicit role of leading and coordinating each relevant initiative in an effort to accomplish the national mission of extending financial inclusion. The institutions engaged in the formulation and implementation of financial inclusion policies and programmes are shown in Figure 2.

Figure 2
Institutions with Financial Inclusion Programme

Several ministries host programmes that directly relate to the financial inclusion strategy. This includes the Ministry of National Education and the Ministry of Religious Affairs, who are obvious counterparts to BI for the financial education initiative. The Ministry of Manpower and Transmigration manages initiatives related to migrants workers. The Ministry of Communication and Information is the relevant ministry for initiatives related to ICT. The Ministry of State-owned Enterprise (SOE) manages the state-owned enterprises (SOEs) and issues the requirement for SOEs to allocate part of their profit for social activities.

The Financial Service Authority (FSA) oversees non-bank financial institutions (insurance, capital market). Under the joint decree, the FSA also oversees venture capital entities.

The Ministry of Cooperatives and Small and Medium Enterprises' main role is to supervise and develop cooperatives and SMEs, including issuing the relevant policies. The joint decree mandates the ministry to oversee the financial sector cooperatives.

The Ministry of Home Affairs manages the National Programme for Community Empowerment (PNPM), of which one component is the establishment of microfinance institutions at the local level. Under the joint decree, this ministry is responsible for overseeing the MFIs that are legal entities as village-owned enterprise.

The Coordinating Ministry of Economic Affairs manages the Credit for People's Enterprise (KUR) Programme. The Ministry of Social Affairs is the host for the government's conditional cash transfer (PKH).

3. Current Status of Financial Inclusion

3.1 Financial Inclusion Programmes

In order to improve access to finance, BI has implemented its financial inclusion policy. The objective is to achieve economic welfare through poverty reduction, distribution of income and financial system stability in Indonesia. The programmes that have been implemented consist of:

3.1.1 TabunganKu and other Basic Savings Account (BSA)

TabunganKu and BSA are some of the saving bank products with no administration fee (no-frills account). Its objective is to encourage the availability and utilisation of TabunganKu and other BSA held by banks.

The effort to encourage increasing the number of accounts and nominal TabunganKu and BSA are:

- Evoking banks to submit plans and progress of Hari RaBu (Saving Day), TabunganKu, student accounts, and other BSA achievement.
- Improving and adjusting the feature of TabunganKu with TabunganKu working group.
- Monitoring the progress report of TabunganKu and BSA of all commercial banks.
- Developing online reporting system which connect with Commercial Bank Head Office Report.
- Coordination with ministries and banks in order to use TabunganKu and BSA for the distribution of government assistance programmes (G-to-P).

3.1.2 Expand the Implementation of Financial Education

The educational programmes aim to raise awareness of financial planning and improved knowledge about the products and services of formal financial institutions, contribute towards the achievement of the objectives of the NSFI. The target of these programmes are students (elementary school, junior high school, high school and college students), Indonesian Workers, and certain groups, such as traders and domestic workers.

Some related programmes aiming at the common objectives are:

- Provide educational material about financial management and Digital Financial Services (DFS) for college students; guidebooks for elementary school and junior high school teachers; Indonesian Workers' module; and training modules for certain groups of society, namely the fishermen/farmers/communities in the border areas.
- Educational programmes for students.
- Banking and entrepreneurship education for specific community.
- Training for the Trainers for college students and lecturers at the Faculty of Economics.

3.1.3 Campaign of TabunganKu

This campaign is a joint effort carried out by BI, the banking industry and related stakeholders to conduct financial education for the public.

3.1.4 Digital Financial Services (DFS)

DFS is the provision of some mix of financial and payment services that are delivered and managed using mobile or web technologies and a network of agents. With increasing financial access, it is expected to improve the ability of the household economy and local economy and will have a positive impact on the national economy and the financial system stability. BI has published its regulation on DFS as one of BI's efforts to improve financial inclusion in Indonesia. Furthermore, BI will issue a Circular Letter on DFS to provide the guidelines for the implementation of DFS.

3.1.5 Government Aid Programmes (PKH)

In order to improve financial access for the community and at the same time support the National Movement of Non-cash (GNNT), BI has developed the DFS.

To boost efficiency while providing a positive value for the economy, the DFS programme is synergised with government aid distribution, as has been done in various countries. Through this synergy, the social assistance payments are no longer paid in cash, but are channeled through electronic money (U-Nik) and can be taken anytime, anywhere via a DFS Agent.

The model of the distribution of conditional cash transfers, PKH of cash-based to non-cash-based approach, is a new model to Indonesia, so a pilot project is required for this activity. After the implementation of the pilot project, there will be a review on the concept of the DFS as an alternative distribution channel in order to improve access and expand the range of financial services to the entire community.

3.1.6 Providing Information For Fishermen and Farmers

The programme aims to reduce asymmetric information for producers, especially farmers and fishermen as well as improve the bargaining position of farmers and fishermen. It also provides information regarding the development of agricultural and fishery commodity prices.

3.1.7 Financial Identity Number (FIN)

The purpose of this activity is to provide comprehensive information on individual financial data, and to minimise the occurrence of asymmetric information from financial institutions.

3.2 Financial Inclusion Indicators

It is important to identify and single out those key variables will become the key performance indicators (KPIs) by which the effectiveness of the strategy itself is measured.

There are three dimensions that can be used to measure the level of financial inclusion in Indonesia, namely:

1) Access, the availability of financial services institutions: number of bank offices, and number of ATMs compared to the adult population.
2) Usage, the real use of financial products and services: number of account ownership compared to the adult population, nominal value of deposits and nominal value of loan compared to the national income (GDP).
3) Quality, the quality of financial services products that suit the needs of clients: i.e., level of financial literacy and level of customer satisfaction.

At the current stage, many of the indicators (particularly those referring to “quality”) are extremely difficult to measure. They will require the collection of data that are not currently available. At the same time, this strategy is forward-looking; therefore, the proposed set of KPIs includes some immediately implementable measures, as well as some more sophisticated measurements. In doing so, it provides a frame of reference for the measurement of the financial inclusion initiatives in line with international best practices.

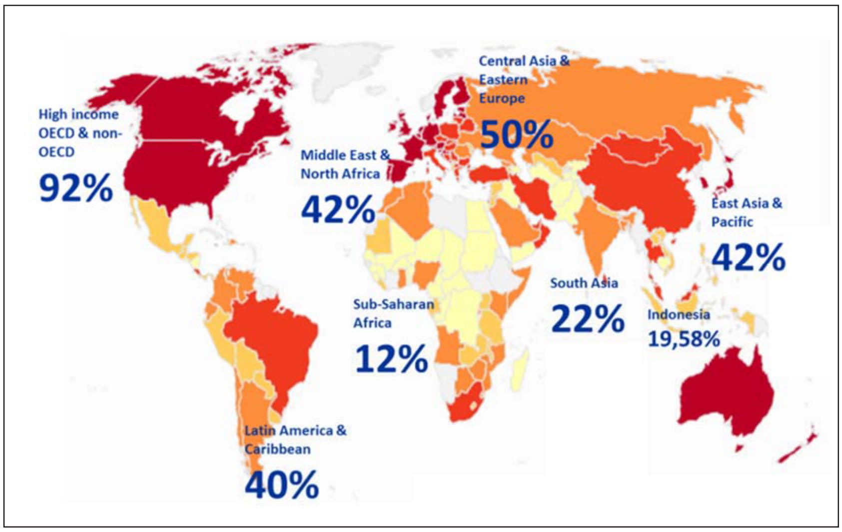
Based on the data availability, which comes from the bank statement, we can calculate the dimensions of access and usage. However, international best practice requires usage to be measured from demand-side survey. Meanwhile, quality dimensions are obtained from the survey results of which the frequency is relatively limited.

The inclusive financial indicators are measured on two dimensions of access and usage dimensions. Access dimensions can be seen from the level of access, namely the number of bank offices and ATM services. Usage dimension is reflected in the use of financial services, namely the number of deposits account.

3.3 Global Financial Inclusion Index

Recognising the need for better data to support the financial inclusion agenda, the World Bank’s Development Research Group has initiated the Global Financial Inclusion (Global Findex) database. Covering a range of topics, the database can be used to track financial inclusion policies globally and develop a deeper and more nuanced understanding of how people around the world save, borrow, make payments, and manage risk.

Figure 3
Adults with an Account at a Formal Financial Institution (in %)



Source: Worldbank, Global Financial Inclusion Index, 2011.

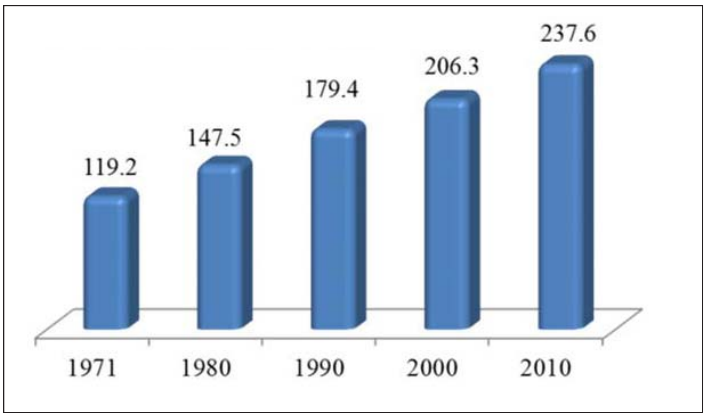
Based on the Global Financial Inclusion (Global Findex), Indonesia still occupies a low rating on the Global Findex, in comparson with its region, South Asia and other regions as shown as Figure 3. The number of adults maintaining accounts with formal financial institutions in Indonesia is only 19.6%.

4. Data Presentation and Analysis

4.1 Indonesian Population and Economy

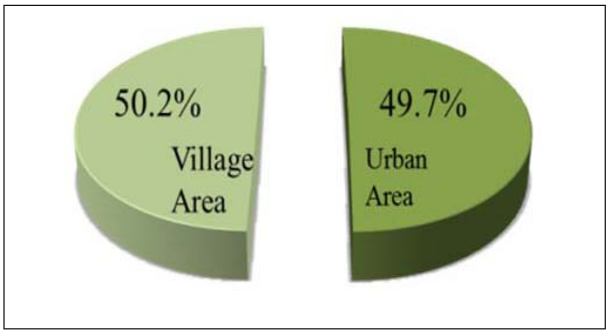
Based on the census of 2010, the population of Indonesia has reached 237.56 million inhabitants, with a composition of 119.5 million men and 118 million women. With high population growth, the demand for financial products and services are expected to increase as well.

Chart 1
Indonesia Population Growth



However, the composition of the Indonesian population distribution is still unbalanced. The majority of Indonesia's population is concentrated in the western region of the Indonesian islands of Java and Sumatra by 58% to 21%. Meanwhile, the proportion of people who live in the eastern region of Indonesia is still very small, for example, Papua occupied only by 3% of the total population of Indonesia. Another fact indicates that urbanisation is causing the population living in the urban areas to increase rapidly. In 1990, the percentage of the urban population reached 31% of the entire population of Indonesia. In 2000, it reached 42% and it is estimated that, by 2025, the state will see a reversal with 57% of the population living in urban areas, and the remaining 43% in the rural areas.

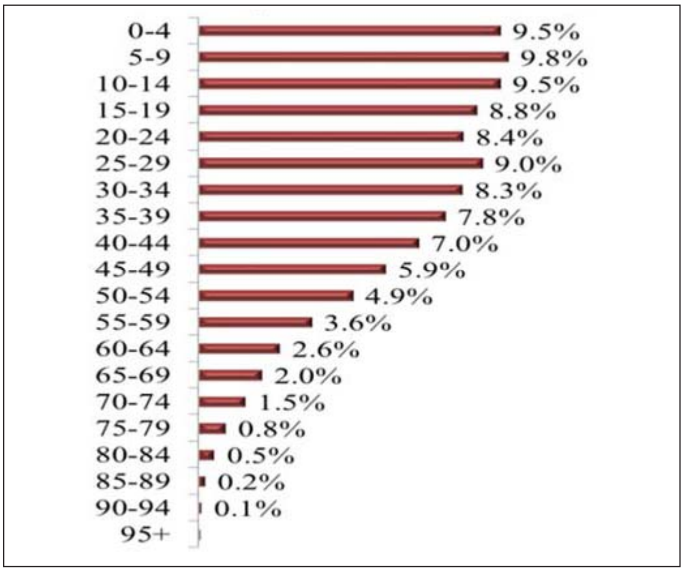
Chart 2
Indonesia Population Growth Based on Area



Source: Based on year of national census.

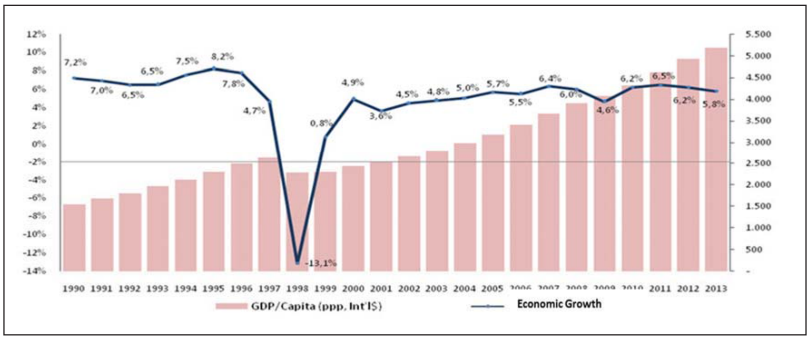
Based on the 2010 census, by composition of the population, the number of people who are in the productive age (15-54 years) reached 60% or 142.54 million people. This segment represents a huge potential for the financial service institutions to offer financial products and services which suit their needs.

Chart 3
Indonesia's Population Growth Based on Age



Source: Statistics Indonesia.

Graph 1
Economic Growth and Income per Capita (1990-2013)



Historically, Indonesia's economic growth from 1990 to 1996 ranged between 6% to 8%, with the highest growth in 1995 which amounted to 8.2%.

Source : Statistics Indonesia – Social Economic Indicator (2013) and IMF-World Economic Outlook Database (Oct, 2013).

However, the impact of the financial crisis in Asia has led to a multi-dimensional crisis in Indonesia, where the economic growth began to slow in 1997, with even negative growth of minus 13.1% in 1998.

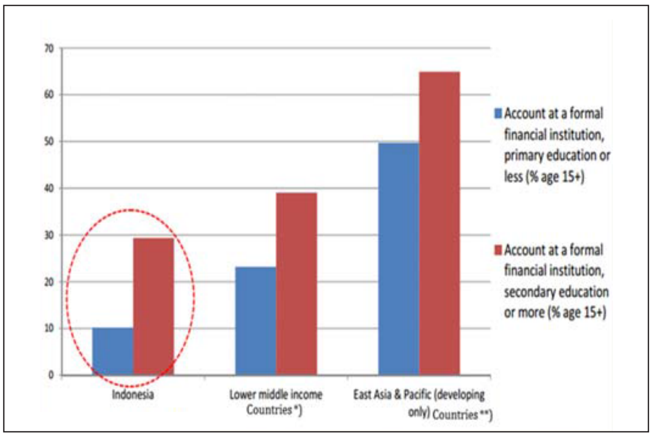
Indonesia's GDP growth cannot be separated from the important role and contribution of the financial services sector of Indonesia, through financial intermediation. However, despite the fact that the financial services sector as a whole has made significant contributions to the economy, that role is still not optimal. It's intermediary function may still be increased especially for the SMEs.

Figure 4
Financial Industry in Indonesia

No.	Role of Industry	Amount	% from PDB
1	Credit Disbursement	U$243,88 billion	35.5
2	Market Capitalization Of Capital Stock	U$343,92 billion	50.1
3	Corporate bond issuance	U$14,93 billion	2.2
4	Distribution of financing by financial institution	U$25,17 billion	3.7

Higher level of education means higher awareness of how to use financial products. Since the population are constrained by the lack of knowledge and awareness of using financial products, financial literacy becomes important and can only be acquired through financial education, which includes customer protection.

Graph 2
Access to Finance by Level of Education (in %)



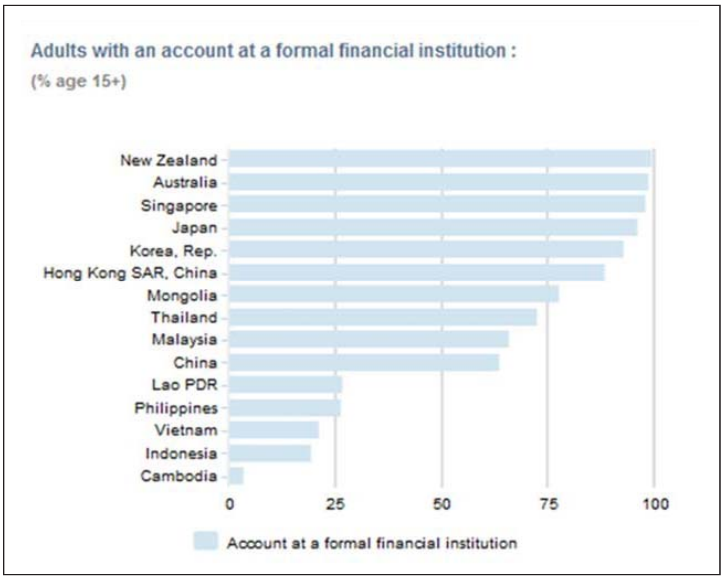
Source: World Bank, 2011.

Financial education is a primary factor affecting the demand side for formal savings, loans and insurance. Compared with the East Asia & Pacific countries, the level of education in Indonesia is still low (Graph 2).

4.2 High Financial Exclusion

Based on the World Bank survey, the Global Financial Inclusion Index 2011 shows that in Indonesia, the adult population having accounts in formal financial institutions are still low as compared with other East and Pacific region countries (Graph 3).

Graph 3
Adults Having Accounts in Formal Financial Institutions (East Asia and Pacific Region)

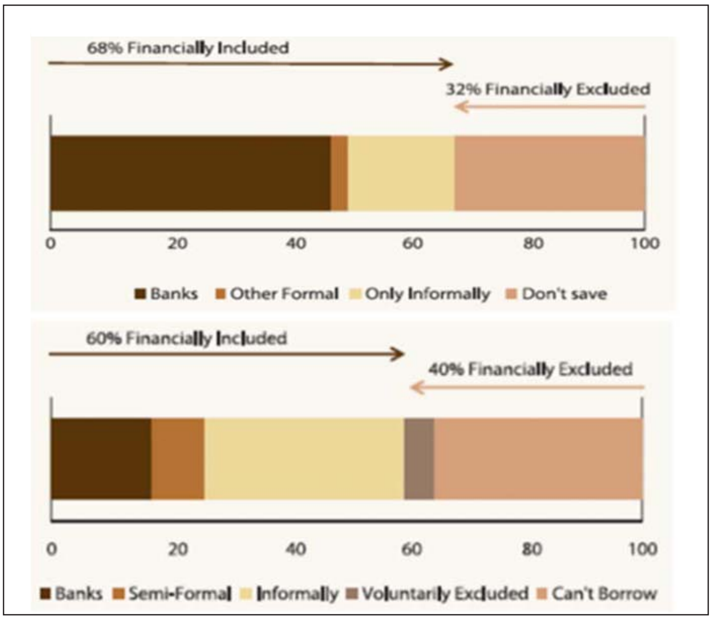


Source: World Bank, Global Financial Inclusion Index - 2011.

As shown in Graph 4, approximately two-thirds of the population has savings in a formal and/or informal institution. As much as 50% of deposits can be found in formal savings accounts. The majority are in banks (a small number are in cooperatives and MFIs). The remaining 18% have savings in schemes such as arisan (informal social saving), savings club, or a revolving fund group.

Furthermore, in Indonesia, the use of loans is lower than those of savings. It is predominantly from informal sources. As much as 60% of the population have access to loans. Access to loans is more commonly obtained from informal sources, such as from friends, families, neighbours, employers, and including 'loan sharks.' Bank credit only covers 17% of the population, while the microfinance institutions account for only 10%.

Graph 4
Savers' and Borrowers' Financial Inclusion (Indonesia)



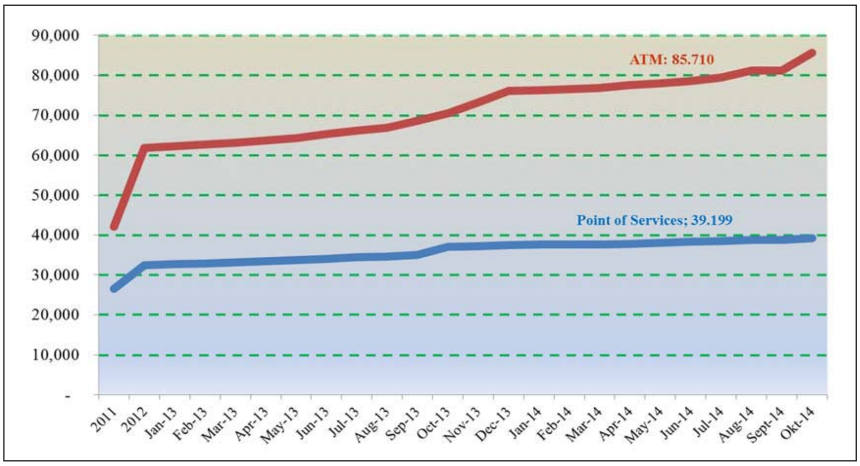
Source: Improving Acces to Financial Services in Indonesia, World Bank, 2010.

4.3 Financial Inclusion Indicators in Indonesia

Access dimension can be shown through total of point of services and ATMs. The number of bank offices and ATMs increased every year. The number of bank offices in October 2014 reached 39,199 offices, and 85,710 ATMs (Graph 5).

Based on survey, the Eastern Indonesian region mostly have limited access to banking services. Meanwhile, the islands of Java and Bali have excessive access to banking services. The entire island in Indonesia should have equal access to banking services to promote increased economic cooperation among the regions. Therefore, the banking system in Indonesia is to be more inclusive.

Graph 5
Total Point of Services and ATMs



4.3.1 Usage

Chart 4: Deposit Accounts Chart

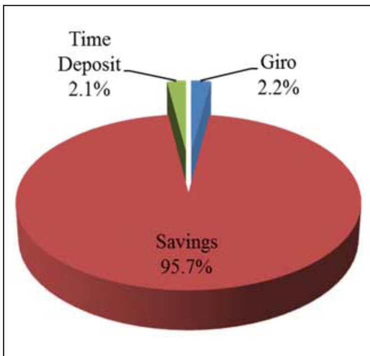
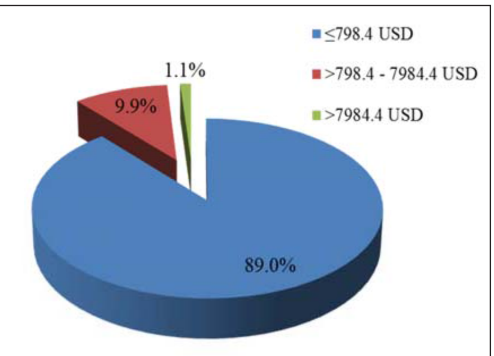


Chart 5: Composition Savings by Savings Balance



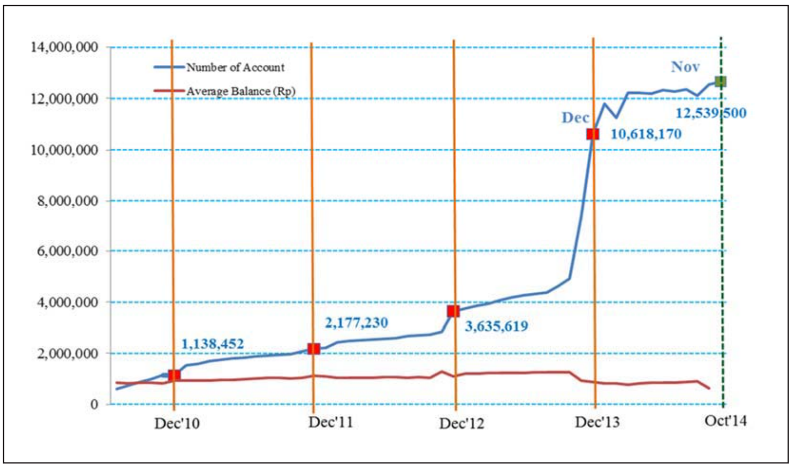
Source: Bank Reports (analyzed).

Savings accounts still dominate total deposits at 95.7% in October 2014. The use of products and financial services commensurate with the level of public awareness of the financial services institutions (Chart 4).

From the various types of financial products and services provided by the financial institutions, savings is still a financial product which is most widely used by the community. BI in conjunction with the commercial banks and rural banks have introduced the TabunganKu which is suitable for the low-income strata and students and they are exempted the administration fee.

In October 2014, the number of TabunganKu (as basic saving account) reached 12.5 million accounts (Graph 7).

Graph 7
Growth of TabungKu and Average Balance



Source: Bank Reports (analyzed).

5. Plan for the Next Decade

5.1 Issues and Challenges

1. *The financial sector faces problems related to assymetric information.* Two classical problems are adverse selection and moral hazard. Adverse selection occurs when a financial service provider cannot distinguish whether the prospective customer is a high- or low-risk customer. Moral hazard occurs when a financial service provider cannot monitor the behaviour of the prospective customer after the credit is granted. These problems makes the financial service provider, especially banks, mandate strict requirements before proving credit. Consequently, many segments of the population, especially those from poorer groups or small entrepreneurs, are unable to meet the administrative requirements.

2. *For most large financial institutions, dealing with many small scale customers is not very profitable.*
   There is a fixed costs for every transaction that must be borne by financial institution, including small scale transactions. The high cost per transaction

often leads to reluctance on the part of the financial institutions to deal with a large number of small size loans or other small transactions, creating a disincentive for the financial service provider to serve this segment of the market.

3. *The design and type of service do not fit the requirements of specific groups of the population.*
   At the micro level, an obstacle to financial inclusion occurs when the design of a certain product or service is not suitable for people with low income. For example, in a savings product, the administrative cost of the savings for some members of the poor community client will be hard to bear. Even more, the cost cannot be covered from the interest they earn.

4. *The lack of enabling regulatory environment for the provision of innovative financial services represents another crucial barrier to be addressed.*
   In order to provide services that can match the needs of the poor communities, innovation is often a key factor, but often the regulatory environment is not supportive enough to allow for such innovations to be tested and implemented. This has a negative consequence for the promotion of access to finance.

5. *Demand-side barriers can include the lack of formal identification system, low levels of financial literacy, inability to track an individual's financial history and the absence of appropriate consumer protection mechanism.*
   Each of the above mentioned barriers needs to be properly addressed with specific interventions that are part of a clear and comprehensive financial inclusion strategy aimed at shielding the most vulnerable from unexpected shocks, while providing them with a wider range of development opportunities.

6. *For the low-income groups, dealing with the financial institutions is generally seen as a difficult process.*
   A formal institution requires client to provide documentation, for example, when applying for credit. Debtors need to submit credit proposal with a plan showing the source of repayment and use of loan funds. The problem is that a large number of people, especially those engaged in micro business, are not able to produce such financial report.

7. *Banks are often geared to more prosperous clients, discouraging lower socio-economic groups form applying for banking services.*
   Poor communities are generally more comfortable if served by a bank in an ordinary service office with a traditional appearance. In addition, people also tend to be more comfortable if served by a bank officer whom they know, or at least view as coming from the same social class.

8. *There is a significant need for fast, low cost and safe products for the transfer of funds.*
   There are approximately 6 million Indonesia migrant workers abroad and an even greater number of internal migrants who earn money that they remit home. New banking services in the form of electronic translation facilities, such as bill payment, and transfer facilities through ATMs, internet and mobile banking (mobile money) provide part of the solution.

9. *For some consumers, their socio-cultural background may make it difficult to ask for financial services.*
   Some community members may find it difficult to ask for financial services because of their faith or other socio-cultural characteristics. For example, some Muslims believe that the interest rate used in conventional banks amounts to usury and is against their faith. For this group, sharia-based financial services is an appropriate solution.

10. *Challenge in Financial Education*
    a. Financial education is an on-going process that requires a strong commitment among the parties.
    b. Another challenge is shifting the paradigm from "education is just a charity programme" to "education is part of business." This means that financial institutions must include financial educational programmes in running their business.

5.2 National Strategy of Financial Inclusion (NSFI)

5.2.1 Pillars of Financial Inclusion Strategy

The general framework of financial inclusion is built on six pillars as follows:

Pillar 1 Education. The aim is to increase the knowledge and awareness of the public about the products and financial services that exist in the formal financial markets, consumer protection aspects and understanding of risk management.

The ultimate intention of financial education for financial inclusion is to support behavioural change and awareness in selection of the proper financial products. Awareness of the products available within a country is an important prerequisite for financial inclusion.

A vigorous and continuous campaign of saving especially among young people and children is needed. This will create a younger generation who are better equipped with good financial management. Furthermore, to optimise the result of the financial educational programme, the said programme should be supported by the availability of formal financial services in the area. Where there is no financial institution branch in the area, appointing agents of financial institution can be a solution.

The most important thing that should be addressed in financial educational programmes is the coordination and collaboration among the institutions.

There are several programmes under the financial educational strategy:

1. Education and National Campaign of Financial Literacy
   a. Increase awareness, knowledge and skills of the public regarding financial products and services.
   b. Changing the mindset and financial behaviour of the community.
   c. Increasing the number of users of financial products and services.

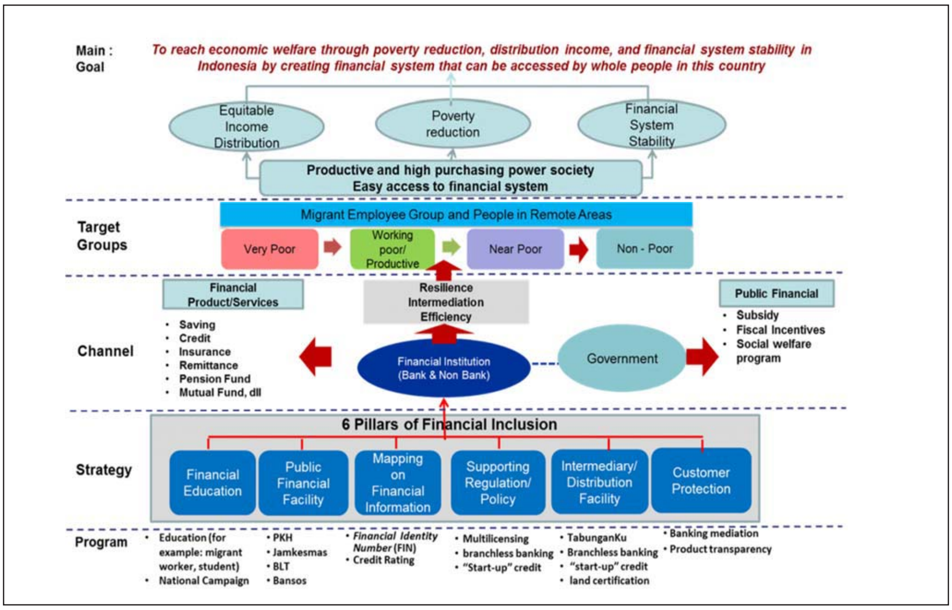
2. Strenghten Infrastructure of Financial Literacy
   a. Strengthen and support national education and financial literacy campaign
   b. Expand and facilitate access to financial literacy information
   c. Ensure the sustainability of financial literacy programme

3. Financial Product and Services Development
   a. Encourage financial institutions to develop financial products and services in accordance with the needs of the community
   b. Encourage financial institutions to improve the quality of financial products and services
   c. Encourage financial institutions to expand the coverage area of financial services

Pillar 2 Public Finance Facility. This strategy under this pillar refers to the ability and the role of the government in the provision of public financing either directly or conditionally to encourage economic empowerment. Several initiatives in this pillar include: (a) subsidies and social assistance; (b) empowerment; and (c) empowerment of SMEs.

Pillar 3 Mapping Financial Information. It aims to increase the capacity of the communities, especially genuine applicants which do not deserve to be considered unviable or unbankable by normal financial institutions, mainly the productive poor and micro businesses. The initiatives undertaken in this pillar include: (a) an increase in capacity (through the provision of training and technical assistance); (b) an alternative security system (more simple, but still consider the associated risks); (c) the provision of simplified credit services; and (d) the identification of potential customers.

Figure 4
National Strategy of Financial Inclusion



Pillar 4 Supportive Policy/Regulations. The implementation of financial inlcusion programmes requires policy support by the government and BI to increase access to financial services. The initiatives to support this pillar include: (a) policies to encourage dissemination of financial services products that suit the needs of the community; (b) designing product schemes that suit the needs of society; (c) encouraging changes in the provisions with regard to the adjustment of the precautionary principle; (d) formulation of regulatory mechanism for channeling funds through banking; (e) strengthening the legal foundation to improve the protection of consumers of financial services; and (f) preparing studies related to financial inclusion to determine the direction of policy on an on-going basis.

Pillar 5 Intermediation Facilities and Distribution Channels. It aims to raise awareness of the existence of financial institutions in the community potential segment and expand the range of financial services by utilising alternative distribution methods. Some aspects of this pillar include: (a) provision of forum to bring together the intermediation of financial institutions with productive community groups (viable and unbanked) to overcome the problems of asymmetric information; (b) increasing cooperation among the financial institutions to increase the scale of the business; and (c) exploration of various possible products, services and innovative distribution channels while paying attention to the precautionary principle.

Pillar 6 Consumer Protection. It is intended to allow people to have a sense of security in their interaction with financial institutions in utilising the products and services offered by financial services. The components that are in this pillar include: (a) the transparency of the product; (b) the handling of customer complaints; (c) mediation; and (d) consumer education.

5.2.2 Target of Financial Inclusion

To measure the progress of financial inclusion and identify the obstacles in the implementation of financial inclusion programmes, we need to set the targets for financial inclusion.

Regarding this topic, BI has quick-win programmes as follows:

1. Establishing the National Coordination Forum of Financial Inclusion (NCFFI) and legal document to gain commitment.
2. Setting up target for financial inclusion

3. Initiating targets for references in setting up the NFSI.
   For example: BI's target for each pillar of NSFI.

Pillar 1:

1. In 2015, implementation of education: training-the-trainer programme in every provinces, at least 2 times a year.
2. In 2015, campaign and socialisation of Digital Financial Services (DFS)/ financial management (campaign through media in 32 provinces, talk show).

Pillar 2:

1. Increase G-to-P payment through electronic money and DFS, especially PKH. In 2019, 50% of PKH disbursemnets through e-money or DFS.

PKH is a social protection programme that provides conditional cash assistance to very poor households (RTSM). This programme, in the short term, aims to reduce the financial burdens of RTSM and, in the long term, is expected to break the chain inter-generational poverty so that the next generation can escape the poverty trap. PKH implementation also supports the efforts to meet the Millennium Development Goals (MDGs). Five MDG goals that are helped by the PKH are: (1) reduction of poverty and hunger; (2) basic education; (3) gender equality; (4) reduction of infant and under-five mortality; and (5) reduction of maternal mortality.

2. In 2015, extensification of G-to-P to other provinces.

Pillar 3 :

In 2015, Pilot Project of Financial Identity Number and Information Systems for Fishermen and Farmers in 2 provinces.

Pillar 4 :

Providing several regulations in 2015:

1. Payment Instrument & Non-cash Transaction for e-commerce activity: a requirement for any website e-commerce provider to provide e-money account for the transaction.

2. Standardisation of e-money server-based (i.e., transaction performance, data and information security, confidentiality, role identification and monitoring, authentication, and access control).

3. Extension of DFS Provider

4. Support simplified CDD in DFS and G-to-P

Pillar 5:

1. Increasing number of DFS agent (+10.000 agents in 2015).

2. Increasing percentage of adults that have accounts in financial institutions
   In 2015, 25% of adults have accounts in financial institutions
   In 2019: 30% of adults have accounts in financial institutions
   In 2024: 40-50% of adults have accounts in financial institutions

3. In 2015, increasing the values of digital payment (retail payment) 2.4 x GDP

4. In 2015, number of customers acquired by DFS agents 500,000 persons

Pillar 6:

1. In 2015, customer satisfaction on payment system products reach 4.75 (scale 1-6) of Survey

2. Increasing percentage of facilitating dispute on payment system product.

5. Conclusion

In going forward, the implementation of the NSFI requires the close cooperation of several institutions. It also requires that some functions be put in places that will facilitate in the implementation.

a. The synergy between banks, MFIs, NBFIs and non-financial institutions (such as communities or associations) should be strengthened.

Non-banking financial institution and non-financial institutions can be directed to be “windows” for the banking sector to reach smaller and more remotely located consumers who are not yet included in the financial sector. For the MFIs, the first important step in making them a “window” for a commercial bank is to provide a legal basis for their operations. The existence of a legal basis for MFIs will provide them with the authority to explicitly carry out various financial services and activities, while at the same time guaranteeing adequate protection of their clients. Ideally, the legal basis for MFIs is the existence of a Law concerning Micro Finance Institutions.

b. Communication and information technology should be supported to further expand the coverage of financial services.

Through technology, consumers can carry out "banking" without ever stepping into a bank. This convenience can be a great incentive for consumers to have a bank account. In addition, business can also make payment transactions.

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Chapter 4

ADVANCING INCLUSIVE FINANCIAL SYSTEM IN THE NEXT DECADE IN MALAYSIA

By
Zarina Abd. Rahman
and
Wan Mohammad Zainuddin Mohammad Zaini[1]

1. Introduction

In 2009, the Malaysian Government introduced the New Economic Model (NEM) which outlines the direction for transforming Malaysia into a high income economy, supported by sustainable growth. Inclusiveness, alongside high income and sustainability, is one of the key desired outcomes of this vision. The participation of the bottom 40% of households based on income stratification in the overall economic and financial sector growth is seen as key to achieving economic prosperity as well as maintaining social cohesion. Although absolute poverty has largely been eradicated in the 57 years since the Independence of Malaysia in 1957, a significant portion of Malaysian households continue to earn less than RM18,000 (US$5,625) annually – significantly lower than the desired annual income goal of RM48,000 (US$15,000) by 2020.

Malaysia acknowledges that an inclusive financial system plays an important part in ensuring sustainable long-term economic growth. Evidence shows the strong positive correlation between the level of financial inclusion and the stage of development of an economy, whereby a higher degree of financial inclusion will contribute to overall economic development[2]. An inclusive financial system provides the more disadvantaged segments of society with access to quality essential financial services and the means to accumulate wealth through savings. It also promotes broader access to financing for investment in economic activities,

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1. Authors are respectively Manager and Analyst of Development Finance and Enterprise, Bank Negara Malaysia.
2. Demirguc-Kunt, A.; T. Beck and P. Honohan, (2008), "Finance for All? Policies and Pitfalls in Expanding Access," Washington, D.C.: The World Bank.

thus creating opportunities for the poor to improve their standard of living. Studies using controlled randomised approaches prove that financial inclusion, especially when designed appropriately, improves the welfare of the poor[3].

2. Supporting Framework for Financial Inclusion in Malaysia

Malaysia's financial sector development policies have facilitated the nation's balanced growth through the realisation of the social and economic benefits of financial inclusion. This includes deliberate measures taken to complement market-oriented development in enhancing and expanding financial services for the broader community and economic sector as well as strengthening the financial infrastructure and institutions to enhance and create an inclusive financial system. Some of the key initiatives are discussed below.

2.1 Strengthened Legal Mandate and Accountability

The Central Bank of Malaysia Act 2009 (CBA 2009) was enacted in July 2009 to replace the Central Bank of Malaysia Act 1958. The CBA 2009 explicitly states that a primary function of Bank Negara Malaysia (BNM, the Central Bank of Malaysia) is to develop and promote an inclusive financial system. Supported by a clear mandate, BNM has been the leading agency responsible for the policies and initiatives aimed at promoting financial inclusion in Malaysia.

2.2 Creating Diverse Institutions to Meet the Needs of the Underserved

Malaysia has created a facilitative business environment that supports the creation of a diverse range of institutions to thrive and compete. In 2006, commercial banks were encouraged to play a key role in expanding access to financing for micro enterprises through the *Pembiayaan Mikro* framework[4]. The framework provided an important platform for the provision of sustainable microfinancing by financial institutions (FIs). Under this framework, micro-enterprises could access uncollateralised business financing in a fast, easy and convenient manner. FIs that participate in *Pembiayaan Mikro* benefit through a shared branding including a common microfinance logo, advertising and promotional platform for their microfinance products. Currently, there are 10

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3. Bauchet, M.; T. Starita and A. Yalouris, (2011) "Latest Findings from Randomized Evaluations of Microfinance," CGAP Access to Finance Forum, No. 2., December 2011.

4. The framework was established following the results of the *2005 Census of Establishments and Enterprises* by the Department of Statistics Malaysia. The Census highlighted that only 13% of micro-enterprises obtained financing from formal FIs.

participating financial institutions (PFIs) providing sustainable micro financing under this framework, with more than 2,400 access points nationwide[5]. The products under this scheme offer financing of up to RM50,000 (US$15,236) with a median approval and disbursement time of 5 working days. Business financing provided by the financial institutions under this scheme is augmented by the Micro Enterprise Fund (MEF) that provides funds at favourable rates for FIs to on-lend to micro-enterprises. The Fund allows the FIs to manage the cost which would have otherwise been high due to the small financing size. Through the MEF, commercial incentives are maintained to drive the provision of microfinancing in a sustainable way. As at end-2013, outstanding micro financing of the PFIs stood at RM857.0 million (US$267.8 million) involving 68,360 micro financing accounts. Supportive financial infrastructures such as credit bureaus have also allowed the commercial banking institutions (BIs) to thrive with differentiated strategies based on their strengths to deliver a broader range of products and services to meet the diverse needs of consumers and businesses.

BNM has also encouraged the growth of Islamic banks in parallel with conventional banks to ensure that all segments of society are served. Islamic financing products and services provide financing options which are aligned with the principles and economic requirements of the underserved. The Islamic banking sector has recorded a significant growth over the last decade and currently accounts for 25.7% of total banking assets[6].

At the same time, development finance institutions (DFIs), cooperatives and micro finance institutions (MFIs) also have an important role in serving niche groups of customers in Malaysia. With a wide distribution of networks across the nation including the rural areas, DFIs and cooperatives complement the other financial institutions[7] in providing businesses and consumers with alternative sources of accessing financial services. There are more than 10,000 cooperatives nationwide with financing disbursed amounting to RM25.2 billion (US$7.9 billion) in 2013. Of this amount, RM20.10 billion (US$6.13 billion) were approved by the two co-operative banks in Malaysia[8].

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5. These financial institutions adopt various sustainable business models such as a mass market model which leverages on existing branches, dedicated micro-finance branches, co-operative model and partnership with strategic distributors.

6. Bank Negara Malaysia, (2013), “Malaysia as an International Islamic Financial Center,” Financial Stability and Payment Systems Report.

7. Bank Negara Malaysia, (2007), Financial Stability and Payment Systems Report.

8. Bank Kerjasama Rakyat Malaysia Berhad (Bank Rakyat) and Koperasi Bank Persatuan Malaysia Berhad.

In addition, MFIs such as Amanah Ikhtiar Malaysia (AIM) and TEKUN were established to further the micro finance agenda. AIM is a private trust that was established in 1987 with the objective of assisting the hard core poor to come out of the poverty trap. This is done through the provision of micro financing for various income generating activities through its 123 branches nationwide[9]. AIM adopts the Grameen Bank model where financing is given to groups of borrowers, primarily women. These types of financing do not require collateral or guarantors, and the recovery of the impaired debt involves engagements with self-help groups without necessary recourse through legal action[10]. As at end-2013, AIM has more than 404,000 micro financing accounts with loans outstanding of RM1.5 billion (US$0.47 billion). Similarly, TEKUN provides micro financing especially to the rural communities for income generating activities as well as to support entrepreneurs, mainly in agriculture and agricultural-based sectors. Established in 1994, it now has loans outstanding totaling RM1.7 billion (US$0.53 billion) as at end-2013. AIM provides financing up to RM20,000 (US$6,095) with tenures of up to 150 weeks, while TEKUN provide financing up to RM100,000 (US$30,473) with tenures of up to 10 years. As at end-2013, these MFIs have cumulatively approved RM12.7 billion (US$3.9 billion) in loans to 3.1 million micro entrepreneurs.

The Credit Guarantee Corporation (CGC) is another key institutional arrangement facilitating greater access to financing by the small- and medium-enterprises (SMEs). By providing credit guarantees to business loans, CGC addresses the issue of lack of collaterals, which is one of the main constraints faced by small businesses. Since its inception up to end-2013, the Corporation has guaranteed RM50.3 billion (US$15.7 billion) in financing involving 417,149 accounts.

2.3 Enhancing Oversight Arrangements for Non-banks

The Development Finance Institution Act (DFIA), enacted in 2002, gives BNM the oversight responsibility to ensure the six DFIs perform their mandated roles in an effective and prudent manner, supported by strong corporate governance and sound financial and business practices. In particular, the National Savings Bank (Bank Simpanan Nasional, BSN) was mandated to mobilise savings in the underserved areas and promote microcredit. The Agricultural Bank

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9. As at-end 2013.
10. Amanah Ikhtiar Malaysia, "Sejarah," Available at: <www.aim.gov.my/~cms/KenaliAIM/Sejarah.htm>.

(Agrobank) was corporatised to enhance its capacity to serve the agricultural sector in a sustainable way, while the SME Bank was established to serve the SME sector. The DFIA also gave BNM oversight responsibility over Bank Kerjasama Rakyat Malaysia Berhad (Bank Rakyat), the largest of the cooperative banks.

BNM has accorded special attention to supporting DFIs which play an important role in serving strategic sectors. Amendments to the DFI Act are being proposed to further strengthen the regulatory and supervisory framework supporting the ability of DFIs to serve their respective mandates effectively. The amendments are scheduled to be tabled to the Malaysian Parliament in March 2015.

In January 2008, the Cooperatives Commission of Malaysia (Suruhanjaya Koperasi Malaysia, SKM) was set up to regulate the development of cooperatives. Apart from exercising a supervisory role over all cooperatives in Malaysia, SKM also aims to create an ecosystem that is conducive to the development of competitive cooperatives through the provision of grants and financing.

2.4 Promoting Basic Banking Products

Increasing access to basic banking services and products such as financing and savings accounts is essential to bring more businesses and households into the formal financial system. Greater participation in the formal financial system in turn, will contribute towards increasing business investments and personal incomes[11]. In 2005, BNM issued a Guideline for Basic Banking Services which required all commercial banks to provide basic banking services. This is to ensure that all segments of society have access to basic deposit and transaction services at a reasonable cost. This Guideline outlines the features of basic savings and current accounts which have low minimum initial deposit requirements, offer reasonable savings rates and provide free over-the-counter and ATM transaction services. As at end-2013, 18.4% of all savings accounts in the financial system are basic savings accounts.

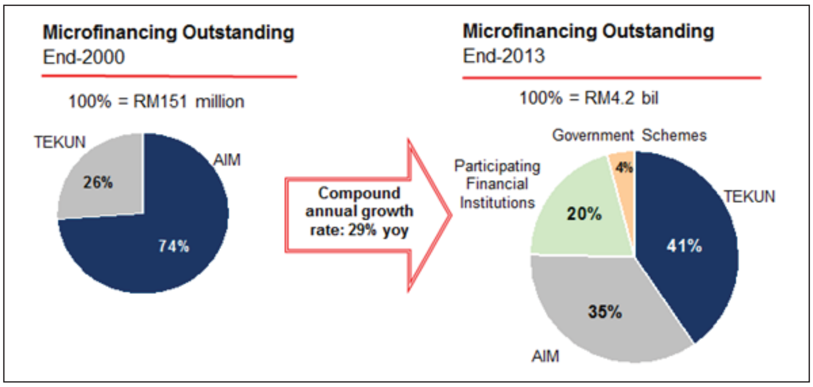
11. Dupos and Robinson, (2011), "Savings Constraints and Micro Enterprise Development: Evidence of Field Experiment in Kenya," *NBER Working Paper*, No. 14693.

Table 1
Features of Malaysian Basic Savings Accounts

Type	Nature of transaction	Number of transactions per month provided by the FIs without charge
Over the counter visit (OTC)	Account enquiries, deposits, withdrawals, funds transfer within the same bank and bill payments	6*
ATMs	Balance enquiries Withdrawal Funds transfer within the same bank	No limit 8* No limit
Deposit Machines**	Cheques deposits Cash deposits	No limit No limit
Interbank GIRO	Interbank funds transfer	2
Internet Banking	Account enquiries Bill payments Funds transfer	No limit No limit No limit

* Additional transactions may incur a charge as determined by the financial institution.
** If deposit machine facilities are not available at the branch, deposit transactions can be made at the counter without charge, These transactions will not be counted in determining the total number of OTC services performed.
Source: www.bankinginfo.com.my.

Illustration 1
Significant Growth of Microfinance in Malaysia[12]



Source: Bank Negara Malaysia, AIM, TEKUN.

12. Government Schemes consists of the Micro Economy Stimulus Package (Micro ESP-i), Special Loan Scheme for Chinese New Villages (Skim Pinjaman Khas Penduduk Kampung Baru Cina), and Micro Credit Scheme for Hawkers and Petty Traders.

2.5 Developing a Comprehensive Supporting Financial Infrastructure

A common barrier to financing access is the lack of reliable credit history on borrowers. Recognising this, BNM has led several important initiatives to promote the development of a comprehensive credit bureau ecosystem. In 2001, the Central Credit Reference Information System (CCRIS) was established to collect credit information from all regulated financial institutions. In addition to supporting BNM's assessment of credit risk in the financial system, the database provides important information on a borrower's credit history to FIs to enable them to perform better credit assessments. At the same time, consumers as the borrowers can build a positive credit history which leads to better access of financing at reasonable costs. As at end-2013, CCRIS captured credit information on about 8.29 million borrowers, including information from major non-bank credit providers.

The Credit Bureau Malaysia (CBM) was established in 2008 to assist SMEs to build credible and comprehensive credit records. CBM credit records include transactions from outside the regulated financial system such as transactions with suppliers, landlords and utility companies. This more comprehensive credit record improves access to finance for businesses that are utilising the formal financial system for the first time. CBM also has incorporated a credit scoring methodology which facilitates financial institutions to assess the credit worthiness of potential customers. Further, CBM plays an important role in educating entrepreneurs on how credit scores are calculated and how they can improve their credit score and provides online credit reports to its clients to facilitate the latter in assessing financing applications. As at end-2013, CBM has 28,435 SME members and had produced 1.4 million credit reports since inception.

2.6 Consumer Education and Protection

A holistic consumer education and protection framework represents an important component of BNM's strategies to promote financial inclusion. Such a framework aims to ensure fair dealings by FIs, informed participation by consumers and sustained public trust in the financial system. These conditions are necessary to ensure that all segments of society are able to use financial products and services responsibly to improve their livelihoods.

In Malaysia, due attention is given on promoting effective disclosures by FIs. FIs in Malaysia are required to comply with general and specific disclosure requirements that aim to ensure that information disseminated to consumers is timely, easy to understand, accurate, and comparable. This will reduce the information asymmetry between financial institutions and consumers. Significant focus is also given to ensuring responsible conduct by financial intermediaries in the provision of financial advice and in carrying out suitability assessments when offering products to consumers.

The Consumer and Market Conduct Department was established at BNM in 2006 to formulate and implement policies that promote fair and responsible treatment of consumers and to supervise and enforce compliance with such policies. These policies cover, among other things, obligations of financial intermediaries to observe fair practices in complaints handling, debt collection, responsible financing, imposition of fees and charges, and provision of credit cards.

In ensuring that consumers have access to advisory and resolution facilities, BNMLINK was established as a centralised point of contact for members of the public and businesses including small- and medium-enterprises (SMEs) to address their inquiries and complaints in relation to the financial sector. The public can interact directly with the FIs or BNM to obtain information and financial advisory services, or resolve any complaints against FIs. TELELINK allows the public to access these services by telephone while MobileLINK extends BNMLINK's advisory services nationwide using a custom made coach equipped with the supporting facilities and technologies.

For dispute resolutions, the Financial Mediation Bureau was established in 2005 to ensure that consumers of all FIs have recourse to an independent, fair and impartial dispute resolution mechanism. Meanwhile, the Credit Counseling and Debt Management Agency (Agensi Kaunseling dan Pengurusan Kredit, AKPK) was established in 2006 to provide counseling on financial matters and assist over-indebted individuals to work out loan repayments with FIs.

At the same time, consumers are empowered with the knowledge and skills to make good financial decisions through financial education (FE) programmes developed by BNM in collboration with AKPK and the industry. This includes the POWER! Programme which was introduced in 2011 and conducted by AKPK, targeted specifically at young individuals and new borrowers with the aim of empowering them to effectively manage their finances. The FE programme helps to enhance the financial literacy of consumers on various financial products and understand the risks and obligations involved in using them. Information web portals have been developed to provide up to date information and knowledge on a wide range of banking and insurance products and services.

Malaysia also established the Malaysia Deposit Insurance Corporation (Perbadanan Insurans Deposit Malaysia, PIDM) in 2005 as a key component of the financial safety net with the mandate of insuring deposits and benefit payments under insurance and takaful (shariah-compliant insurance) policies against the failure of banks or insurance and takaful providers. PIDM protects deposits up to RM250,000 (US$78,125) per depositor per bank and up to RM500,000 (US$156,250) per policyholder in insurance and takaful benefits. The protection is provided automatically at no charge to the consumers.

2.7 Driving a Strategic Focus on SME Development

The development of a strong and dynamic SME sector is a high priority on the national development agenda as SMEs account for 97% of the total business establishments in Malaysia. This sector accounts for 59% of total employment and contributes about 32% to gross domestic product and 17% of total exports of the nation. While private initiatives drive the economy, the Government has a critical role in providing an enabling environment for private enterprises to thrive.

The National SME Development Council (NSDC) was established to formulate broad national policies and strategies aimed at creating an enabling environment for the comprehensive development of SMEs across all sectors. BNM served as the Secretariat to the NSDC until 2008. The NSDC, chaired by the Prime Minister, is the highest policymaking body for SME development in Malaysia and brings together of more than 15 ministries and 60 agencies under a coordinated national strategy. To implement the policies of the NSDC, the SME Corporation Malaysia (SME Corp) was established in October 2009 as a dedicated agency to ensure the effective implementation of SME development programmes to bring SMEs to the next level, broadly focusing on three strategic areas: strengthening the enabling infrastructure, enhancing the capacity and capability of SMEs and enhancing access to financing. For the year 2013 alone, a total of 161 programmes amounting to RM12.0 billion (US$3.8 billion) were implemented to develop high performance and resilient SMEs.

Moving forward, the SME Masterplan 2012-2020[13] which was endorsed by the NSDC will create a conducive ecosystem to accelerate the growth of SMEs

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13. SME Corp, SME Masterplan 2012-2020; Available at: <http://www.smecorp.gov.my/vn2/node/190>.

towards achieving a high income economy. The SME Masterplan is an inclusive plan for all SMEs, across sectors, regions and strategic areas which translates bold measures into strategies across 6 focus areas, namely:

(i) Innovation and Technology;

(ii) Market Access;

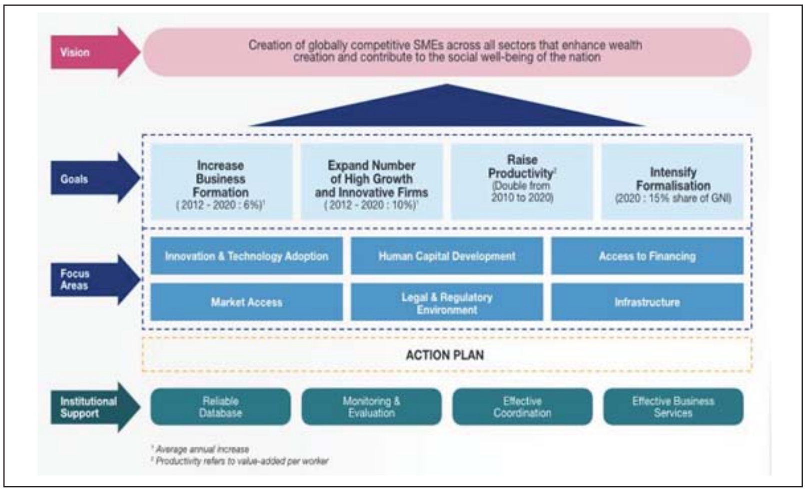
(iii) Access to Financing;

(iv) Legal and Regulatory Environment;

(v) Human Capital; and

(vi) Infrastructure.

Illustration 2
SME Masterplan 2012-2020

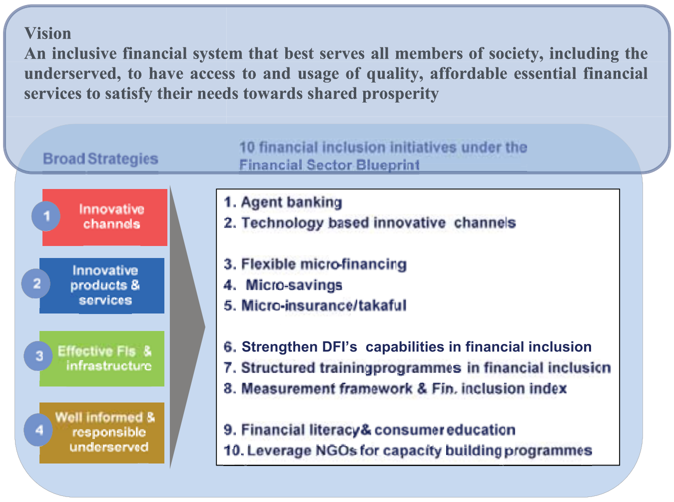


Source: SME Corporation Malaysia.

3. Current and Future Priorities in Elevating Financial Inclusion

The financial inclusion agenda continues to be advanced with the introduction of a holistic Financial Inclusion Framework under the Financial Sector Blueprint (FSB). The Framework includes 10 initiatives in relation to four broad strategies focusing on innovative delivery channels, enhancing financial products and services, increasing the efficiency of the FIs and enabling infrastructure, and empowering consumers through financial education. As at end of September 2014, five of the financial inclusion initiatives have been implemented. The key achievements of these strategies are illustrated in this section.

Illustration 3
FSB's Holistic Framework to Further Financial Inclusion



3.1 Enhancing Access Through Innovative Channels

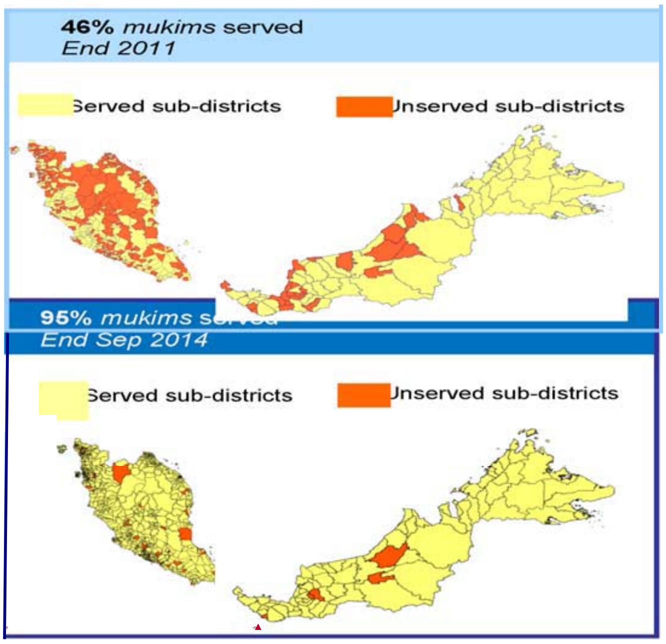
A diverse set of delivery channels have been deployed to ensure widespread access to financial services. The branching policy has encouraged FIs to establish an extensive branch network across the Malaysia to ensure sufficient access to financial services. As at end-2013, there were 1.5 bank branches per 10,000 adults and 5.4 automated teller machines (ATMs) per 10,000 adults in Malaysia. Banks are also encouraged to establish mini branches and mobile units in rural districts.

In facilitating the expansion of financial access points, the Agent Banking Guidelines was introduced in 2012, superseding the Shared Banking Services circular issued in 2007[14]. BNM is encouraging the expansion of agent banking by enabling non-financial businesses such as sundry shops, post offices and petrol

14. The Shared Banking Services Circular was introduced in 2007. The circular allows up to two domestic commercial banks to utilise the branches of DFIs and Pos Malaysia to deliver the commercial banks' products.

stations to provide basic financial services in a safe and cost-effective manner. This initiative has enabled all 144 districts in Malaysia and 95% of the 837 sub-districts with more than 2,000 populations to have access to essential financial services. As at end-2013, there were 5,474 banking agents nationwide with accumulated transactions valued at RM1.6 billion (US$487.8 million).

Illustration 4
Percentage of Sub-districts (Mukims) which are Financially-served



Source: Bank Negara Malaysia.

FIs are also encouraged to leverage on innovative digital channels such as internet banking to increase access of banking services to more people while keeping costs low. BNM has issued several guidelines to facilitate the development of electronic banking and e-payment system. As at end-2013, there are 15.6 million internet banking subscribers representing 52.2% of the total adult population[15].

15. Bank Negara Malaysia, Malaysia's Payment Statistics, Available at: <www.bnm.gov.my/index.php?ch=ps&pg=ps_stats&eId=box1>.

3.2 Introducing Innovative Financial Products and Services

In order to meet the diverse financial needs, particularly of the underserved community, BNM had facilitated the development of a broader range of micro financial products. This initiative includes the development of flexible micro financing that meets the needs of the micro enterprises that have irregular or seasonal income streams; long-term contractual micro-savings with low committed periodical savings and favourable terms to inculcate a healthy savings habit; and microinsurance/microtakaful to provide financial protection against unexpected adverse events. Currently, all three products are at the pilot stage to test the demand and acceptance by the targeted consumers.

3.3 Developing Human Capital

In developing quality human capital to support financial inclusion, BNM has partnered with the Irving Fisher Committee (IFC) on Central Bank Statistics, AFI and OECD to organise various capacity building programmes for policymakers globally on financial inclusion. Meanwhile, the Asian Institute of Chartered Banker's programme provides leadership and technical training to micro finance practitioners in the region.

3.4 Enhancing the Measurement of Financial Inclusion

Recognising the importance of measurement in translating policies into real impact, BNM adopted the Sasana Accord during the Alliance for Financial Inclusion (AFI) Global Policy Forum 2013 in Kuala Lumpur, by developing a set of key performance indicators and a financial inclusion index (FII) framework to track the progress and estimate the impact of policies to intensify the outreach of the financial sector. This has enabled BNM to prioritise areas of focus for its policy and development initiatives (discussed further in the next section).

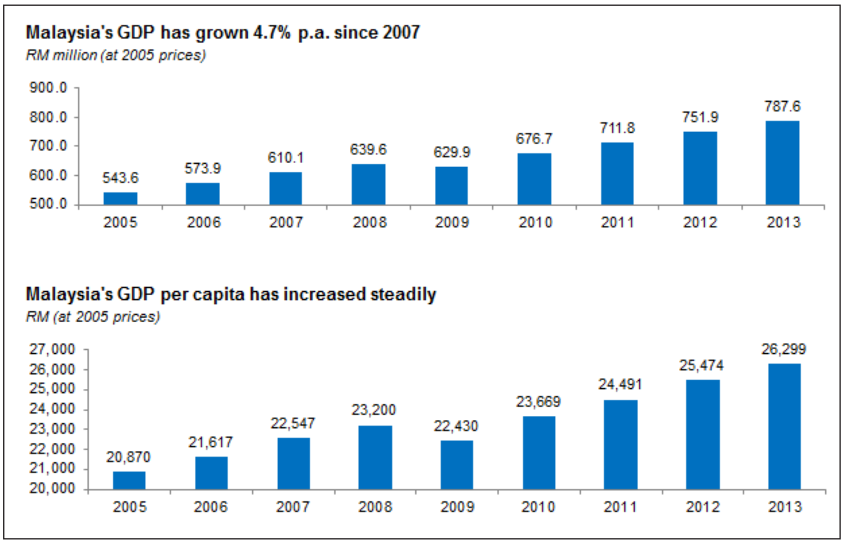
3.5 Ensuring Proportionate Regulation

Proportionate regulations advocate a risk-based approach to regulations that balance the objectives of financial inclusion, integrity and stability. In the context of financial inclusion, BNM aims to ensure that regulations such as those on anti-money laundering and prudential requirements serve to adequately protect the financial ecosystem without hindering the implementation of financially-inclusive policies. Thus, BNM fully supports the creation of the Global Standards Proportionality Working Group (GSPWG) under AFI which is working to develop a Guideline Note for regulators to effectively implement risk-based frameworks that contributes to balancing of integrity and inclusion[16].

4. Assessing the Impact of an Inclusive Financial System on the Economy

Malaysia is an upper-middle income economy oriented towards the exports of goods and services, especially electrical and electronic goods. Between 2010 and 2013, Malaysia's GDP[17] grew at a compounded annual growth rate of 5.2% from RM676.65 billion (US$219.44 billion[18]) in 2010 to RM787.61 billion (US$240.02 billion[19]) in 2013. Unemployment figures have remained steady for the past years, ranging from 3.0% to 3.2% between 2010 and 2013.

Illustration 5
Significant Growth in Malaysia's GDP



Source: Department of Statistics Malaysia.

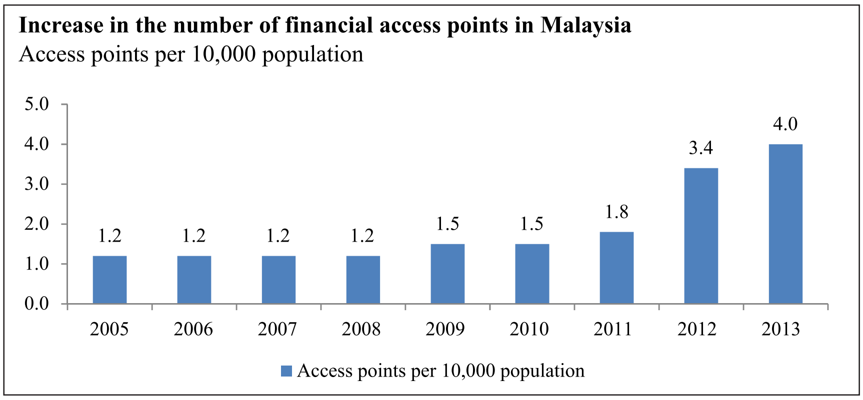
16. Alliance for Financial Inclusion, "Balancing Inclusion, Integrity and Stability," Available at: <http://www.afi-global.org/policy-areas/balancing-inclusion-integrity-and-stability>.

17. At constant 2005 prices.

18. Based on US$1 = RM3.0835, on 31 Dec. 2010.

19. Based on US$1 = RM3.2815, on 31 Dec. 2013.

Illustration 6
Growth in Financial Access Points has Risen Correspondingly[20]



Source: Department of Statistics Malaysia.

Aside from economic development, Malaysia has actively sought to improve the living conditions of its population, especially those from the low-income groups. Combining progressive social policies with the industrialisation of the economy and the development of the financial sector, the incidence of poverty has fallen from 49.3% in 1970 to 1.7% in 2012 while income equality has improved from a Gini coefficient of 0.513 in 1970 to 0.431 in 2012. Malaysia scored 0.773 in the Human Development Index, as published in the United Nations Development Programme's 2014 Human Development Report, which classifies Malaysia as a High Human Development country.

Despite these achievements, Malaysia recognises that there are still areas where further improvements can be made. Furthermore, the level of satisfaction in using the available financial products and services is difficult to determine since high take-up does not necessarily equate to high satisfaction.

An important first step in addressing these perceived issues is to identify and consequently measure the impact of financial inclusion initiatives. In this regard, BNM has established a comprehensive monitoring and evaluating approach as outlined in the FSB, mainly relying on financial inclusion indicators, supported by a few key economic indicators.

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20. Inclusive of bank branches and banking agents. Data prior to 2009 exclude DFIs. The agent banking initiative was initiated in 2011.

Box Article
Financial Inclusion Index

In 2012, BNM introduced a financial inclusion index to measure the level of inclusive finance in the country. The index incorporates four equally-weighted dimensions into the determination of an index score, measuring convenient accessibility, take-up rate, responsible usage and satisfaction. Data for the index is collected both from the supply side and the demand side database. This data is included into the financial inclusion index formula that will compute a score ranging from 0 (indicating a lack of any financial services) to 1 (indicating full financial inclusiveness) which is then used to rate the level of a country's financial inclusion.

The following table illustrates the distribution of weight for each indicators and each dimensions measured by the financial inclusion index:

Table 2
Distribution of Weightage of the Financial Inclusion Index Indicators and Dimensions

Indicators		Dimension indices		Index
Indicators	**Weightage**	**Dimensions**	**Weightage**	
% of *mukim* with >2,000 people with at least one access point	0.5	Convenient accessibility	0.25	Index of Financial Inclusion
% of population in *mukim* with at least one access point	0.5			
% of adults with deposit accounts	0.5	Take-up rate	0.25	
% of adults with financing accounts	0.25			
% of adults with life insurance / takaful policies	0.25			
% of customers with active deposits	0.5	Responsible usage	0.25	
% of customers with performing financing accounts	0.5			
% of customers satisfied with overall financial services	1.0	Satisfaction	0.25	

A brief elaboration of the dimensions and the rationale for choosing them are provided in Appendix II.
Inputting data from the Financial Inclusion Demand Side Survey into the abovementioned formula results in the following FII score of 0.77, based on data from 2011.

Table 3
Malaysia's Financial Inclusion Index Score among the General Population

Dimension	Indicators	Data (%)	Target (%)	Index of Each Indicator	Weight	Index of Each Dimension	Equal Weighted Dimension	Equally Distributed FII
Convenient Accessibility	% of *mukim* with at least 2,000 population with at least one access point	46	90	0.51	0.5	0.64	0.25	0.77
	% of population living in *mukim* with at least one access point	82	95	0.86	0.5			
Take-Up Rate	% of adult population with deposit accounts	92	95	0.97	0.5	0.70	0.25	
	% of adult population with financing accounts	36	50	0.72	0.25			
	% of adult population with life insurance / takaful policies	18	40	0.45	0.25			
Responsible Usage	% of customers with active deposits	87	90	0.97	0.5	0.98	0.25	
	% of customers with performing financing accounts	97	97	1.00	0.5			
Satisfaction Level	% of customers who are satisfied - overall financial services	61	80	0.76	1.0	0.76	0.25	
Index ranges from 0 –1, with 1 being perfect financial inclusion 0 — 0.25 — 0.5 — 0.75 — 1 Low, Moderate, Above Average, High							1.00	0 – 1.00

At 0.77, Malaysia can be considered to have high financial inclusiveness mainly supported by the high number of active deposit accounts and performing financing accounts, as well as the significant number of individuals that live within *mukims* that have access to financial services.

4.1 Major Findings and Policy Implications

Using the financial inclusion index and given comparable data, the level of financial inclusion of different economies can be measured side-by-side. The FII can be utilised to analyse financial inclusion for the different income-levels within a single country. This assists policy-makers in the formulation of appropriate recommendations by highlighting the differences in accessibility, take-up, usage and satisfaction between the general population and any income group, especially the low-income households.

In the case of Malaysia, the results supported the hypothesis that low income households experience lower financial inclusiveness, scoring 0.68 in contrast to the general population index score of 0.77.

Table 4
Malaysia's Financial Inclusion Index Score among the Low-Income Households

Dimension	Indicators	Data (%)	Target (%)	Index of Each Indicator	Weight	Index of Each Dimension	Equal Weighted Dimension	Equally Distributed FII
Convenient Accessibility	% of *mukim* with at least 2,000 population with at least one access point	46	90	0.51	0.5	0.64	0.25	0.68
	% of population living in *mukim* with at least one access point	82	95	0.86	0.5			
Take-Up Rate	% of adult population with deposit accounts	89	95	0.94	0.5	0.32	0.25	
	% of adult population with financing accounts	10	50	0.20	0.25			
	% of adult population with life insurance / takaful policies	8	40	0.20	0.25			
Responsible Usage	% of customers with active deposits	87	90	0.97	0.5	0.98	0.25	
	% of customers with performing financing accounts	97	97	1.00	0.5			
Satisfaction Level	% of customers who are satisfied - overall financial services	60	80	0.75	1.0	0.75	0.25	
Index ranges from 0 –1, with 1 being perfect financial inclusion 0 – 0.25 Low; 0.25 – 0.5 Moderate; 0.5 – 0.75 Above Average; 0.75 – 1 High							1.00	0 – 1.00

Comparing the results between the general population and the low-income households, it is noted that the latter recorded a lower FII score driven by a lower index score in the take-up rate dimension. In particular, low-income households indicate lower take-up rates for financing, and life insurance and takaful policies. Nevertheless, even among the low-income households, the take-up of deposit accounts is high.

Similar scores for convenient accessibility is expected as accessibility is a geographical measure and given the limited exposure of the lower-income households to financial products other than deposit accounts, the high rating for 'responsible usage' is reasonable. In terms of satisfaction, 60% of respondents from low-income households expressed satisfaction with overall financial services, a similar percentage for the general population (61%).

As at end-2013, Malaysia's FII score is at 0.88 based on available data. Comprehensive updates of the FII scores are limited by the frequency of the financial inclusion demand-side surveys are conducted[21].

21. The last financial inclusion demand-side survey conducted in 2012.

From the empirical analysis, strategies to further enhance financial inclusion in Malaysia will aim to increase the following dimensions of financial inclusion:

- Percentage of *mukims* with populations of 2,000 or more with at least one access point
- Percentage of the adult population with deposit accounts
- Percentage of the adult population with financing accounts
- Percentage of the adult population with life insurance or takaful policies
- Percentage of customers who are satisfied with overall financial services

Of these identified areas for improvement, the most impact to financial inclusion can be accomplished by improving the number of access points. A key area for improvement is enhancing access to more mukims with populations of 2,000 and above. as well as extending financial access points to more than 1 access point per mukim especially for those with large populations.

In regard to the issue of take-up, responsible usage and satisfaction, BNM is cognisant that these can be addressed through the continuation of the financial awareness and financial literacy programmes. These programmes serve to raise awareness of customers to available financial products, making oneself bankable and the proper utilisation of these financial services. Combined with convenient accessibility, it is envisaged that meaningful financial inclusion can be attained.

A key channel for the delivery of these financial services is agent banking. It is envisaged that agent banking will be instrumental in extending the availability of financial access points to locations that are considered economically unviable for a formal bank branch to be set up.

5. Conclusion

Although the financial inclusion initiatives in Malaysia have resulted in significant achievements in terms of outreach and the prevalent usage of deposit accounts, there are areas of access to financial services which require continued improvements including extending further the availability of financial access points and increasing the take-up of insurance/takaful products services. As access is increased and more financial products are taken up, financial institutions must ensure that the quality of service is upheld so that satisfaction is maintained and does not negatively affect the acceptance of formal financial services.

The empirical evidence also highlights the need to factor in different considerations in efforts to enhance financial inclusion for low-income households. Beyond overcoming the challenges of providing access to financial services, authorities must invest in initiatives that bring up the level of financial awareness and financial literacy. Promoting financial education for all ages and income will require close coordination between relevant ministries and other stakeholders.

Last but not least, BNM recognises the importance of learning from international experiences in financial inclusion as well as benchmarking with global best practises. Malaysia will continue to collaborate closely with financial inclusion experts and international policymakers from the Alliance for Financial Inclusion (AFI) as well as other organisations such as the United Nations Capital Development Fund (UNCDF) and the World Bank in furthering financial inclusiveness in the country.

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Appendix 1

Selected Key Indicators of Financial Inclusion in Malaysia (as at end-2013)

Accounts	
No. of loan accounts (individuals)	19,058,559
No. of loan accounts (SMEs)	676,144
No. of deposit accounts	72,173,792
Access Points	
No. of bank branches	3,226
No. of ATMs	11,904
No. of cash-in & out agents (POS and BSN's agents)	5,474
No. cash deposit machine	5,177
Other cash-in & out access points - BSN's mobile units	10
Total no. of cash-in & out access points per 10,000 adults	4.0
Mukims (sub-district) served with financial access points (%)	92.5% (out of 837)
DUN served with financial access points (%)	99.8% (out of 576)
Note: All 144 districts have access points by June 2011	
Access to Loans	
% of adult with active loan accounts *	37%
No. of loan accounts per 10,000 adults	8,673
No. of loan accounts (SMEs) per SME population	1.0
% of oustanding SME loans to total business loans of FIs	42.1
% SME financing to GDP	21.6%
Access to Deposits	
% of adults population with deposit accounts [1]	92%
% of adults with active deposit accounts *	92%
No. of deposit accounts per 10,000 adults	32,846
Proportion of Basic Savings accounts [2]	18.4%
Proportion of Basic Current accounts [3]	10.9%
Branch and ATM Penetration	
No. of bank branches per 10,000 adults	1.5
No. of ATMs per 10,000 adults	5.4
No. of CDMs per 10,000 adults	2.4
Insurance Penetration	
% of adults with life insurance policy *	33%
No. of conventional policies in force [4]	11,716,875
No. of takaful policies in force [4]	4,171,045
No. of conventional & takaful policies in force per 10,000 adults	7,231
Conventional & takaful premiums to GDP (%) [5]	3.2

Denominator Items

Total Malaysian adult population [6]	21,973,341
Total no. of SMEs in Malaysia (SME population) - Census 2011	645,136
GDP at current price (RM million) [7]	984,453

* Source: JPS, National ID Survey (IC Project), 2013.
[1] Financial Inclusion Demand-Side Survey 2011.
[2] Data for basic savings accounts refer to savings accounts that are opened by individuals (Source: JPS).
[3] Data for basic checking accounts refer to accounts that are opened by individuals and SMEs (Source: JPS).
[4] Source: JPS.
[5] Source: Insurance data-JPS, GDP-DOSM.
[6] Projection of total adult population for 2013 based on Population and Housing Census of Malaysia 2010 (Source: DOSM, 2011).
[7] Source: DOSM.

Appendix 2

Rationale for the Choice of the Four Financial Inclusion Indicator (FII) Dimensions

i. *Convenient accessibility*
Convenient access to financial access points is the cornerstone of any financial inclusion programme and should be the starting point of any measure of financial inclusiveness. As such, the FII deems that a given geographical administrative unit has access to financial services if there is at least one financial access point within it.

The geographical administrative unit that was utilised for Malaysia's financial inclusion index is the *mukim* (sub-district) with populations exceeding 2,000 people. The rationale behind choosing the *mukim* is that it allows for the survey results to be collected and compiled based on established administrative groupings, while at the same time filtering out geographical units with smaller populations. 837 *mukims* in Malaysia were included for having populations of more than 2,000.

Convenient accessibility is measured by the percentage of *mukims* with populations exceeding 2,000 that has at least one financial access point and the percentage of the total population that live in these *mukims*.

ii. *Take-up rate of financial products*
The second dimension measures banking penetration through the size of the banked population. While the first dimension measure gauges the accessibility of populations to a financial access point, the second dimension looks at the number of adults that utilises these access points to avail to financial services.

The take-up rate is measured through the percentage of respondents who stated that they have any deposit accounts, financing accounts, or life insurance or takaful policies.

iii. *Responsible usage*
The third dimension on responsible usage further refines respondents to measure those who do not only have access to financial services and utilise them, but who also use these financial services actively and responsibly. This is based on the concept of the underbanked and the marginally-banked,

referring to people with bank accounts that they do not or hardly ever use[22]. By including this dimension into the FII, the FII is adjusted for the overstatement of effective financial inclusion from the non-utilisation of services by these marginally-banked persons.

Responsible usage is measured by the percentage of respondents that indicated that they actively use and service their deposit and financing accounts.

iv. *Satisfaction level*

The final dimension measures the satisfaction level of the respondents to the overall financial services received. Although satisfaction is less easy to quantify and doesn't directly contribute to the availability or utilisation of financial services, we believe that it is an indispensable component to any financial inclusion index. Measuring satisfaction serves to countervail against the implementation of superficial improvements in outreach which sacrifice quality of service to achieve quantitative objectives.

In the FII, satisfaction is measured by the percentage of survey respondents who answered that they felt 'satisfied' or better with the overall financial services.

22. Chattopadhyay, S.K., (2011), "Financial Inclusion in India: A Case-Study of West Bengal," *RBI Working Paper,* WPS (DEPR) 8 / 2011.

Chapter 5

ADVANCING INCLUSIVE FINANCIAL SYSTEM IN THE NEXT DECADE: A CASE OF NEPAL

By
Hem Prasad Neupane[1]

1. Background

1.1 Country Information

Nepal is a small and land-locked rural country[2] with more than two-thirds of the population engaged in agriculture. In FY 2013, agriculture contributed 34.8% whilst the service sector accounted for more than half of the country's gross domestic product (Figures 1 and 2). However, the industrial sector contributed 14.8% of the GDP in 2013/14. Nepal's per capita income is US$703 in 2013, and 23.8% of the population remain below the poverty line (Economic Survey, 2014).

Nepal is facing high and growing trade deficit which stood at 28.2% of the GDP in FY 2013 and almost two thirds of its total trade is with India. The major exports of the country are ready-made garments, woolen carpets, pulses, polyester yarn, textiles, jute goods and the major imports are petroleum products,[3] gold, vehicle and spare parts, other machinery and parts, electrical equipment, medicine, among others. The current account remains in surplus often times due to the contribution of remittance, which accounts more than 28 % of GDP in 2014.

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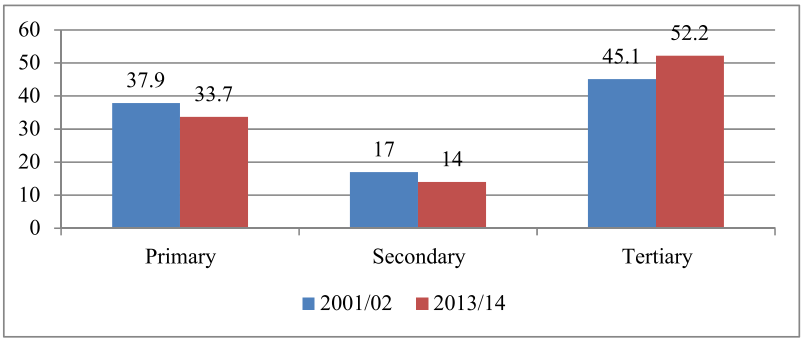
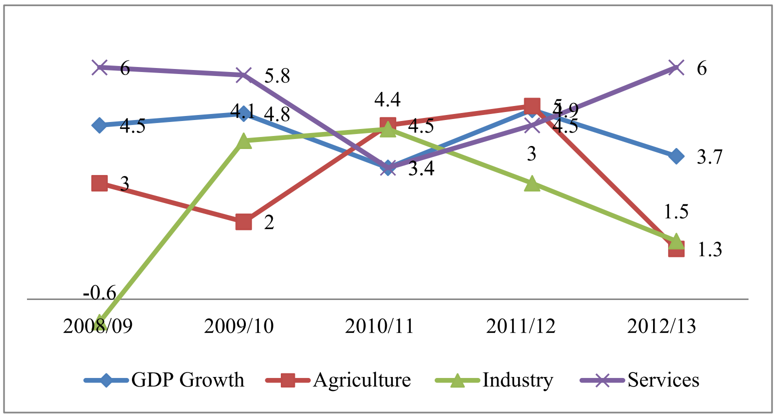
1. Deputy Director, Bank Supervision Department, Nepal Rastra Bank.
2. Population Census, 2011- the total population of the country was 26.49 million, out of which an overwhelming majority (83%) reside in the rural areas
3. Total export revenue cannot cover the import of petroleum item alone, for instance total exports of the country was Rs.90.29 billion while import of petroleum products was Rs.133.18 billion in FY 2013/14.

Figure 1
Gross Domestic Product (GDP) Structure



Data Source: Economic Survey, 2013/14.

Figure 2
GDP Growth by Sectors



Data Source: Economic Survey, 2013/14.

With regard to sectoral growth, the service sector remains somewhat stable while other agriculture and industry were fluctuating in the last five years (Figure 1.2).

1.2 Financial System

The Nepalese financial sector is primarily dominated by commercial banks. The financial institutions licensed by the Nepal Rastra Bank (NRB) fall under four categories, namely Commercial Banks, Development Banks, Finance Companies and Microfinance Development Banks. Commercial banks occupy the largest share, taking almost two-thirds of the total assets in the banking sector, whereas the development banks' share is 10.7%. Nevertheless, the non-banks hold about 8.4% and insurance companies just 4.5% of the share (Table 1). The other contractual saving institutions like Employees Provident Fund and Citizens Investment Trust also hold significant percentage share.

Table 1
Structure of the Nepalese Financial Sector
(Asset size as of mid-July)

(%)

Institutions	2007	2010	2012	2013 January
NRB Regulated	**85.4**	**86.1**	**85.2**	**85.4**
Commercial Banks	72.0	65.7	65.5	66.3
Development Banks	3.4	8.8	10.0	10.7
Finance Companies	7.8	9.5	6.8	5.4
Microfinance Development Banks	1.5	1.5	1.9	1.9
Financial Cooperatives*	0.4	0.6	0.7	0.8
Financial NGOs*	0.3	0.2	0.2	0.3
Other Institutions	14.6	13.9	14.8	14.6
Employees Provident fund	8.7	7.7	7.8	7.7
Citizen Investment Trust	1.3	2.0	2.4	2.3
Insurance Companies	4.5	4.0	4.6	4.5
Postal Savings Bank	0.1	0.1	0.1	0.1

*With limited banking
Data Source: Macroeconomic Indicators of Nepal, November 2013.

The capital market is still in the developing stage in terms of availability of instruments, market penetration and transaction volume. Banks dominate the market as out of 237 listed companies in the Nepal Stock Exchange (NEPSE), banking and financial institutions (BFIs) account for 204 as at mid-July 2014 taking up about 76% share of the total market capitalisation. In terms of size of the market, the market capitalisation to GDP is 54.8% in 2014, which is far below of that of the developed economies.

1.3 Need for Inclusive Financial System

Financial inclusion is the provision of a full range of affordable financial services to economically active people, including those who have been underserved or excluded from the formal financial sector. Financial inclusion covers the aspects of access to credit, savings, insurance, payments, remittances, and others. Some important dimensions of financial inclusion are access to the appropriate financial services at affordable cost. It also includes the access and uses of financial services, consumer protection and financial literacy.

The empirical evidences suggest that financial inclusion plays a vital role in reducing poverty and income disparity facilitating higher economic growth. The importance of financial inclusion for a developing country like Nepal can be summarised as follows:

a) Tool for poverty reduction.

b) The population still have low access to finance and disparity in access across the region in Nepal. For instance, the population per bank branch in Nepal is around 8,000 in mid-July 2014. The distribution of the bank branches is uneven. Bank branch coverage is deep in the urban and semi-urban areas whereas it is less in most of the hills and mountainous areas. Among the 75 districts in the country, there are 10 districts where a branch has to serve more than 25,000 people and 2 districts serving more than 50,000 people as at mid-July 2014.

c) Small and medium enterprises may create a larger share of employment if formal access to finance is improved. However, these sectors are deprived of access to formal financial institutions and suitable products. An inclusive financial system can provide easy and affordable access to financial services for all the segments of society and can create employment opportunities, which ultimately will uplift the status of the poor and vulnerable communities.

d) Large sections of the population are using informal financial services instead of transacting with the banking units nearby. Nepal Living Standard Survey (NLSS) 2010/11 data shows that 51.1% of the population depended on relatives for household loans, while 20% received loans from the banks. As such, expanding financial literacy can help the general public to understand the importance of the formal financial sector.

e) The government has the dual responsibility of uplifting the status of the people and providing other facilities for the needy and low-income strata. Financial inclusion helps in widening the economic base of such people and co-opting them in the development process.

f) It helps in distributing social security funds in a secured and transparent manner.

g) The Rural Credit Survey, 1994 [4] revealed that only 20% of the population have used the services of formal financial institutions. The NLSS III (2010/11) also revealed the low coverage of formal financial institutions (Annex 1). Policy intervention and rigorous effort are deemed necessary in expanding financial inclusion in the country.

1.4 Financial Inclusion Policies and Institutions

1.4.1 Brief History of Financial Inclusion Policies and Programmes

With the establishment of the Nepal Bank Ltd. in 1937, the Nepalese banking system was formally introduced. After that, the NRB, the Central Bank of Nepal, was established in 1956. Consequently, the Rastriya Banijya Bank (1966) for commercial banking purpose and the Agricultural Development Bank (ADB) (1968) for the developing agricultural sector were established under government ownership.

Following the wave of globalisation and liberalisation in the mid-1980s, the Nepalese financial sector started to pursue the course of liberalisation. In the first stage, joint-venture banks were allowed to be established as private banks. The liberalisation was later further relaxed to allow the establishment of wholly domestic private sector banks. As a result of this, the number of BFIs was significantly increased. For instance, from 1990 to 2010, the NRB initiated several measures and policies to enhance banking services across the country in line with the government policies. For this, direct subsidies were provided to the state-owned banks in the early days. The ADB, having many rural branches, plays a crucial role in providing financial services to most of the rural areas in

4. There has not been any survey conducted after that, but the NRB plans to conduct one this year.

the country. The following are some of the initiatives taken for Financial Inclusion in the past:

a) To increase banking access to all districts in the country, the NRB initiated a Banking Development Programme in the late 1960s. Commercial banks were encouraged to establish branches in the specified areas with an offer of compensation for net loss incurred by the branches for the first five years of operation. The banks could claim compensation of 100%, 75%, 50%, 25%, and 10% of the loss, respectively, in the first, second, third, fourth and fifth year. The government of Nepal in her 7th five-year plan (1985-90) stipulated an ambitious target of establishing at least one bank branch per 30,000 thousand people. To meet the target, the NRB implemented the Banking Development Scheme. According to this scheme, branches which incur losses would receive interest free loan from the NRB for a period of 10 years to assist the operation of such branches.

b) From April 1997, prior approval is required from the NRB for banks to open branches in the Kathmandu valley and major cities. Pursuant to this provision, banks were required to open two branches into the nearby semi-urban areas conjoined with the municipalities or a branch in the defined rural district/ area of the country to open a branch in the Kathmandu, Pokhara, Biratnagar, Lalitpur, Bhaktapur, Birgunj and Bharatpur municipalities. This policy was later revised and the branch opening requirement was simplified in terms of opening a branch in the Kathmandu valley vis-a-vis outside the Kathmandu valley. Agriculture-based cooperatives, which were established in 1950s, was the first step in the development of microfinance services in Nepal. Initially these cooperatives which were established under the Small Farmers' Development Project were subsequently transformed into the Small Farmers Cooperatives Ltd. (SFCLs). These institutions are currently managed by the farmers themselves.

c) In order to channel the available resources of the commercial banks and to increase production and employment, especially into the rural agriculture, cottage industry and service sector, the NRB directed the banks to lend a certain percentage of their loans to the small sectors at a preferential rate; such credit extensions were later classified as priority sector loans. Following the liberalisation of the financial sector, the provision of loans at concessionary rate of interest was abolished in 1989 and a specific percentage of priority sector lending was required to be extended to the deprived sector (a deprived sector was defined as a borrower having less than 1 Bigha land in Terai, 20 Ropani in hill and income less of than Rs. 25000 yearly) from 1991/92.

The priority sector lending was phased out from 2005/06 keeping the deprived sector requirement intact. Presently, the commercial banks are required to lend 4.5%, development banks 3.5% and finance companies 3.0% of their total portfolio to the deprived sector as stipulated in the Monetary Policy, 2013/14. As of mid-January 2014, the outstanding loans to the deprived sector by commercial banks was Rs.36.62 billion, development banks Rs. 6.34 billion and finance companies Rs. 1.79 billion. The BFIs can lend directly to such sector and lend indirectly through other financial institutions.

d) Institutional Set-up

i. Grameen Bank Model

Following the Grameen Bank model of Bangladesh, the regional rural development banks were established in 1992 in the Eastern and Far Western development region. Later, two more regional development banks were established in the Western and mid-Western region in 1995. One more rural development bank was established in 1997 in the Central development region. These banks were established with the direct shareholding of GoN, NRB and the private sector banks. Apart from these institutions, the same types of institutions in the private sector have been allowed to be established across the country. As of mid-January 2014, these institutions have 50,900 centres, serving 259,219 groups, 1,422,430 members, 1,003,284 borrowers, 840,498 depositors, and with the total loans standing at Rs. 15.74 billion.

ii. Wholesale Lending Model

The Rural Self-reliance Fund (RSRF) was established by the GoN to provide credit to the rural poor for income generating activities in order to improve their standard of living through NGOs. The GoN allocated a fund of Rs. 20 million initially to operate the RSRF. From FY 2001/02, the GoN allocated a fixed amount and NRB allocated 5% of its profit yearly to increase the fund (Rs. 290 million by GoN and Rs. 253.4 million by NRB with a total of Rs. 543.4 million). Other wholesale microfinance institutions, like the Rural Micro-Finance Development Centre and the Sanakisan Bikas Bank, were established and the policy opened for the private sector to set up wholesale institutions to channel wholesale fund to the grass-root level organisations. The Youth and Small Entrepreneur Self-employment Fund was established by the GoN in FY 2007/08. The fund provides wholesale loans in group guarantee amount up to Rs.2 lakh in concessional interest rate for self-employment, like animal rearing, agriculture, horticulture, service business, cottage industry, etc.

iii. Project-based Micro-credit Model (Donor-supported)

Some donors supported project-based micro-credit programmes which were operated in the country mainly during the 1980s to late 2000s. Some of them were Production Credit for Rural Women (PCRW), Micro-credit Programme for Women (MCPW), Poverty Alleviation Project in Western Terai (PAPWT), Third Livestock Development Project (TLDP), Rural Microfinance Programme (RMP), Community Ground Water Irrigation Service Project (CGISP) (Annex 2). Enhancing Access to Financial Services (EAFS), financial support by the UNDP and UNCDF was successfully completed in 2013 (Annex 2).

Likewise, the UNCDF has been assisting the implementation of Mobile Money for the Poor (MM4P), financial support provided by the Danish government to fund the Access to Finance Programme for Inclusive Growth in Nepal targeting 7 districts in the Eastern development region. Moreover, on the grant of the Asian Development Bank, the Raising Income of Small and Medium Farmers Project (RISMFP) was established and operated in 5 districts of Far Western and 5 districts mid-Western Development region.

iv. FINGOs and SACCos Model

The NRB had issued licence to Financial NGOs (FINGOs) and Savings and Credit Cooperatives (SACCos) to conduct limited banking activities aiming to expand financial services basically for the members. Currently these institutions have been given time for them to be transformed into D-class institutions.

e) The NRB presently has a moratorium for licensing bank and financial institutions. However, licensing to establish D-class (microfinance) institutions is still encouraged with incentives into the unbanked areas. Cross-holding investment is restricted among A, B and C-class institutions, but it is allowed for D-class institutions.

f) The NRB provides direct financial support to the BFIs where the number of banking units is low. BFIs opening a branch among the specified 14 remote district headquarters will get Rs. 5 million interest free loan and Rs. 10 million, if the branch is opened outside the district headquarters. For microfinance institutions, opening a branch in the specified 22 remote districts having low banking access, they will receive Rs. 2 million interest free loan. And there are no requirements for obtaining pre-approval from the NRB to open branches in such districts for the MFIs.

g) Deposit Insurance and Credit Guarantee (DICG) schemes have been put in place (where deposits up to Rs. 0.2 million are insured in the BFIs). The Priority Sector loans had to be guaranteed by DICG in the past. As of mid-January 2014, a total of 176 BFIs representing 9.3 million depositors with deposits worth Rs. 232.31 billion have been insured (which accounts for 74% of the account volume and 17.4% of total deposits).

h) The NRB has given priority to technology-based innovative financial products like mobile and branchless banking.

i) The NRB participates as an active member in the Alliance for Financial Inclusion (AFI). The NRB committed to the Maya Declaration in 2013 upholding major four commitments: promotion of financial literacy; conducting of rural credit survey; preparation of the financial sector development strategy; and introduction of mobile money service. These commitments are required to be fulfilled by the end of 2014.

j) The National Microfinance Policy, 2010, has already been implemented. A separate microfinance authority has been proposed to regulate and supervise these institutions. Capacity building of these institutions and assurance of financial education and literacy campaign are other important aspects of the Microfinance Policy.

k) The NRB has been providing technical support to the Department of Cooperatives for conducting on-site inspection and off-site supervision of large cooperatives.

l) The Banking Promotion Board was formed in 1968 to promote banking services and educate the people. The Sub-committee of the Board regularly publishes information to create awareness through the print media. It also aired a radio programme for 40 years and an audio-visual programme was produced and broadcasted in many television programmes and channels. The Board has been handed over to the Nepal Bankers' Association and continues with the promotional activities.

m) The cooperatives sector is considered as the third pillar of national development in Nepal. According to the Department of Cooperatives, there are almost 28,000 cooperatives in the country representing 4.1 million members, Rs. 29 billion capital, Rs.147 billion deposits and Rs.137 billion loans in aggregate as of mid-January 2014.

n) In providing adequate investment opportunities to a wide general public, the NRB requires the BFIs to allocate a minimum 30% of their shares to the general public. Likewise, a mandatory provision has been implemented to allocate a certain percentage of the share of hydropower generating companies to the local people who may be directly affected by the project.

o) The GoN has embarked on the scheme of insurance of crops and animals. The GoN allocates its budget to subsidise insurance premiums to farmers as a model programme.

1.4.2 Major Plans, Policies and Programmes on Inclusive Finance

a) A financial literacy programme is being carried through the audio-visual and print media. Launching a programme, "NRB with the Student," and coordinating the universities and the Ministry of Education to incorporate financial education in the textbooks are some of the recent efforts to increase financial literacy.

b) As committed in the Maya Declaration, the NRB has formulated a five-year Financial Sector Development Strategy (FSDS). The FSDS will cover all the players of the financial sector, like Securities Board of Nepal (SEBON), Insurance Board of Nepal, Department of Cooperatives, and Ministry of Finance. The major focus of the FSDS on the financial inclusion pillar includes:

   i. Developing the institutional arrangements for expanding financial access and growth;

   ii. Strengthening the regulatory and supervisory norms for the microfinance institutions;

   iii. Promoting product innovation and effective delivery channels to expand the outreach of financial services to poor people; and

   iv. Enhancing public awareness and promoting customer protection, financial literacy and financial education.

c) There are about 13,000 Savings and Credit Cooperatives across the country as of mid- March 2014 (Economic Survey, 2014). Due to the lack of proper regulation and supervision, large numbers of customers are being cheated every year. Thus, the regulation of the MFIs and these cooperatives has been a long felt need. The microfinance policy also has envisaged a separate authority to regulate and supervise such institutions.

d) As committed in the Maya Declaration, a nation-wide survey focusing on access to finance, credit and interest rate, and financial literacy is being carried out in 2014. This will be useful in framing policies and strategies for improving rural finance.

1.4.3 Institutions Engaged in Formulation and Implementation of Financial Inclusion Policies and Programmes

A number of organisations are involved in the formulation and implementation of financial inclusion policies and programmes. The following institutions have been implementing financial inclusion programmes:

a) There is no specific financial inclusion policy issued so far in the country. However, the NRB has been implementing policies and programmes of financial inclusion.

b) The FSDS is being prepared. For this, a high level committee and a working level committee have been formed with representation from Ministry of Finance, NRB, SEBON, Insurance Board, etc.

c) The NRB works as a regulator, supervisor, promoter, and facilitator of micro finance, and formulates the policies expanding access and outreach of financial services across the country.

d) The NRB licensed banks and financial institutions (A,B,C,D class institutions, FINGOs, Cooperatives, Centre for Microfinance).

e) Deposit and Credit Guarantee Corporation (DCGC).

f) Donor organisations (ADB, UNDP, World Bank).

g) Insurance companies and the insurance regulator (Insurance Board).

h) Telephone and Internet companies: As of mid-March 2014, six telephone companies are operating services across the country. The total number of telephone subscribers reached 23,006,799 with a telephone density of 74% of the total population. Likewise, the total number of Internet subscribers was 8,146,910 with Internet density of 30.70%. This vast telecommunication network can also be used for financial inclusion purpose.

2. Current Status of Financial Inclusion

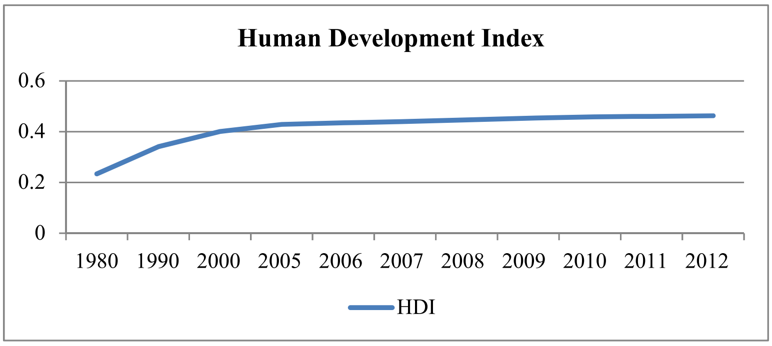
2.1 Outlook of Economic Growth, Employment and Poverty

The Nepalese economy has been witnessing slow economic growth in the recent years. The economic growth in FY 2012/13 was estimated at 3.7%. The average growth of the last three years was only 4% and the growth rate for the current FY 2013/14 is estimated to be at 5.5%. According to the Economic Survey, 2012/13, around 0.45 million youths enter the labour market yearly. Due to slow growth and low employment opportunities in the country, 30% of the labour force remains underemployed or are wholly unemployed. The population below the poverty line is estimated at 23.8% in the FY 2013/43 while it was 25.4% in the preceding year.

2.1.1 Human Development Index

Nepal is among the countries showing slow growth in the human development index. If we look at the data from 1980s to 2012, it is almost horizontal. An upward trend could be observed during the 1980s and 90s.

Figure 3
Human Development Index of Nepal

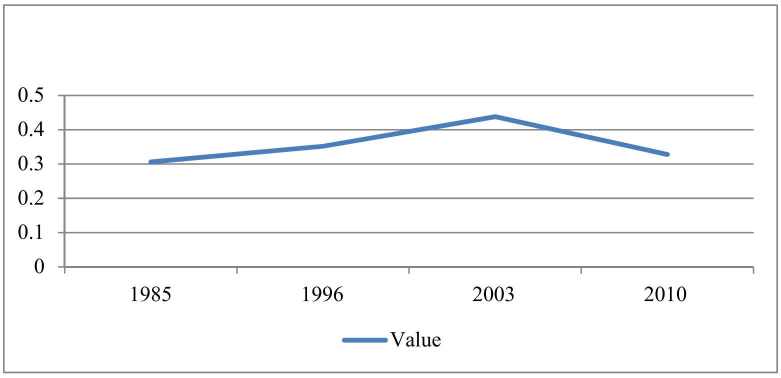


Data Source: Human Development Reports.

2.1.2 Gini Coefficient

The Gini coefficient shows income disparities in the economy. Figure 4 depicts the Gini coefficient (disparities) rising in 2003 (during that period, Nepal was severely affected by the insurgency) and declined to level out in 2010.

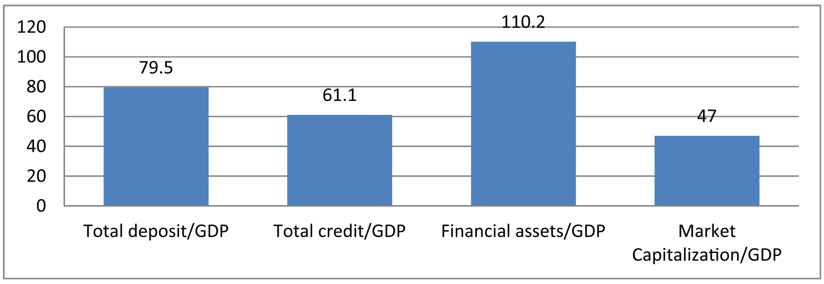
Figure 4
Gini Coefficient



2.2 State of the Financial Sector Development

As compared with the other developing countries, the Nepalese financial sector development is remarkable. The ratio of total deposits to GDP has reached up to 80% while the credit to GDP ratio is above 60%. As of mid-January, the 2014 market capitalisation to GDP ratio, a capital market development indicator reached 47%. While looking at the number of banks and financial institutions, as of mid-January 2014, there are 31 commercial banks, 87 development banks, 58 finance companies and 35 microfinance development banks (Annex 3). Figure 5 depicts the financial development state.

Figure 5
Financial Development Indicators, mid-January 2014
(as % of GDP)



Data Source: BFIRD Statistics, NRB.

The insurance penetration is very low in Nepal. As of mid-January 2014, the total number of life insurance policies stood at 234,288 (0.9% of the population) and the premium collection was Rs. 4.10 billion (0.24% of the GDP).

2.3 Financial Inclusion Indicators

There is no institution which regularly collects and compiles financial inclusion data in Nepal. Thus, we need to rely on various sources to look at the financial inclusion situation. As of mid-January 2014, one bank branch (including branches of MFIs) on average served 8,091 people whereas one ATM served 17,000 people.

Table 2
Financial Access Indicators
(As of mid-January 2014)

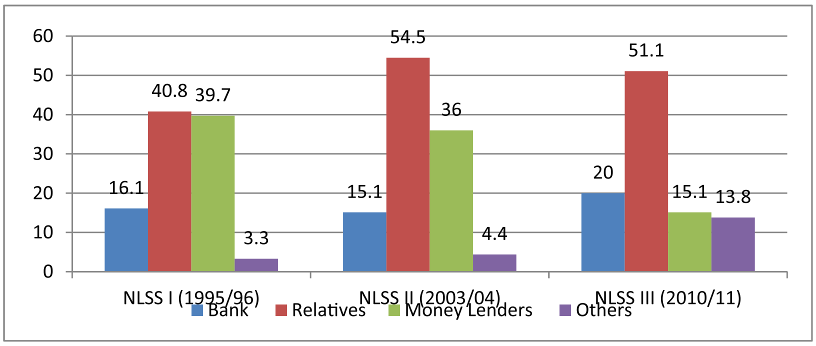
Indicators	Numbers
Bank branch per 100,000 population	12.3*
Total number Deposit Accounts (A,B,C)	12,131,298 (45.8% of population)
Total number of Loan accounts (A,B,C)	884,536 (3.3% of population)
ATM per 100,000 population	5.9
Total number of ATM card holders	3,755,485 (14.2% of population)
Total number of Credit card holders	54,064 (0.20% of population)

* Including MFI branches.
Source: BFI Statistics, NRB.

a) The National Agriculture Census, 2011, conducted by the Central Bureau of Statistics (CBS) found that only 22% of the farmers are using agricultural loans and 42% of the respondents indicated that they need loans for farming.

b) The NLSS 2010/11 revealed that only 40% of the households in the country can access the nearest bank within 30 minutes and 44% of the households can access the nearest bank within 2 hours or more. The figure was 20.7% in NLSS I (1995/96) and 27.8% in NLSS II (2003/04). The survey also revealed that 62.6% of the households have outstanding loans. The sources of loans are still dominated by the informal sectors: 51.1% by relatives, 15.1% by money lenders and 13.8% by other institutions. There is positive trend of a decline in the money lenders' share, but the percentage of borrowing from relatives and other institutions was increased.

Figure 6
Source of Household Loans



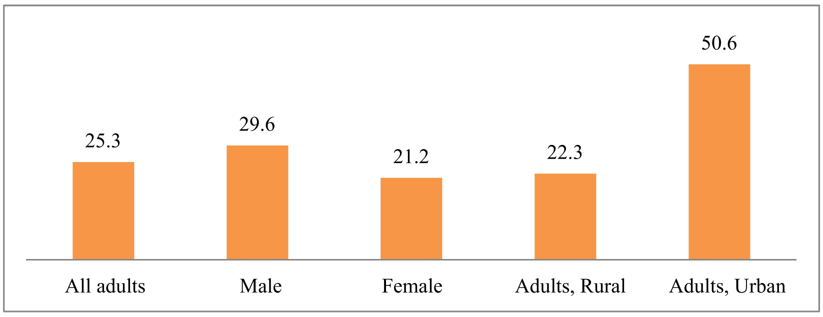
Data Source: Nepal Living Standard Survey 2010/11.

c) The Doing Business Survey, 2013 published by the International Finance Corporation ranks Nepal at 70th position out of 185 economies in the getting credit component.

d) The World Economic Forum, Global Competitive Report, 2013 ranks Nepal at 90th position in terms of availability of credit, 88th in affordability of financial services and 107th in ease of access to loans among 149 economies.

e) The World Development Indicators, Little Data Book on Financial Inclusion, 2012 (FINDEX) reveals that 25.3% of the adults (male 29.6% and female 21.2%) have bank accounts in Nepal. The level of education and income level have significant influence for operation of bank account. Only 1.8% of the youths paid for health insurance (Annex 4).

Figure 7
Account at the Formal Financial Institutions (in %)



Data Source: The Little Book on Financial Inclusion, 2012.

f) The Global Financial Development Report 2014, Financial Inclusion (by IFC, MIGA and the WB) segregating individuals and firms as banking products reveals that 25.3% adults have bank accounts and 10.8% adults have bank loans, 3.7% adults have debit cards and only 0.5% make electronic payments. At the firm level, 73.7% have saving and current accounts, 39.1% have credit line, 32.1% have working capital loans and 17.5% use banks to finance investments in Nepal.

g) As of mid-March 2013, the total number of telephone users reached 19.6 million (density 74%), mobile phone users 17.4 million (density 66.7%) and total Internet customers 6.3 million (density 24%) in Nepal.

h) Access to the Financial Services Survey, 2006 conducted by the World Bank, revealed that 19.6% of the people are financially excluded, 27.7% are informally served, 27.6% are served by the banks and 24.7% are served by other formal institutions in Nepal.

The above-mentioned data reveals that despite several efforts of extending branch banking network throughout the country, large parts of the country are still excluded financially. Also, there is lack of consolidated data and one have to depend on various sources. Though the population served per bank branch has been reduced significantly, the distribution of the branch network remains uneven across the country.

3. Empirical Analysis

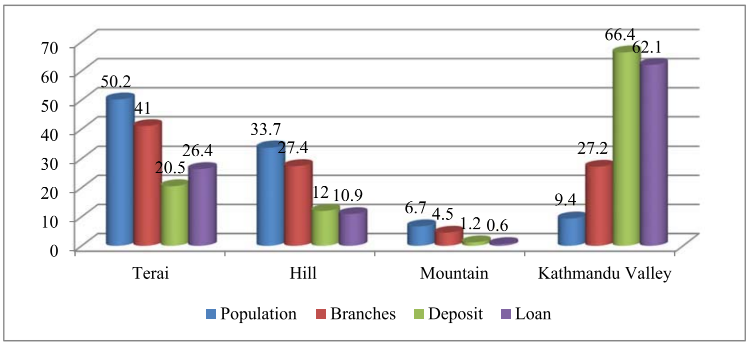
3.1 Trend Analysis

Despite numerous initiatives taken to provide financial access throughout the country, the distribution of bank branches remains uneven in Nepal. The BFIs are focused on expanding branches in the urban areas. This section looks at the distribution of bank branches, per capita deposit and loan in the districts. Additionally, poverty incidence of the districts is also presented.

3.1.1 Distribution of Bank Branch, Population, Deposit and Loan (Geographical Distribution)

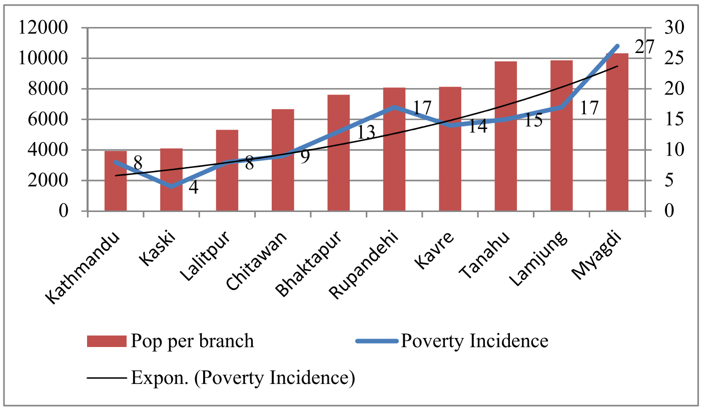
Banking service is concentrated in the Kathmandu valley (Kathmandu, Lalitpur and Bhaktapur districts). Some 9.4% of the population in the valley accounts for 27.2% of the bank branches, 66.4% deposits and 62.1% loans. However, the Terai region, which accounts for 50.2% of the total population, only has 41% of the branches, 20.5% deposits and 26.4% loans. The situation in the hills and mountainous regions is even starker (Figure 8).

Figure 8
Distribution of Population, Branch, Deposit and Loan



The population per bank branch and poverty in the banked districts (less population per bank branch) show an upward trend of poverty incidence along with the high population per bank branch (Figure 9).

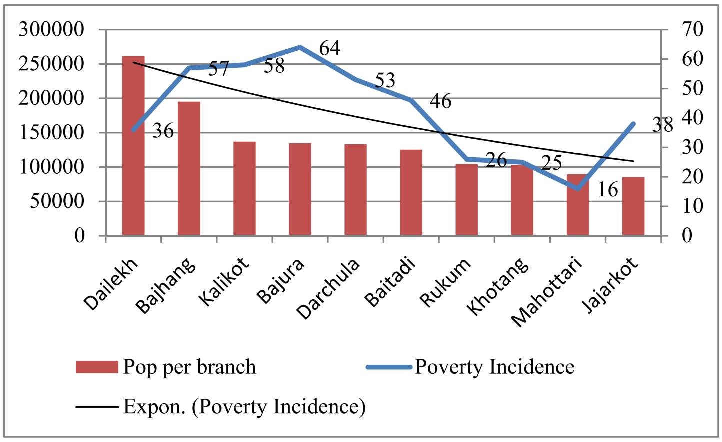
Figure 9
Population per Bank Branch and Poverty in Banked Districts



Data source: BFI Statistics and author's calculation.

On the other hand, the poverty incidence in the less banked districts is downward trend in comparatively less banked districts like Bajhang, Jajarkot, Kalikot, Bajura. These districts have more poverty incidence (Figure 10).

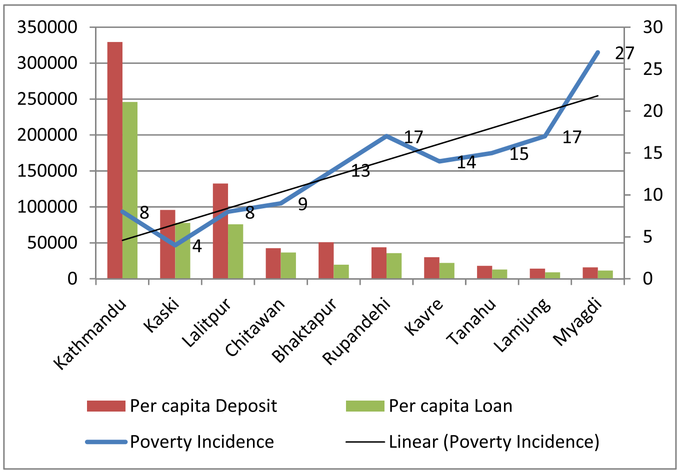
Figure 10
Population per Bank Branch and Poverty in Less-banked Districts



Data source: BFI Statistics and author's calculation.

It is also observed that the districts having more per capita loan is associated with less poverty incidence and vice versa. Figure 11 depicts the relation between poverty and banking services with regard to per capita deposit and per capita loan (banked or unbanked).

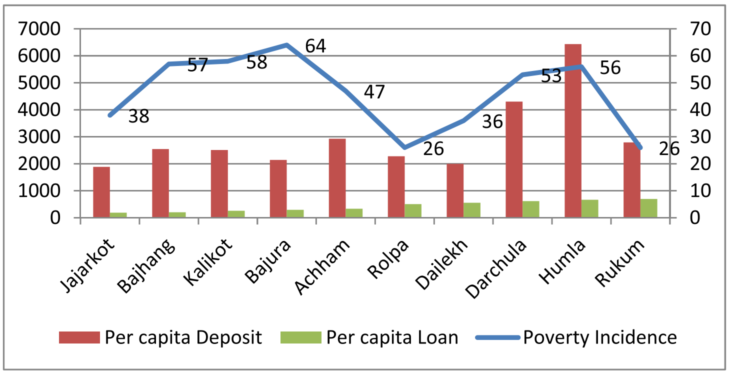
Figure 11
Per Capita Deposit, Loan and Poverty in Banked Districts



Data source: BFI Statistics and author's calculation.

The Figure 12 shows the poverty in less banked (per capita loan and deposit) districts. It also shows financial access help to reduce poverty or vice versa.

Figure 12
Per Capita Deposit, Loan and Poverty in Less-banked Districts



Data source: BFI Statistics and author's calculation.

3.2 Empirical Analysis

The relationship between the financial inclusion variables and poverty incidence is analysed empirically by using population per bank branch, per capita deposit, and per capita loan, including all 75 districts of Nepal for the year 2012. For the analysis, the econometric software STATA 11 is applied.

As we can observe, the decreased population per branch (meaning that people having more access to formal financial services) and increased access to deposit and credit facilities will decrease the poverty incidence, we can model this relationship as:

$$PI = \alpha + \beta_1 \log(Pop - Branch) + \beta_2 \log(PCL) + \beta_3 (PCD) + \varepsilon \qquad (1)$$

Where *PI* refers to the poverty incidence representing the percentage of population being poor; *Pop-Branch* is the division of the total population of the particular district by the total number of bank and financial institutions available in that district; *PCL* is the per capita loan which is the total loans disbursed by the banks and financial institutions in that district, divided by the population; and *PCD* is the per capita deposit of the particular district.

We hypothesised that decreased population per branch should decrease the poverty and increased per capita deposit and per capita loan should also decrease the poverty. Hence, the sign of the coefficient of *Pop-Branch* is expected to be negative and the signs of the coefficients of *PCL* and *PCD* are expected to be positive.

The data relating to population per branch, per capita deposit and loan were taken from the NRB, Statistics Division; and the data of poverty incidence was taken from the small area sample of Poverty Survey, 2011, CBS, Nepal. Data of the population was taken from the Statistical Pocket Book, 2012 of the CBS.

3.2.1 Regression Results

The estimated coefficients of the Equation (1) are presented as follows:

$$PI = \underset{(0.52)}{22.26} + \underset{(0.63)}{1.579} \log(POP\_Branch) - \underset{(-5.70)}{11.177} \log(PCL)^{**} + \underset{(3.17)}{9.075}(PCD)^{**} \qquad (2)$$

Values in ( ) are t-stats. R2 = 0.53., Adj R2 = 0.51 F-Stat = 26.33
*** - significant at 1% level*

The estimated coefficients of Equation (2) show that per capita loan is significant to decrease the poverty. For instance, 1 percentage point increase in per capita loan would decrease the poverty incidence by 0.11 percentage point. However, against our assumption, per capita deposit does not have any impact in decreasing poverty. The argument can be made that as loan is taken by the poor whose income is insufficient to save, the amount deposited could be from those who are not reflected in the poverty statistics. People with sufficient income can deposit their money in the bank. Although the sign is as expected, the population per branch variable is not significant in the model. Nonetheless, if the poverty data is regressed on the financial data of 2014, all the variables become significant with the expected signs (Annex 5). Since all the t-statistics are greater than 1.96 and p>|t| smaller than 5% level of significance, all the three regressors are statistically significant.

With the financial outreach to rural areas increasing due to the NRB policies and reflected in the decreasing trend of poverty, we can infer that access to finance can significantly reduce poverty in Nepal. In contrast to this, there is the possibility that banks open branches where people have sufficient income to save. The relationship might also work the other way.

The RAMSEY Reset test confirms that there is no omitted variable bias in the model and the Breusch-Pagan/Cook-Weisberg test for heteroskedasticity confirms the constant variance of the model (Annex 6).

Box: 1 Case Study

Investment Opportunity: Maximise Wealth of Rural People

The Chilime Hydropower Company Limited, a hydropower generating company, was established in the remote district of Rasuwa, Nepal. The district was characterised by high poverty incidence, low literacy rate and lack of access to basic infrastructures. The project generates 22 mw electricity. Initially, the company was established as a subsidiary of the Nepal Electricity Authority, a state-owned enterprise. Later on, the provision for allocation of a portion of its shares to the affected area was made mandatory. Accordingly, in 2010, 31 shares for each family with a face value of Rs. 100 and 29 shares at premium of Rs. 223 were allotted to the locals. The company has been able to pay out good returns, both in cash as well in stock dividends each year. Including bonus share, the total share a family holds reached to 141 in 2014. The initial cost for 60 shares was Rs.12,467. If the present value of the share in the stock market (ignoring the cash dividend received earlier) as of August 7, 2014 is considered, a family will get about Rs. 374,000. By this, the net income from the shares will be more than Rs. 360,000. This is strong evidence that shows how an excluded poor family can benefit and maximise wealth and can come out of abject poverty. The investment made by the poor and the rich in the company is the same, but the value of such returns to the poor are greater than for the rich people. After ensuring safe investment to such projects and providing opportunities for the poor people, we can generate inclusive growth in the economy.

4. Plan for the Next Decade

4.1 Major Issues

There was an ambitious plan of expanding banking services to the every part of the country. The seventh 5-year plan which envisaged at least a bank branch for every 30,000 people was a very ambitious plan that time. (A bank branch had to serve more than 100,000 people that time). Though the branch expansion policy increased branch network significantly, the penetration of the branch networks remains uneven and many rural areas are still unbanked or are less banked. In this context, the following issues emerge in the formulation of the financial inclusion plan for the country.

4.1.1 Operational Efficiency and Affordability of Services

There are many microfinance institutions located in the Terai and accessible hills, but the interest rate of loans still remains very high. The high cost of operation and high profit margin of these institutions make their financial services more expensive and unaffordable to the poor and destitute people.

4.1.2 Duplication of Services

There are many institutions of the same kind operating across the urban and easy areas. These institutions provide basically the same types of products and services. There is a mushrooming of services in the easy areas while such services are lacking in the remote and unbanked areas.

4.1.3 Business Motives of MFIs

Most of the MFIs operating in Nepal are listed in the NEPSE and are regarded as high earners. The share prices of most of the listed MFIs are higher than that of commercial banks and some hydro power companies. They have leverage in using low-cost funds from the A,B,C institutions and can disburse loans with higher rates or park their funds safely with the same institutions.

4.1.4 Insufficient Commitment in International Arena

Nepal has committed to the Maya Declaration recently. Some of the commitments are very simple and do not require any serious effort to achieve them. The commitments in the Maya Declaration are: promotion of financial literacy; conduct of rural credit survey (a routine work); formulation of Financial Sector Development Strategy; and introduction of Mobile Money Services.

4.1.5 Lack of Periodic Review and Continuation of Programmes

The NRB hitherto has not performed any periodic review of the policy impact of the programmes and has allowed automatic continuation of programmes to expand banking services. The priority sector programme was phased out 10 years ago keeping the Deprived Sector lending intact. Without any impact assessment, the programme has been running for the past 20 years. And the donor-supported programmes were token programmes which have very little impact in expanding and improving the condition of the poor people.

4.2 Challenges

4.2.1 Difficult Geographical Terrain and Infrastructure

Large numbers of villages are still unbanked. As these villages are far from the district capital and are thinly concentrated with scattered dwellings, it is a challenge for providing basic facilities to these places, like electricity, telecommunication, banks, and health facilities.

4.2.2 Coordination among the Relevant Institutions

There are many government agencies which provide basic infrastructure and some kinds of financial services. The government is providing allowances to the old-aged people, but the money has been misused before reaching the targeted segment due to the lack of a proper channel in disseminating the funds. Besides, there is no mechanism for sharing information with the Department of Cooperatives, and also no common platform for information sharing with the Securities Exchange Board, Insurance Board and NRB. There are many donor-sponsored programmes, but they are not coordinated with the relevant agencies, including the NRB.

4.2.3 Demand- and Supply-side Constraints

There have been very few organised efforts to enhance financial literacy and education. Educating people about the services and designing suitable products for the people are some dimensions that may habituate people to the formal banking services. Moreover, it is also observed that although there are financial services available, people are not aware of it, products are not suitable for them, and/or the pulling factors are lacking for the general public to go to the BFIs. From the supply-side perspective, it is necessary to change the mindset of the banks and financial institutions for them to view the poor as customers who are bankable and can be trusted. The banks always function as profit-making institutions and require complex and burdensome documentation which hinders the poor from gaining access to the formal funds.

4.3 Recommendation and Suggestions

4.3.1 Connecting and Providing Basic Infrastructures

Most of the rural villages are deprived of basic infrastructure, like road connectivity, telecommunication, electricity, and so forth. Hence, provision of these facilities facilitates the implementation and usage of techno-based financial products. As the techno-based products are low cost and easy to operate, priority has to be given for telecom companies, ISPs, BCs, PoS, Smart cards, smart phones to deliver financial products throughout the country.

4.3.2 Activating Demand and Supply Side

Financial literacy programmes activate demand for financial products. Formal initiatives for incorporating this issue in textbooks and creation of awareness through mass media are needed. Promoting microfinance, motivating microfinance business as social business as well as reviewing and amending the existing policies will help to smooth the supply side.

4.3.3 Using Basic Bank Account to Remission of Payment by Government

Nepal is without modern, fast, convenient and reliable delivery channel for remitting payments from the government to public till now. Due to lack of this telecommunication platform, tens of thousands of rupees are misappropriated every year. Using the use of bank accounts can be a useful vehicle to provide such services to the targeted people.

4.3.4 Mapping of Poverty and Financial Inclusion/Access

The targeted programmes are achievable when the mapping of poverty and financial inclusion or access is done properly. Though district-based poverty data have been developed, it is not sufficient. To effectively implement any programme of poverty reduction or financial inclusion, mapping will be effective for the planning and implementation of such programmes.

4.3.5 Research and Development

There is very limited few research in the area of financial inclusion and its relation to poverty and economic growth. There is also lack of research on the causes of the low level of loan utilisation from the MFIs. Product development suitable for the targeted people can be another potential area for research. Conducting periodic survey on financial literacy and education, as well as collecting, compiling and disseminating financial inclusion data periodically will also help in the designing of the appropriate policy.

4.3.6 Banning Informal Financial Services and Migrating Them to Formal Channel

The NLSS reveals that loans from the informal sources, like friends and relatives and money lenders, are the major sources for household loans. Large numbers of cooperatives are beyond the regulatory and supervisory purview of the state regulators. In this scenario, banning such activities and formalising these institutions is one of the ways of increasing financial access across the country.

4.3.7 **Unique Identification Number for All Account-holders**

There are multiple deposit accounts in use by the same individuals. A unique identification number can be created for each individual and used for opening bank accounts and taking loans. On one hand, it helps to create accurate database for credit information. On the other, it supports government agencies in providing allowance to the targeted people (any payments from government to people). India and Indonesia have made remarkable progress in this area.

4.3.8 Providing Safe Investment Opportunities to the Poor

Providing safe investment opportunities helps people to maximise their wealth which ultimately promotes inclusive growth. The case study of Chilime Hydro is a good example of inclusive growth assurance. There are several hydropower projects in the pipeline in Nepal which not only provide ownership of the projects to the local people, but also improve their living standards. Hydropower projects with more than 10 mw capacity can be launched by mandate as public limited companies and minimum 10-20% share can be allotted to the local people, especially for the poor and destitute. This can be one of the useful ways to reduce poverty and co-opt people into the main stream of the development process.

4.3.9 Establish Proper Coordination Among the Relevant Agencies

Proper coordination is lacking among the different agencies working for financial inclusion, like the NRB, Insurance Board, capital market, cooperatives, Ministry of Finance, Ministry of Poverty Reduction, donor agencies, and so forth. There must be focal points assigned to coordinate, direct and review the policies executed in the propagation of financial inclusion.

4.4 Delivery Models

Many efforts have been undertaken in improving the financial access or inclusion in the country but they are not sufficient. A significant portion of the people is still deprived of formal financial services, as reflected in the per capita deposit and loan statistics for many districts. To expand the formal financial services to the all parts of the country, a new strategy and further efforts are required. This cannot be done by any single organisation, the NRB or government. The government, NRB, banking community, business houses, and donor agencies should actively collaborate and play their part. Delivery models can be bank branches, mobile phone (the subscription rate of which is very high and with coverage in most parts of the country), BCs, branchless banking, PoS and other innovative products. The MM4P (mobile money for the poor) project with the support of foreign partners is in progress.

4.5 Implementation Plan (Strategies)

Our financial inclusion plan should envision: "No one will be unbanked in next decade in Nepal."

The following strategies can be useful in achieving the vision:

a. Increase the availability of BFI's services in rural and remote areas;

b. Formulate national level policies for expanding financial access and inclusion;

c. Improve the institutional arrangements for expanding financial access;

d. Promote consumer protection with respect to the use of financial services;

e. Strengthen the regulatory and supervisory framework for microfinance organisations; and

f. Enhance public awareness, financial literacy and financial education.

5. Summary and Conclusion

The Nepalese economy has been witnessing slow growth, under-employed resources, low productivity and mass poverty, especially in hilly and mountainous regions of the country. Regarding financial access, these districts have low access to finance, meaning that they are financially excluded.

The paper attempts to study the relation between financial access and poverty incidence. Graphical plots and data observations show that there is some kind of relationship between them. This is also borne out by empirical analysis using cross-sectional regression. The empirical estimates indicate that poverty can be reduced by increasing access to formal financial services. The NRB, with policy support and coordination with government agencies, can facilitate the propagation of financial inclusion to reduce poverty and achieve inclusive growth. The expansion of financial inclusion is a significant measure to achieve the economic transformation of Nepal from least developed country to the status of a developing country by 2022.

As discussed earlier, the per capita deposit has no bearing on the reduction of the poverty level. It can be argued that people who deposit regularly would not be poor. Geographical hardship, lack of infrastructures, lack of technology-based products, lack of financial literacy, and products and services not compatible with the needs of the poor, are some of the reasons for the financial exclusion. Likewise, the insurance sector is also underdeveloped in Nepal. The GoN's recent initiative in embarking on a crop and livestock insurance scheme financed by the state is a positive development.

There are several challenges and issues in financial inclusion which are not easy to overcome within a short span of time. Enhancement of operational efficiency, reduction in duplication of the services, periodic review and evaluation of on-going programmes, are some of the issues to be addressed. Coordination between the relevant authorities plays a vital role in accomplishing the planned goals. In view of its rugged geographical terrain, Nepal needs to deploy technology-based banking services on a wider scale (since mobile phone service is available in almost all parts of the country). Unique Identification Number is also a useful tool to facilitate G-to-P benefits. Policymakers should pay attention to these issues and should incorporate these inputs in the forthcoming FSDS. Effective implementation of these strategies can significantly produce the desired results.

Nobel Laureate Prof. Yunus once stated that "People were poor not because they were stupid or lazy. They worked all day doing complex physical tasks. They were poor because the financial institutions in the country did not help them to widen their economic base." The NRB has an important role to play under the FSDS in focusing and aligning the business activities and operations of the BFIs towards the promotion of financial inclusion as a development strategy to benefit and make a difference in the lives of the people of Nepal.

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Annex 1: Sources of Household Loans

Source of Household Loans	NLSS I (1995/96)	NLSS II (2003/04)	NLSS III (2010/11)
Bank	16.1	15.1	20.0
Relatives	40.8	54.5	51.1
Money lenders	39.7	36.0	15.1
Cooperatives	-	-	5.1
NGO/ relief agency	-	2.3	4.1
Others	3.3	2.1	4.6

Annex 2: Project-based MF Programme Supported by Donors

Project Name	Project Period	Disbursement	District Covered	Beneficiaries	Donor
Production Credit for Rural women (PCRW)	1981/82-1995	SDR 4.75 million and US$ 1.0 Million	67	68,000 women	IFAD, FINIDA
Micro-credit programme for Women (MCPW)	1993-2002	SDR 3.54 million	15	25,000	ADB
Community Groundwater Irrigation Programme (CGISP)	1999-2005	SDR 9.93 million	12	9,404 families	ADB
Third Livestock Development Programme (TLDP)	1996-2004	SDR 12.5 million	26	10,605 families	ADB
PAPWT	1997-2004	SDR 2.57 million	8	29,000	IFAD
Rural Micro-finance Programme (RMP)*	1999-2005	SDR 14.2 million			ADB

Annex 3: Nepalese Financial System

Institutions	No	Asset (Rs. billion)	Percent
NRB Regulated		**1,601**	**85.4**
Commercial Banks	30	1,243	66.3
Development Banks	88	200	10.7
Finance Companies	58	101	5.4
Micro-finance Development Banks	36	36	1.9
Financial Cooperatives*	16	15	0.8
Financial NGOs*	25	6	0.3
Contractual Savings Institutions		**273.4**	**14.6**
Employees Provident Fund	1	145	7.7
Citizen Investment Trust	1	43	2.3
Insurance Companies	25	84	4.5
Postal Savings Bank	1	1.4	0.1
Total		**1,874.4**	**100.0**

* with limited banking activities.

Annex 4: Financial Inclusion Indicators, WB 2012	Nepal	SA	Low Income
Account with a Formal Financial Institution			
All adults (%, age 15+)	25.3	33	23.7
Male adults (%, age 15+)	29.6	40.7	27
Female adults (%, age 15+)	21.2	25	20.5
Young adults (%, age 15-24)	23.6	24.7	15.6
Older adults (%, age 25+)	25.4	36.6	28.2
Adults with a primary education or less (%, age 15+)	19	27.8	16.2
Adult with secondary education or more (%, age 15+)	41.5	54.2	35.4
Adults in income quintiles I (lowest and II (%, age 15+)	16	25.3	16.3
Adults in income quintiles III, IV, V (highest) (%, age 15+)	30.8	41	29.4
Adults living in rural area (%, age 15+)	22.3	30.8	22
Adults living in urban area (%, age 15+)	50.6	39.2	35.8
Access to Formal Accounts			
0 deposits/withdrawal in typical month (% with an account)	1.7	6.6	5.4
0 deposits in a typical month (% with an account)	1.7	11.7	8.3
1-2 deposits in a typical month (% with an account)	89.2	70.5	64.7
3+ deposits in a typical month (% with an account)	6.2	12.9	23.1
0 withdrawal in a typical month (% with an account)	6.4	15.9	21.2
1-2 withdrawals in a typical month (% with an account)	81.6	66.4	59.1
3+ withdrawals in a typical month (% with an account)	7.6	11.9	16.1
ATM is the main mode of deposit (% with an account)	0.9	2	4.3
Bank teller is the main mode of deposit (% with an account)	81.4	85.3	78.8
Bank agent is the main mode of deposit (% with an account)	15.1	5.3	9.1
ATM is the main mode of withdrawal (% with an account)	11.8	18	23
Bank teller is the main mode of withdrawal (% with an account)	75.1	68.6	62.9
Bank agent is the main mode of withdrawal (% with an account)	11.9	4	5.4
Has debit card	3.7	7.2	7.4
Use of Formal Accounts (%, age 15+)			
Use an account for business purpose	3	4	4.6
Use an account to receive wages	3.6	7.4	5.9
Use an account to receive government payments	1.2	3.5	2.5
Use an account to receive remittances	4.6	2	4.7
Use an account to send remittances	1.2	1.6	2.8
Mobile Payments (%, age 15+)			
Use mobile phone to pay bills	0.3	2	2.6
Use a mobile phone to send money	0.4	0.8	7.1
Use a mobile phone to receive money	0.3	1.9	9.1
Savings (%, age 15+)			
Saved any money in the past year	18.4	21.3	29.9
Saved at a formal financial institution in the past year	9.9	11.1	11.5
Saved using a saving club in the past year	6.3	3.3	8.2
Saved for future expenses in the past year	13.6	15.5	20.3
Saved for emergencies in the past year	15.1	17.2	22.8
Credit (%, age 15+)			

Loan from a formal financial institution in the past year	10.8	8.7	11.4
Loan from family or friends in the past year	33.2	19.5	30.2
Loan from an informal private lender in the past year	19.2	6.4	7
Outstanding loan to purchase a home	5.1	2.4	2.4
Outstanding loan for home construction	13	4.4	6.3
Outstanding loan to pay school fees	12.5	4.9	6.9
Outstanding loan for health and emergencies	23.9	14.1	16.1
Outstanding loan for funerals or weddings	5.7	3.9	5.4
Insurance (%, age 15+)			
Personally paid for health insurance	1.8	5.5	2.2

Annex 5: STATA Output of Equation (1)

Source	SS	df	MS
Model	6974.61938	3	2324.87313
Residual	6269.96729	71	88.3093985
Total	13244.5867	74	178.980901

Number of obs	= 75
F(3, 71)	= 26.33
Prob > F	= 0.0000
R-squared	= 0.5266
Adj R-squared	= 0.5066
Root MSE	= 9.3973

poverty	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
lnpop_branch	1.579185	2.506887	0.63	0.531	-3.419405	6.577775
lnpcd	9.075447	2.861273	3.17	0.002	3.370231	14.78066
lnpcl	-11.17734	1.959526	-5.70	0.000	-15.08453	-7.270157
_cons	22.26204	43.11523	0.52	0.607	-63.7073	108.2314

Regression Result of 2014 Financial Data.

Source	SS	df	MS
Model	7837.9558	3	2612.65193
Residual	5145.69698	68	75.6720144
Total	12983.6528	71	182.868349

Number of obs	= 72
F(3, 68)	= 34.53
Prob > F	= 0.0000
R-squared	= 0.6037
Adj R-squared	= 0.5862
Root MSE	= 8.699

pi	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
lpop_all	13.77745	3.962606	3.48	0.001	5.870193	21.68471
lpcd	7.567366	2.627671	2.88	0.005	2.32393	12.8108
lpcl	-5.592369	2.389362	-2.34	0.022	-10.36027	-.8244708
_cons	-124.194	52.2069	-2.38	0.020	-228.3712	-20.01677

Annex 6: Test for Heteroskedasticity and Omitted Variable Bias

a) Breusch-Pagan / Cook-Weisberg test for heteroskedasticity
Ho: Constant variance
Variables: fitted values of poverty
chi2(1) = 0.16
Prob>chi2 = 0.6933

b) Ramsey RESET test using powers of the fitted values of poverty
Ho: model has no omitted variables
F(3, 68) = 1.31
Prob> F = 0.2773

Annex7: District-wise Data of Poverty, Population Per Branch, Per Capita Deposit and Per Capita Loan

S.N.	District	Poverty Incidence	Population Per Branch	Per capita Deposit	Per Capita Loan
1	Jhapa	11	12,129	19,337	17,005
2	Ilam	7	32,250	10,032	5,321
3	Panchthar	11	47,954	4,071	1,874
4	Taplejung	27	31,865	5,825	1,225
5	Sunsari	12	11,065	18,826	19,774
6	Morang	17	14,627	23,140	35,860
7	Dhankuta	16	16,341	5,954	3,744
8	Terhathum	15	25,394	4,886	2,516
9	Sankhuwasabha	21	26,457	7,020	4,075
10	Bhojpur	24	60,820	1,619	854
11	Saptari	40	79,911	4,949	2,867
12	Udayapur	26	22,681	4,806	3,042
13	Siraha	35	45,523	5,260	4,239
14	Khotang	25	103,156	1,736	1,216
15	Okhaldhunga	21	73,992	3,985	1,395
16	Solukhumbu	26	17,648	14,177	6,268
17	Sarlahi	18	51,315	3,578	2,477
18	Dhanusha	23	35,942	13,932	7,297
19	Mahottari	16	89,654	4,931	3,067
20	Dolakha	26	13,326	9,291	4,434
21	Ramechhap	27	67,549	3,708	1,537
22	Sindhuli	38	26,927	4,575	3,132
23	Bara	30	40,453	4,511	4,670
24	Rautahat	33	57,227	3,346	2,074
25	Parsa	29	11,340	27,371	55,904
26	Chitawan	9	6,666	42,655	36,484
27	Makawanpur	28	13,140	18,344	15,409
28	Kathmandu	8	3,928	329,322	245,861
29	Bhaktapur	13	7,616	50,866	19,674
30	Lalitpur	8	5,320	132,481	75,894
31	Rasuwa	32	14,433	5,709	4,188
32	Dhading	19	21,004	5,741	4,177
33	Sindhupalchok	25	13,705	6,501	3,503
34	Kavre	14	8,126	30,073	22,029
35	Nuwakot	20	25,225	8,451	6,492
36	Lamjung	17	9,866	14,106	9,088
37	Tanahu	15	9,797	17,938	12,830
38	Gorkha	20	14,266	9,572	4,729
39	Manang	37	6,538	18,623	7,039
40	Syangja	12	18,072	11,901	8,299

41	Kaski	4	4,101	95,855	77,719
42	Gulmi	26	21,551	7,014	4,213
43	Nawalparasi	17	18,386	7,580	7,055
44	Palpa	26	21,765	12,786	6,814
45	Arghakhanchi	29	28,233	6,811	3,152
46	Rupandehi	17	8,075	43,856	35,674
47	Kapilbastu	36	38,129	6,344	3,148
48	Baglung	23	15,801	10,413	6,834
49	Parbat	13	16,288	8,234	4,767
50	Mustang	40	4,484	59,811	11,530
51	Myagdi	27	10,331	15,916	11,505
52	Rolpa	26	74,835	2,281	503
53	Dang	25	14,542	12,983	9,125
54	Rukum	26	104,284	2,795	696
55	Salyan	29	80,815	1,948	724
56	Pyuthan	32	25,345	4,425	1,880
57	Jumla	49	27,230	6,986	2,352
58	Mugu	47	55,286	4,829	801
59	Humla	56	25,429	6,437	665
60	Kalikot	58	136,948	2,513	259
61	Dolpa	43	36,700	6,602	1,042
62	Dailekh	36	261,770	1,995	554
63	Surkhet	31	20,636	10,056	6,196
64	Jajarkot	38	85,652	1,890	188
65	Bardiya	29	53,322	4,437	1,810
66	Banke	26	11,698	21,285	18,064
67	Bajhang	57	195,159	2,548	204
68	Doti	49	52,937	4,236	1,132
69	Bajura	64	134,912	2,142	297
70	Kailali	34	23,506	10,206	9,151
71	Achham	47	42,913	2,931	333
72	Darchula	53	133,274	4,304	616
73	Baitadi	46	125,449	2,919	812
74	Dadeldhura	43	20,299	7,627	3,351
75	Kanchanpur	31	25,069	10,717	8,819
	Total		**14,138**	**37,080**	**28,604**

Chapter 6

ADVANCING INCLUSIVE FINANCIAL SYSTEM IN THE NEXT DECADE: THE CASE OF MOBILE BANKING IN PAPUA NEW GUINEA

By
Williamina Hubert[1]

1. Background

Papua New Guinea's (PNG) population in mid-2011 was 7.3 million (National Statistical Office Census, 2011). With an average annual growth rate of 3.1%, it is estimated that by mid-2015, PNG's population will be around 8.1 million and considerably smaller compared to other SEACEN economies. However, PNG shares similar demographic characteristics to its SEACEN neighbours in terms of a higher population of younger people. Close to half of its population are aged 19 years or younger, whilst 3% are above 64 years with women accounting for approximately half the population. (Household, Income and Expenditure Survey (HIES), 2009-2010).

The most important statistic for financial inclusion initiatives is the estimated two thirds of the population living in rural areas engaged largely in subsistence farming (2014 National Budget, p.65). This segment of society have had, until only recently, very limited access and/or exposure to financial markets of any form. The country is geographically fragmented with mountainous terrain and many scattered small islands. Many communities live in relative isolation from each other, let alone having accessibility to a commercial bank, post office or health care centre. Expensive air travel is typically the only form of transportation between the capital city of Port Moresby and the other 22 provinces. Villages and districts that are along main highways and arterial roads such as Dagua villages in the East Sepik Province are better placed to directly benefit from financial inclusion programmes compared to those living in remote communities such as Sofia - a remote village in Musa Oro Province, surrounded by the rugged terrain of the Owen Stanley Ranges and a rough four to five day walk to the main highway.

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PNG is one of the most culturally diverse country in the world. It is known to have more than 800 different minority speaking language groups, each with their own unique and distinct traditional practices. To some extent, these same traditional customs and norms may have contributed to the isolation of communities. Population density ranges from 1.8 people per square kilometre (km) in the Western Province to 1,325 people per square km in the nation's capital Port Moresby, situated in the National Capital District (NCD).[2] The average population density for the total 21 provinces and 1 autonomous region,[3] is 77.2 people per square km. Given this background, the practical implementation of development policies including basic health services, education and rural electrification, to name a few, has proven to be extremely challenging for successive governments. Nevertheless, the drive - and it seems the pressure, to include those financially excluded from the formal financial sector is receiving growing prominence in government policy.

In 2014, the country stepped into a new era of economic growth, heralded by the Liquified Natural Gas (LNG) project, destined to be the most profitable project since independence in 1975. To avoid a repeat of the Bougainville Crisis[4], the Government of PNG (GoPNG) must endeavour to be a fair and equitable distributor of wealth generated from this project. The US$10 billion LNG project signed between GoPNG and Exxon Mobil in November 2009 is now worth US$19 billion and projected to generate unprecedented wealth for the country over the next 40 to 50 years. To facilitate this project, major infrastructural reforms were undertaken in 2006 allowing for competition in the telecommunications sector and the development of a National Payments System (NPS). Undoubtedly, both these infrastructural changes have created an enabling environment for all sectors of the economy to prosper.

2. Port Moresby, the capital, is in the National Capital District (NCD). The NCD is classified as a province. It is 240 square kilometres (km), the smallest of all the 21 provinces and 1 autonomous region but with the highest estimated population of 318,000 people.

3. The Autonomous Region of Bougainville (ARB) was previously known as the North Solomon's Province.

4. The Bougainville Crisis was the darkest decade in PNG's history from 1988-1998. Civil war broke out as a result of unequal distribution of royalties from the GoPNG to landowner Bougainvilleans. Bougainville Copper Limited, a subsidiary of Rio Tinto was the operator of the Panguna mine one of the world's largest open pit mines. The Crisis resulted in the deaths of some 15,000-20,000 Bougainvilleans.

Notably, the spinoff benefits resulting from competition in the telecommunication sector has revolutionised the use of mobile phone technology in the provision of financially inclusive products and services. In turn, this has the potential to open another dimension of competition within the financial sector itself. With stakeholders' combined efforts aimed at delivering products and services at fair and affordable prices, the outlook for finally involving ordinary Papua New Guinean's in the country's economic story is reaching a reality. However, despite this advancement, PNG's financial inclusion agenda is still at infancy stages. Numerous hurdles including stakeholder capacity building need to be addressed. The most pressing task for the central bank, the Bank of Papua New Guinea (Bank of PNG) in particular, is to formulate regulations over a new breed of current and potential electronic financial products.

Whist this paper will seek to highlight general aspects of financial inclusion in PNG, its main aim is to investigate the impact of mobile phone banking since its inception in 2003 and its projected contribution for financial inclusion over the next decade. It will look specifically at the role of the central bank, the Bank of PNG and monetary policy implications of mobile banking. Important regulatory changes that need to be undertaken to monitor this new medium of transaction will also be discussed.

The paper is structured as follows. Section 2 will discuss the main financial inclusion policies and programmes currently in place and earmarked to take place in future. It will also discuss the role of important stakeholders in the financial inclusion drive. Section 3 will discuss the current status of financial inclusion, specifically looking at the current state of financial sector development and outlining some of the main challenges. Section 4 will present an in- depth analysis of financial inclusion and highlight the potentially significant gains that can be harnessed using mobile money banking as a means for financial inclusiveness. Section 5 will outline the plan for the next decade with a focus on using mobile technology to advance financial inclusion whilst Section 6 will conclude.

2. Financial Inclusion – Policies, Initiatives and Institutions

2.1 Brief History of Financial Inclusion in PNG

In March 2010, GoPNG reiterated the importance of an efficient financial and banking sector in its Development Strategic Plan (DSP) 2010-2030. The DSP is aligned with the country's Vision 2050 statement and is meant to act as 'a guide to success.' It's overriding goal and vision respectively, is to achieve a high quality of life for all Papua New Guineans and to be a prosperous middle-income country by 2030.

A shorter term plan called the Medium Term Development Plan (MTDP) 2011-2015 was released to complement the DSP. The MTDP clearly identified elements of financial inclusion (although it does not explicitly state the word) as a means of assessing GoPNG's performance in achieving financial and banking sector development. These include expansion of financial products and services to private sector small to medium enterprises (SMEs), developing affordable and financial products to meet the needs of these customers and others, and encourage financial services in rural areas as a medium-term initiative for long-term growth (Department of National Planning & Monitoring 2010, p.19-20). Finally, National Budgets since 2010 have made explicit budget allocation for financial inclusion related projects specifically the Financial Inclusion and Literacy Program (FILP).

These endeavours are a culmination of efforts that began in 2001/2002. During these years, the Asian Development Bank (ADB) and the Australian Agency for International Development (Ausaid) - now termed Development Cooperation under the Australian Department of Foreign Affairs and Trade (DFAT),[5] with GoPNG's support - embarked on a programme to create an inclusive financial system for the country's unbanked and predominantly rural population. Whilst the PNG Microfinance and Employment Project (MEP1) came to a closure in 2010, this specific project had created a good foundation for the country's financial inclusion initiatives going forward. During the early 2000's MEP1 was instrumental in providing financial assistance programmes to disadvantaged and low-income sections of society which formal financial markets had done little to support.

Significant milestones to date include: PNG's signing of the 2020 Money Pacific Goals; the launch of a National Informal Economy Policy 2011-2015; launch of the Microfinance Expansion Project (MEP2); endorsement and launch by the National Executive Council (NEC) of a Centre for Excellence in Financial Inclusion (CEFI); PNG's commitment to the Maya Declaration; and the launch of the country's first Financial Inclusion and Financial Literacy Strategy 2014-2015. Table 1 provides a timeline of these events and each will be discussed in detail in this section.

5. For simplicity, this document will continue to refer to all Australian government Development Cooperation assistance packages as AusAID.

Table 1
Important Milestones in PNG's Financial Inclusion History

Date Acquired	Milestone
2009	• Signing of the 2020 Money Pacific Goals • Bank South Pacific (BSP) Limited became the first financial institution to introduce mobile banking services via short message service (SMS) to its customers.
February 2011	Launch of a National Informal Economy Policy, 2011-2015
April 2012	Launch of the Microfinance Expansion Project
April 2013	Endorsement and launch by the National Executive Council (NEC) of a Centre for Excellence in Financial Inclusion (CEFI)
September 2013	Commitment to the Maya Declaration
December 2013	Launch of first Financial Inclusion and Financial Literacy Strategy 2014-2015.
December 2013	Launch of the country's National Payments System - Kina Automated Transfer System (KATS)

Source: Various Sources.

2.2 Major Plans, Policies and Programmes

PNG signed the Maya Declaration on Financial Inclusion in September 2013. Whilst its international commitment came a little later than most SEACEN economies, its regional and domestic commitments began a few years earlier than this Declaration (but not necessarily earlier than other SEACEN economies).

2.2.1 2020 Money Pacific Goals

PNG's regional commitment is the 2020 Money Pacific Goals (MPG). The MPG is an initiative of the Pacific Island Countries (PICs) endorsed by the Forum Economic Ministers Meeting (FEMM)[6] and South Pacific Central Bank Governors in 2009. Similar to the goals of other FI providers in the region like the Pacific Financial Inclusion Program (PFIP), the MPG has four main goals aimed at introducing financial education curricula to all primary and secondary schools by 2020.

6. The Pacific Islands Forum Secretariat is an international organisation advancing regional agenda's for the 16 South Pacific Island Countries (SPICS) which are: Cook Islands, Kiribati, the Marshall Islands, Nauru, Niue, Palau, Tuvalu, Federated States of Micronesia, Tonga, Samoa, Vanuatu, Fiji, Solomon Islands, PNG, Australia and New Zealand.

The first goal is for all school children to receive financial education through core curricula. Without explicitly stating the number of adults, the second goal is to ensure that adults have access to financial education. The third aim is to establish simple and transparent consumer protection while the final goal is to halve the number of households without financial access to basic financial services. The MPG represents PNG's dedication to a regional commitment of financial inclusion objectives. In addition, GoPNG in collaboration with other partners had formulated two key documents for PNG's national financial inclusion agenda.

2.2.2 National Informal Economy Policy 2011-2015

In 2004, GoPNG formally recognised financial inclusion as an important variable for economic growth particularly for rural dwellers and the urban unemployed. It enacted the Informal Sector Development and Control Act and later produced the National Informal Economy Policy 2011-2015 (the Policy) launched in February 2011.

The Policy acknowledged the importance of the challenges faced by the informal sector and aimed to address these challenges using two main 'arms': financial inclusion and provision of goods and services of strategic value. More importantly, it provided a step in which the national policy framework encompassed in the Financial Inclusion and Financial Literacy Strategy could be developed.

2.2.3 Financial Inclusion & Financial Literacy Strategy 2014-2015

The Financial Inclusion & Financial Literacy Strategy 2014-2015 (the Strategy) is PNG's first national strategy on financial inclusion which, in addition to the above policy, was formulated based on the Financial Diaries & Financial Competency Surveys conducted for low-income households. Launched in December 2013, the Strategy's main aim is to reach one million more unbanked low-income people and SMEs with a diverse range of financial services by end 2015. Additionally, it targets 50% of those reached to be women.

Other aims include creating a financially competent generation of Papua New Guineans through financial products and financial education and financial literacy designed for young minds. Additionally, the Strategy seeks to actively support innovative use of technology for scaling-up access to financial services and financial literacy. Furthermore, it aims to strengthen consumer protection by issuing prudential guidelines and creating a platform for various national regulators and industry networks to monitor consumer protection. Its other aims are to fully strengthen the capacity of the newly established CEFI to effectively coordinate, monitor and collect vital financial inclusion access data.

The findings of the Financial Diaries and Financial Competency Surveys (the Surveys) are worth mentioning because, in the absence of quantitative evidence over the years, anecdotal evidence has become the primary source for policy making. The Survey's findings are especially important because, for the first time, we can show quantitatively that low-income households depend on PNG's social network or 'wantok' system to assist during times of financial emergency, for example when faced with mounting funeral expenses due to traditional obligations.

The longitudinal Financial Diaries survey carried out by the United Nations, PFIP, Bank of PNG and Microfinance Opportunities (MFO) provided a unique and comprehensive view of livelihoods and transactions of low-income households in Goroka, Kimbe and Port Moresby including the LNG plant at Lealea. Interestingly, it confirmed that people travelled long distances to conduct formal financial transactions even when agents are located in nearby areas. A seemingly small issue of trusting an agent takes root because of a lack of understanding about how agent banking works. A small issue like this leads to a physical trip, at great and unnecessary expense to the customer, to a main commercial bank or other established financial institution.

2.3 Initiatives and Policy Formulating and Implementing Institutions

2.3.1 Microfinance and Employment Project (MEP1)

The MEP1 project ran from 2002-2010. Financed by the ADB and co-funded by AusAID its total budget was US$20.5 million although only US$13.9 million was incurred. There were three main project components: building the capacity of microfinance institutions (MFI) through a Microfinance Competence Centre (MCC); developing, testing and implementing new savings and loans products and delivery methods; and establishing a Revolving Finance Facility (RFF) for MFIs. (ADB (2012), pp.3-4)

The ADB's support activities in MEP1, in collaboration with the Bank of PNG, contributed to the establishment of two micro-finance banks in 2004: PNG Nationwide Micro-bank (formerly Wau Microbank) and now the country's largest licenced micro-bank; and PNG Microfinance Limited (PML). Whilst its target for portfolio quality of regulated MFIs was not achieved at project completion and little attention to savings was given, it nevertheless, was instrumental in providing access to financial services for SMEs and rural farmers when access was previously limited.

2.3.2 Microfinance Expansion Project (MEP2)

The Microfinance Expansion Project (MEP2) is an extension of MEP1 and launched by ADB in April 2012. Worth US$24 million, MEP2 is co-funded by AusAID, GoPNG and participating financial institutions. Its expected project completion date is 2017.

MEP2 is designed to take forward the learning and initiatives of MEP1. Its focus is on programmes for financial literacy to encourage the unbanked population to become part of the monetised sector; continue to work with MFIs to develop management and technical capacity whilst also developing appropriate regulatory framework for their supervision. Additionally MEP2 aims to increase lending to SMEs. One of the major outcomes of MEP2 is the endorsement of the CEFI in April 2013.

2.3.3 The National Survey of Financial Capability

The National Financial Capability Survey (NFCS) is a recent initiative under the financial inclusion umbrella. Launched in November 2013 by the World Bank and the Bank of PNG, it is funded by the World Bank with the support of the Korean Trust Fund and coordinated in collaboration with the Bank of PNG, PNG's National Statistical Office (NSO) and the Institute of National Affairs (INA) a privately funded non-profit policy research institute.

The cost of NFCS was estimated at US$260,000, but due to cost over-runs only two provinces were covered as of 31 December 2014, from an initial sample estimate of 7 provinces. It is expected to provide a comprehensive understanding of how Papua New Guinean's manage money, their financial planning habits and how they use formal and informal financial services. Results of the study will be used to develop a national baseline of financial capability across all income groups and locations and develop effective delivery methods of products and services.

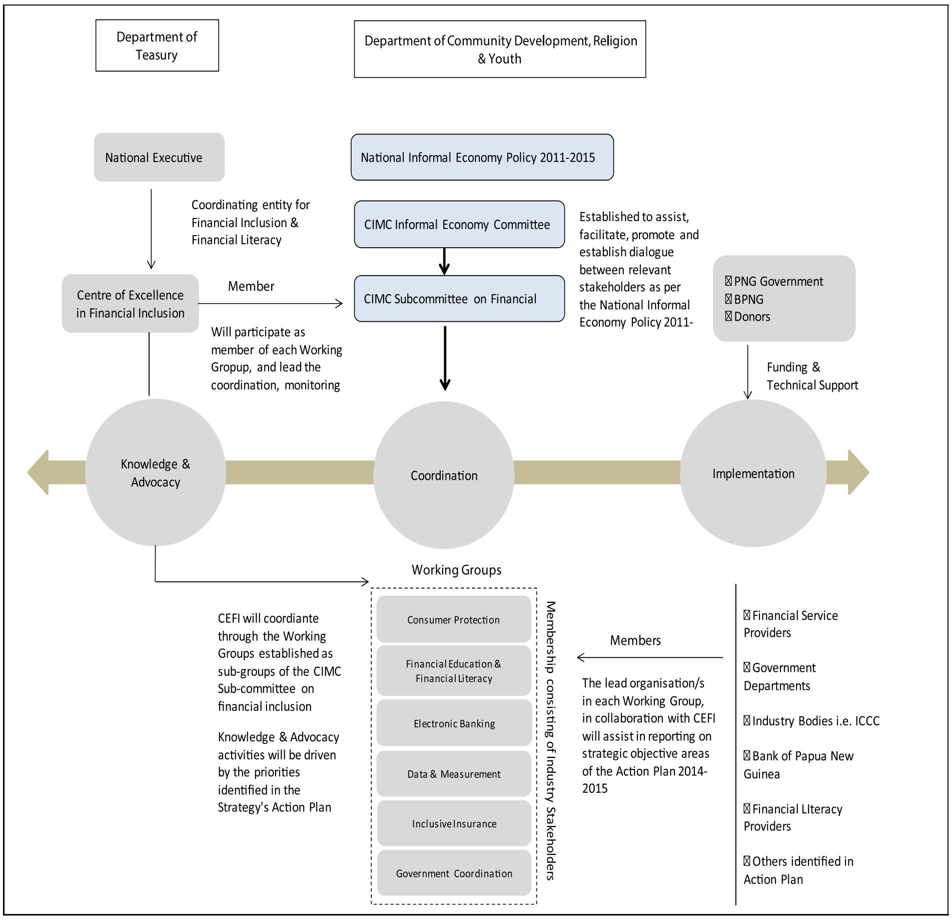
2.4 Institutions Engaged in Formulation and Implementation of Financial Inclusion Policies

Funding and technical support for financial inclusion is predominantly provided by GoPNG, Bank of PNG and main aid donors: ADB, AusAID and the World

Bank. Key financial literacy providers include the Department of Education for primary and secondary school financial inclusion programmes.

Figure 1 shows the institutions engaged in formulating, implementing and coordinating financial inclusion policies in PNG.

Figure 1
Implementation Management



Source: National Financial Inclusion & Financial Literacy Strategy 2011-2015.

2.4.1 Policy Formulating Institutions: Consultative Implementation and Monitoring Council (CIMC) Financial Inclusion Sub-Committee

The financial inclusion agenda is formulated by the Department of Community Development, Religion and Youth in conjunction with the Department of Treasury. These two government departments work in collaboration with other important stakeholders to formulate, monitor and implement financial inclusion policies. The Consultative Implementation and Monitoring Council (CIMC) was established to assist the NEC to oversee the formulation process of the policy on Informal Economy Financial Inclusion as encompassed in the respective National Informal Economy Policy 2011-2015.

Additionally, the CIMC Financial Inclusion Sub-Committee was established to specifically assist, facilitate, promote and establish dialogue between relevant stakeholders. CEFI in particular will work closely with CIMC to monitor progress of this and other financial inclusion policies.

2.4.2 Centre for Excellence in Financial Inclusion (CEFI)

CEFI was endorsed in April 2013. Unlike implementing or policy formulating agencies, its main role is to coordinate all financial inclusion initiatives in the country, bringing together stakeholders involved in financial inclusion and monitor targets and report progress outlined in the national Financial Inclusion & Financial Literacy Strategy 2014-2015. Recently in April 2014, CEFI appointed its first Director.

CEFI's approach in fulfilling its responsibility is two-fold; focusing on (1) Coordination and (2) Advocacy. Coordination efforts are channelled through 6 main Working Groups: Consumer Protection, Financial Education and Financial Literacy, Electronic Banking, Data and Measurement, Inclusive Insurance, Government Coordination on Financial Inclusion as part of development in all levels of government. Meanwhile, the Advocacy approach taken will be analytical - developing products that are captured by evidence based data, providing quarterly industry trend analysis and disseminating information pertaining to best practices and industry standards to all relevant stakeholders.

As the financial inclusion agenda is multifaceted, CEFI is working in collaboration with several stakeholders. Table 2 lists these respective partners and roles in the financial inclusion agenda.

Table 2
CEFI's Partners

Funding Partners	ADB, AusAID
Executing Agency	Bank of PNG
Technical Partners	MicroSave
Project Steering Committee	Department of National Planning and Monitoring, Department of Planning and Community Development, Small Business Development Corporation, Institute of Banking and Business Management, Federation of Savings and Loan Societies Limited (FESALOS)
Development Partners	Pacific Financial Inclusion Programme (PFIP), Consultative Implementation and Monitoring Council (CIMC) Financial Inclusion Sub-Committee
Partner Financial Institutions	Nationwide Microbank, PNG, Microfinance Limited, Kada Poroman Microfinance Limited, Niu Alian Savings and Loan Society, National Farmers Savings and Loan Society, Sepik Savings and Loan Society, East New Britain Savings and Loan Society
Training Partners	Reformation Ministries and Church Network (RMCN), PNG Sustainable Development Programme Limited, Ambumangrae Credit Scheme, Bogia Cooperative Society Ltd.

Source: Centre for Excellence in Financial Inclusion, Papua New Guinea.

3. Current Status of Financial Inclusion

3.1 Implementation of the National Strategy for Financial Inclusion

Whilst the plans described above provide a guide for financial inclusion going forward, it is important to reiterate that the implementation of infrastructure that is needed to facilitate these plans take time. For example, the six Working Groups, described in the section above, whose job is to formulate strategic activities and plans, are only recently being put in place.

In addition, CEFI - the coordinating agency, has only recently appointed its Director and establishing databases to capture and monitor the National Strategy. The road towards its full operationalisation is progressing well. Furthermore, whilst the Bank of PNG has conducted a series of financial expo since 2012, educational outreach so far has been limited to only major centres. Moreover, the roll-out of the National Youth Savings Campaign - an initiative to foster a 'savings' attitude among young children and adults between the ages of 6-25 years is slow to take form despite agreements among relevant stakeholders.

Worryingly are reports that the Financial Capabilities Survey has, only until recently, managed to get back on track after a setback to its schedule due to budget overruns. Despite these teething problems, the established MEP2 funded by the ADB is progressing well.

3.2 Economic Growth and Social Development

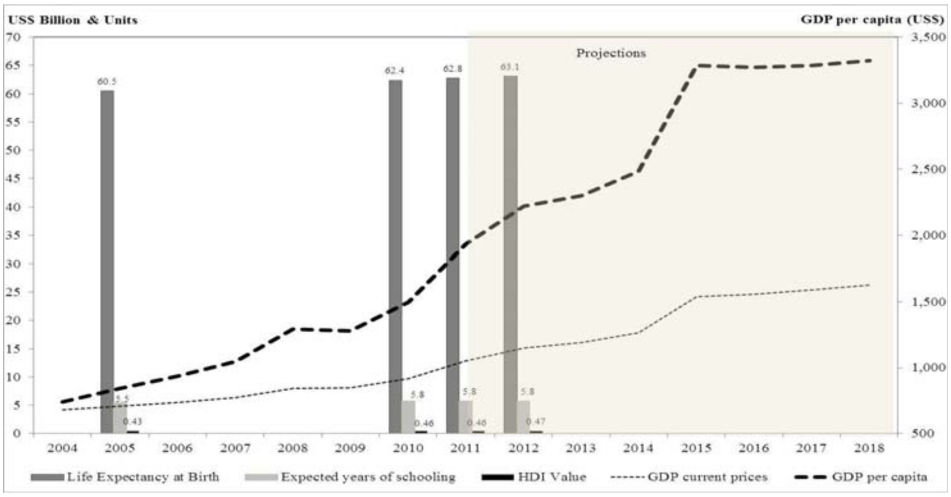
Against this background of financial inclusion objectives and progress to date, there has been strong growth in Papua New Guinea's mining and resource sector which has led to PNG becoming the sixth fastest-growing economy in the world as of 2011 and has recorded a projected GDP of US$17.82 billion in 2014. (International Monetary Fund, World Economic Outlook) Despite this, many people still live in extreme poverty, with one-third of the population living on less than US$1.25 per day. The majority of the population still live in traditional societies and depend on subsistence-based agriculture. If financial inclusion is ever to impact the lives of these people, surely this should be reflected in basic human development indicators (HDI).

PNG has had a bad record of HDI. In 2012, the HDI value was 0.466 - in the low human development category - positioning the country at 156 out of 187 countries and territories. The United Nations Development Program (UNDP) estimates that between 1980 and 2012, PNG's HDI value increased from 0.324 to 0.466. By 1980, PNG's life expectancy at birth increased by 10.3 years, mean years of schooling increased by 2.7 years and expected years of schooling increased by 1.7 years. This is significantly below the average for countries in East Asia and the Pacific.

The only recorded World Bank data on income inequality, the Gini Index was 50.9 in 1996. This means that half of the population share all the income while the other half have nothing - a clear divide between the haves and have nots. Is it reasonable to assume that income inequality has increased? Gibson et al., 2005 find evidence that income inequality is largely seen within geographical areas and that poverty in the 1990s was mainly due to an increase in income inequality and not necessarily to a slow rise in average incomes. These dimensions of inequality are important if GoPNG is ever going to make an impact in eradicating extreme poverty and hunger by 2015 as agreed to in its Millennium Development Goals (MDG).

Figure 2 illustrates some of these indicators against GDP from 2004-2012. GDP projections begin in 2011.

Figure 2
Economic Growth and Selected Human Development Indicators



Source: GDP data - IMF World Economic Outlook; HDI indicators – UNDP.

3.3 State of Financial Sector Development, Issues and Challenges

In December 2013, PNG launched its National Payments System with the introduction of a Real Time Gross Settlement (RTGS) called the Kina Automated Transfer System (KATS). KATS paves the way for increased efficiency in payments and settlements and raises the possibility for the creation of a secondary debt market. In line with this, the National Payments System Act 2013 was certified in September 2013 to replace the obsolete Bills of Exchange Act (1976). At present, work is being carried out to develop a consumer protection act. Whilst these developments are welcomed, financial markets in PNG remain underdeveloped with little competition especially between commercial banks.

The ADB (2010) estimates that merely 15% of the total population have access to either formal or informal banking facilities. Whilst there have been increases in the number of financial institutions - especially licenced financial institutions other than commercial banks, the depth of products and services offered is relatively limited. As of November 2013, PNG had 4 commercial banks, 1 state owned National Development Bank, 11 licenced financial institutions (LFI) - 2 of which are first tier MFIs, 21 savings and loans societies (SLSs), 1 authorised mobile network operator (MNO), 2 authorised money remitters, 2 authorised foreign exchange dealers and 6 authorised money changers. In addition, PNG has 13 superannuation funds licenced to conduct activities specified under the Superannuation (General Provisions) Amendment Act 2002 – two of which are major superannuation funds.

Table 3
State of Financial Sector Development as of November 2013

Number of Commercial Banks	4
State Owned National Development Bank	1
Licenced Financial Institutions	11
Savings and Loans Societies	21
Authorised Mobile Network Operator	1
Authorised Money Remitters	2
Authorised Foreign Exchange Dealers	2
Authorised Money Changers	6
Superannuation Funds	2

Source: Bank of Papua New Guinea.

Three of the four commercial banks - Australia and New Zealand Banking Corporation (ANZ), Westpac and Maybank are foreign-owned. Bank South Pacific (BSP) is the nationally owned bank with branches in Fiji, Solomon Islands and Niue. The first two banks and BSP are the largest lending group and generally target creditworthy and corporate customers. In PNG, commercial banks constitute up to 80-90% of the financial system in terms of their balance sheets. As at September 2013, total assets of the banking system (excluding superannuation funds and life insurance companies) was approximately K27.6 billion (around US$11.8 billion). Total deposits in the banking system were K16.7 billion (US$7.16 billion).

Lack of current credit information particularly in a central location inhibit lending while access to finance in rural areas continues to be low despite a surge in agent banking networks in the recent past. Furthermore, SMEs continue to face difficulty in gaining financial access. Whilst the two major microfinance providers – PNG Microfinance Limited and Nationwide Microbank and SLSs have gained momentum in their outreach programmes, the cost of reaching rural customers, in particular, is extremely high. In September 2013, commercial banks' weighted average cost for deposits was 0.32%, a significant decline from three years ago when it was 1.0%. By comparison, the weighted average loan rate was 10.4% three years ago against the 9.6% recorded in 2014. While loan rates are much lower than they were three years ago the spread between deposit and lending rates have dramatically increased.

Nevertheless, the ADB reports that the Microfinance Competence has listed more than 90 organisations or institutions involved in microcredit. The number of bank branches, although still small, is increasing steadily. Of notable value is the significant increase in mobile phone banking and penetration of financial service delivery through this medium. Table 4 lists some basic statistics of financial inclusion.

Table 4
Selected Financial Inclusion Indicators as at December 2014

Number of Banks	4
Number of Branches per 10,000 adults nationally	0.55
Number of ATMs per 10,000 adults nationally	0.84
Number of EFTPOS per 10,000 adults nationally	22.91
Number of Agents per 10,000 adults nationally	0.76
Number of mobile/financial services accounts/mobile wallet accounts per 10,000 adults	944.02
Percentage of banks offering mobile banking, such as checking one's balance from a mobile phone	3%
Percentage of banks offering mobile financial services, including transfer of e-money	3%
Existence of Central Bank regulatory framework for consumer protection	No
Financial education integrated into the national school curriculum	No

Source: Alliance for Financial Inclusion.

3.4 Issues and Challenges

Whereas these developments point towards a greater involvement for Papua New Guineans in the formal financial sector, there are still some significant hurdles to address. The most important of these are the regulatory aspects surrounding consumer protection. The ADB along with key stakeholders including the Bank of PNG, are in the process of formulating policies that will better guide the industry, particularly with regard to the use of mobile phone banking services.

With the rapid expansion of mobile banking and electronic payments for access products as well as e-payments schemes offered by commercial banks, the biggest challenge is regulating this form of currency. Whilst the country does have a National Payments System Act 2013 and a National Information

Communication & Technology (ICT) Policy, defining regulatory responsibilities are yet to be incepted.

Significant management capacity constraints still exist in not just the small microfinance companies and credit unions but larger stakeholders as well. In a move to address this issue, the Bank of PNG has recently put in place an in-house restructure to accommodate a key department, housing an explicit financial inclusion unit. Moreover, the high operational costs combined with low population density and security threats makes bank branch or agent operations unprofitable to business. On the demand side, geographical difficulties such as rugged terrains, swamps, fast flowing rivers make it difficult for people to travel to urban centres.

Most importantly is the proper management and data collection to report progress and to ensure corrupt practices are not carried out. The financial inclusion agenda is worth millions of US$ and the sooner monitoring and data management processes are in place, the better the accountability and effectiveness of the initiatives.

4. Data Presentation and Analysis

The financial inclusion agenda is in its infant stages in PNG. As data collection for basic financial inclusion indicators only began in 2006/07, there is thus a limited number of observations to conduct sufficiently robust statistical analysis to gauge whether financial inclusion or its delivery modes has economic growth potential. Given this, what follows is a descriptive analysis on some of these basic statistics to date.

4.1 Formally Banked Adults and Adults with Credit at Regulated Institutions

Table 5 below shows usage and access in PNG using the G20 Financial Inclusion Indicators for which data is available. It presents national and four regional statistics which are Southern, Highlands, Momase and Islands.

Table 5
PNG Financial Inclusion Indicators

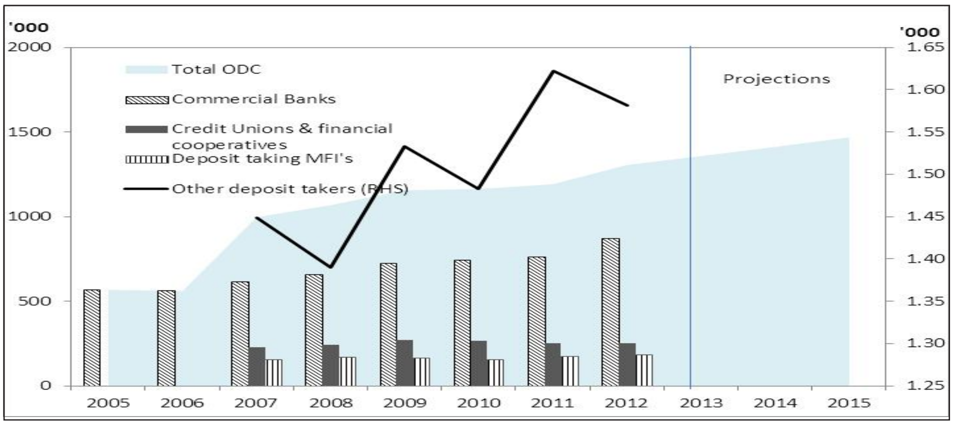
Category	Indicator		Indicator Calculation	Measures
Formally banked adults	% of adults with an account at a formal financial institution (June 2013)	National	14.63%	Usage
		Southern	21.05%	
		Highlands	8.33%	
		Momase	17.82%	
		Islands	20.75%	
	Number of deposit accounts per 1,000 adults (June 2013)	National	439	
		Southern	632	
		Highlands	250	
		Momase	535	
		Islands	623	
Adults with credit at regulated institutions	% of adults with at least one loan outstanding at a regulated financial institution (December 2012)	National	6.98%	Usage
	Number of borrowers per 1,000 adults (December 2012)	National	70	
Point of Service	Number of branches per 100,000 adults (June 2013)	National	3	Access
		Southern	6	
		Highlands	2	
		Momase	4	
		Islands	5	
	Number of ATMs per 100,000 adults (June 2013)	National	10	
	Number of POS terminals per 100,000 inhabitants (June 2013)	National	330	
E-money accounts	Number of e-money accounts for mobile payments (July 2013)	National	386,000	Access

Source: Centre for Excellence in Financial Inclusion, PNG National Financial Inclusion & Financial Literacy Strategy 2014-2015.

As of June 2013, the unbanked population was 85.3%. The Highlands region had the highest unbanked percentage of 91.6%, followed by Momase. The Islands and Southern regions both have around 80% unbanked. Additionally 439 out of every 1,000 adults have deposit accounts with a large share of these accounts held at commercial banks. Figure 3 and 4 show increases in both the number of deposit accounts and consequently growth in the Kina[7] value of outstanding deposits of Other Depository Corporations (ODCs) over the last ten years.

7. Kina is the name of PNG's domestic currency and is denoted by "K".

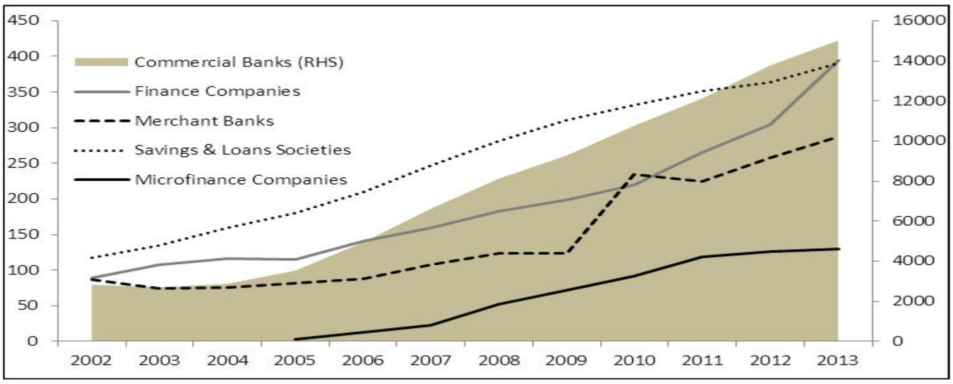
Figure 3
Number of Deposit Accounts by Other Depository Corporations



Source: International Monetary Fund, Financial Access Survey.

According to this indicator, financial inclusiveness is increasing. As of 2012, there were approximately 1.3 million deposit accounts. This was an increase of 9.6% from 2011 and the highest since 2009. Over the last three years, there was a growth of around 4%. Assuming this optimistic growth continues over the next three years from 2013-2015, the number of deposit accounts would exceed the target of 1 million new deposit accounts set in the National Financial Inclusion and Financial Literacy Strategy 2014-2015 by about half a million. As of 2013, deposit taking institutions appear to be performing relatively well in terms of this indicator with the exception of ‘other deposit taking institutions’ which shows spikes and dips in number and value of deposits.

Figure 4
Private Sector Deposits by Other Depository Corporations
(Kina Million)

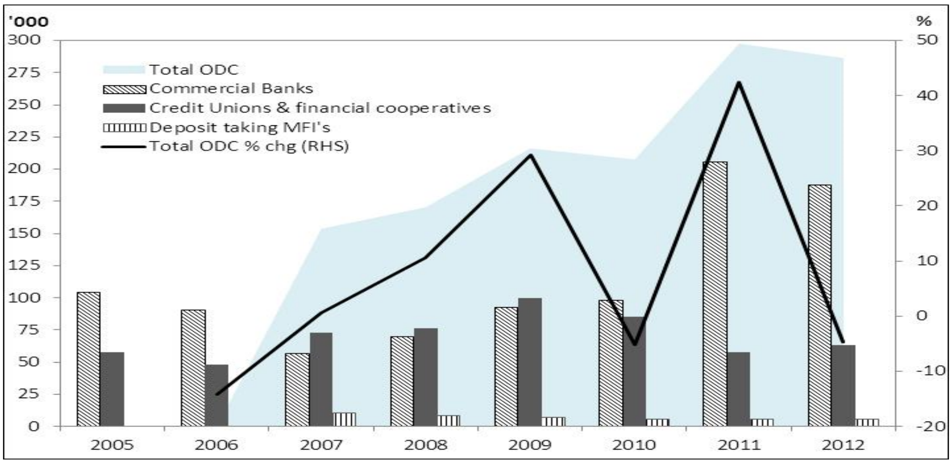


Source: Bank of PNG, Quarterly Economic Bulletin.

Figure 4 shows the Kina value of private sector deposits by ODCs. Whilst all ODCs are performing well, microfinance institutions appear to be lagging behind with growth in deposits plateauing in 2013 despite considerable efforts placed in this area since MEP1 began in 2002.

Surprisingly, the growth in loan accounts in 2012 declined by about 5% following an increase of 42% in 2011 and a similar decline in 2010 as in 2012. By ODC, Figure 5 shows that credit unions and financial cooperatives saw more loan growth than commercial banks from 2007-2009. This can be largely explained by commercial banks' risk adverse stance during the Asian Financial Crises.

Figure 5
Number of Loan Accounts by Other Depository Corporations

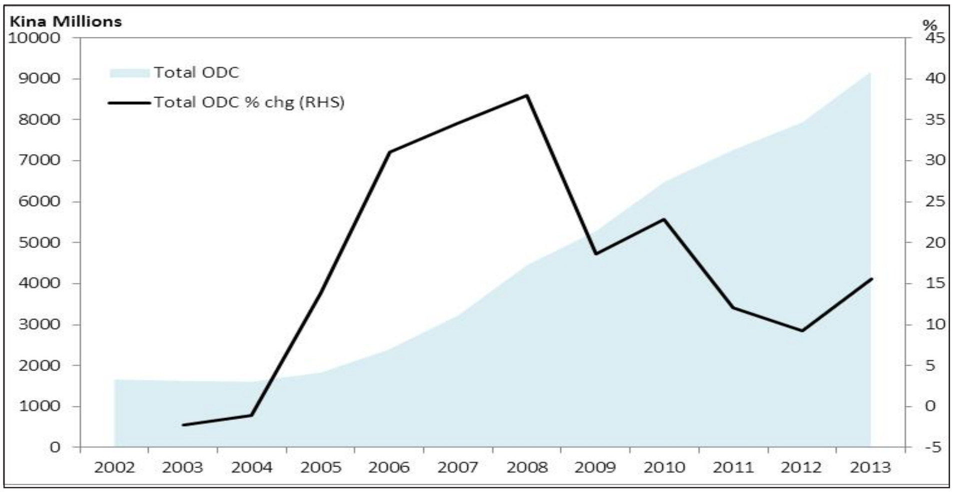


Source: International Monetary Fund, Financial Access Survey.

However in 2010, commercial bank loan account numbers began to rise, culminating in a significant increase in 2011 and then falling back slightly in 2012. The number of loan accounts in credit unions and financial cooperatives began to decline while MFI loan accounts remained relatively flat.

Similarly the value of loans over a ten year period, although positive, have seen a sustained period of fast growth from 2004-2009, followed by some swings. Figure 6 shows these movements with loan values on the rise in 2013.

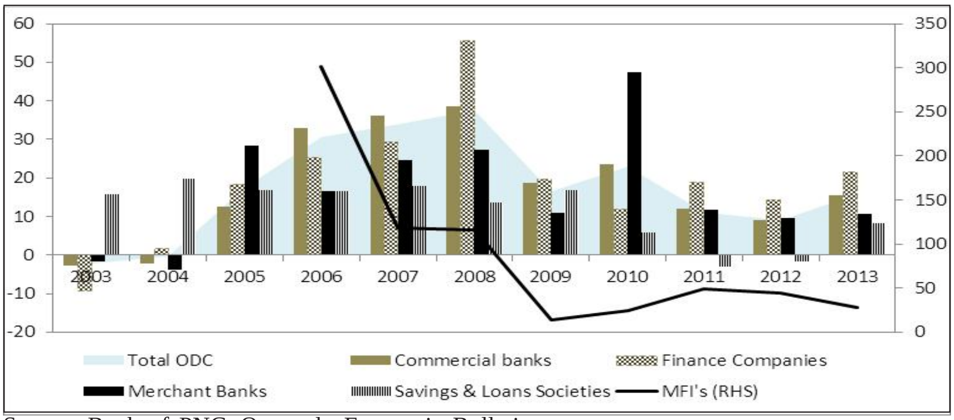
Figure 6
Private Sector Loans



Source: International Monetary Fund, Financial Access Survey.

Sources of loan value growth were mainly from commercial and merchant banks and finance companies during the period 2004-2009. Figure 7 shows the percentage change in the Kina value (in millions) of loans from each ODC. For commercial banks in particular, the period highlighted shows that although the growth in the number of loan accounts slowed, the associated values did not. This is similar to other ODCs with the exception of MFIs.

Figure 7
Percentage Change in Kina Value of Private Sector Loans by Other Depository Corporations



Source: Bank of PNG, Quarterly Economic Bulletin.

The decline of MFI loans is of great concern as considerable funding has been dedicated to microfinance expansion projects since 2002. From 2005-2010[8] an average of K7.1 million loans was made. However, the rate of downward growth in loan value was phenomenal. In 2006, from a high rate of almost 300% from 2005, loan growth rates for MFIs began to plummet and kept declining until 2009. Despite some recovery over the last three years with an average loan value of K40.7 million, marginal increases remain slow and thus total loans made by MFIs have plateaued in 2013.

Nevertheless, although growth in MFI loans can be viewed as a direct measure of financial inclusiveness, it is also important to note that the financial inclusion agenda has also been embraced by the three big commercial banks – BSP, ANZ and Westpac albeit only in recent years. This could be a reason why we see a decline in MFI loans and an increase in commercial bank loans. Unfortunately, this remains a statistical question and best left until sufficient data is available. Small as MFI loans are relative to other established forms of financing, efforts made through MEP1 and CEFI promises to be successful as more Papua New Guinean SMEs seek out opportunities presented from the expectations of economic growth.

In contrast, Table 5 shows that the percentage of adults with more than one loan is significantly low at 6.98%. This indicates that whilst private sector loan growth, which includes households, is increasing, this may not necessarily be true for the latter. Many factors influence loans demand, especially personal lending rates which have been excessively high at around 18-20%. Overall, the number of loan accounts and volume of loans have increased. This varied growth trend makes it difficult to predict a simple annual average growth path for total loans over the next three years, let alone a decade.

4.2 POS Indicators

Whilst the numbers of access points to financial services remain low relative to other South Pacific Island countries and SEACEN members, the rise in e-money accounts and the exponential growth of information and communication technology (ICT) has significant growth potential.

8. Data available from 2005 onwards.

Table 6 shows financial coverage infrastructure across PNG's four regions as of March 2014.

Table 6
Financial Coverage Infrastructure By Region as at March 2014

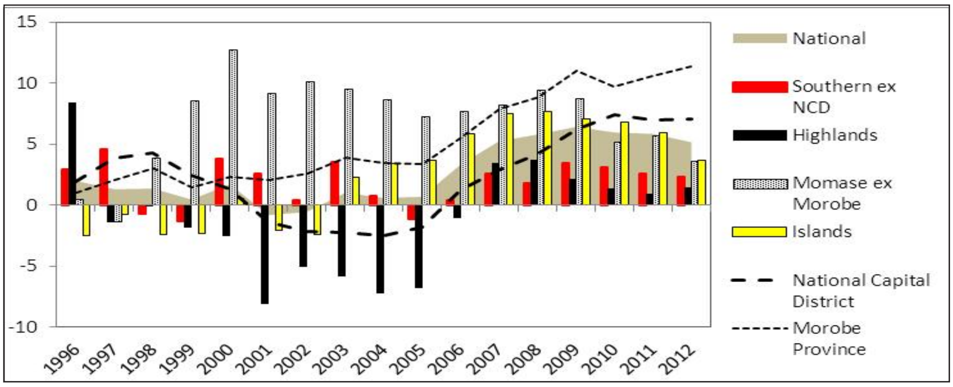
Region	Number of branches	Number of agents	Number of ATMs	Number of EFTPOS terminals
Highlands	49	92	70	2,209
Momase	38	49	69	2,846
Southern	50	66	165	4,856
Islands	40	56	61	2,277
National	177	263	365	12,188

Source: Bank of PNG, Microfinance Unit.

The Southern region, which is where the capital Port Moresby is located, has the highest number of financial coverage infrastructure. It has the highest number of Automatic Teller Machines (ATMs) and number of electronic funds transfer at point of sale (EFTPOS) terminals. All four regions have roughly the same number of bank branches but more agents in the Highlands region, reflecting the geographical constraints of this region compared to the other regions. In addition to lower economic activity, this factor can also explain the regions' low number of EFTPOS terminals relative to other regions. The Bank of PNG's employment index[9] which can be used to approximate economic activity in the absence of current GDP data shows that economic activity has slowed over the past five years with the Highlands region most affected (see Figure 8).

9. The BPNG conducts a quarterly employment survey on some 400 businesses in PNG. It is the most comprehensive survey of its kind in the country.

Figure 8
Employment Growth by Region (5 Year Moving Average) (%)



Source: Bank of Papua New Guinea, Quarterly Economic Bulletin.

Using Figure 8, we can postulate that an increase in employment growth should indicate growth in private sector economic activities and for these to be catalysts for demand in convenient means of financial infrastructure such as ATMs and EFTPOS terminals. This is anecdotally evident in the Momase and Southern regions and not surprising as these two regions are where the two bigger cities are located - Lae and Port Moresby respectively. However, even within region, the gap between rural and urban areas remains significantly large.

4.3 E-money Accounts

Perhaps the most promising means to encourage a financially inclusive population has been the use of ICT in banking and the combination of tailored products that make banking convenient, safe and easy to use. In PNG, mobile money has become an important factor in meeting the demand for cash security. Table 5 shows that in July 2013, the number of e-money accounts for mobile payments reached 386,000. However, recent BPNG data for March 2014 reveal a lower number of 208,089. Whilst this highlights the need for data reconciliation across different agencies – a key task for CEFI - it is indicative of the significant potential of mobile money.

Customers can now perform basic tasks such as checking their account balance, transferring funds within the same bank and for others without bank accounts, topping up mobile airtime credits and paying for electricity. In addition to the three banks; BSP (Wantok Moni), ANZ (goMoney) and Westpac's telephone banking, other companies also engaging in mobile money transfer services include Digicel Financial Services Limited (Digicell Cellmoni), Post PNG (Salim Moni Kwik Mobile) and Nationwide Microbank (MiCash).

A recent Pacific Financial Inclusion Programme (PFIP) (2008) Report on the potential of building a mobile money network distribution in PNG concludes that neither technology nor the regulatory environment presents obstacles to the development of mobile money in PNG. It only needs a developer with resources and ability to link customers with major money suppliers. The potential is so great that the report claims electronic payments could directly reach over 500,000 households (p. 4). This could become a reality in the not-too-distant future but only if we can identify pockets of the population without mobile phones and design suitably appealing products accordingly. This is important because in recent years, mobile phone subscription rates have declined considerably.

At face value, it appears that steady increase in financial inclusiveness is reflected by growth in the number of deposit accounts, loan accounts and e-money accounts amongst others. However, in countries like India, some critics caution the interpretation of such numbers. Ashok Jha, former Finance Secretary of the Indian Government said in January 2014[10], that the comprehensiveness of statistics for financial services to low income households can be misleading. He gives the example where several deposit accounts are opened in one household but only one account is actively used for transactions. This highlights a crucial aspect of financial inclusion which relates to access versus frequency of use. Financial inclusion should not be driven by a desire to meet targets rather it should look at the quality and depth of financial inclusion. The warning should also be seriously considered in PNG's case and risk management procedures should be drafted especially given the significant sums of money involved.

5. Plan for the Next Decade

5.1 Issues and Challenges

Whilst these developments point towards a greater involvement for Papua New Guineans in the formal financial sector, there are still some significant hurdles to address. The most important of these are the regulatory aspects surrounding consumer protection. The ADB along with key stakeholders including

10. Cited from Economic Times India, 23 January 2014.

the Bank of PNG are in the process of formulating policies that will better guide the industry particularly with regard to the use of mobile phone banking services.

With the rapid expansion of mobile banking and electronic payments for access products as well as e-payments schemes offered by commercial banks, the biggest challenge is regulating this form of currency. Whilst the country does have a National Payments System Act 2013 and a National Information Communication & Technology (ICT) Policy, defining regulatory responsibilities are yet to be arranged.

In addition, significant management capacity constraints still exist in not just the small microfinance companies and credit unions but larger stakeholders as well. In a move to address this issue, the Bank of PNG approved an organisational restructure in early 2014 to include a new department – the Financial Systems and Development Department (FSDD). A key component of FSDD will be a unit solely responsible for financial inclusion. Recruitments for this department and the existing banking and superannuation and life insurance departments are currently underway.

A more challenging issue is how to meet the demand for cash security. High security threats, high operational costs and low population densities, particularly in rural areas, lower the incentives for additional growth in bank branches and agents. These risks make it unprofitable to business operations. Furthermore, on the demand side, geographical difficulties such as rugged terrains, swamps, fast flowing rivers makes it difficult for people to travel to urban centres to conduct transactions. Even when agents are nearby, the issue of trust and cash security prompts rural households to travel 2-3 days into an urban centre for banking business.

Finally and most important is the need for accurate data collection to validate actual outcomes against targets. Data should clearly indicate access as well as the frequency of use to verify a product's usefulness. Given the growing interest and resulting significant financial support of the financial inclusion agenda, it is imperative that proper management and accounting be established at the outset to report on progress and to ensure and safeguard against corrupt practices. The financial inclusion agenda is worth millions of US$ and the sooner monitoring and data management processes are in place, the better the accountability and effectiveness of the initiatives.

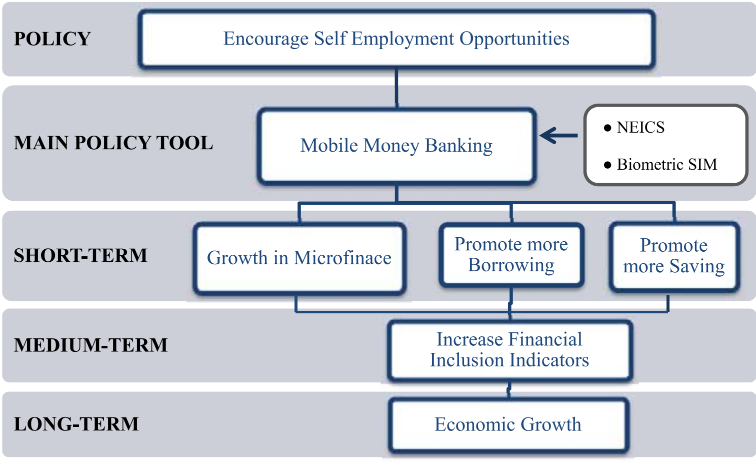
5.2 Policies, Targets and Strategies – The Case for Mobile Money Banking in Financial Inclusion for Greater Economic Growth

Given the rapid increase in mobile phone penetration rates and its potential in impacting economic growth as evidenced in some African economies (Adrianaivo and Kpodar, 2011) and particularly in Kenya (Ngugi et al., 2010), mobile money banking is the main policy tool that has the potential of reaching PNG's 85% unbanked, largely rural and illiterate population. Even though the LNG promises significant employment gains for PNG, sadly it will benefit a minority of university graduates with little employment creation for the urban unemployed or rural households. To make financial inclusion a reality, we need to create employment. In PNG, employment creation must be targeted to the latter groups of people. Thus in this context, the focus must be to create self-employment opportunities.

Figure 10 presents a flow chart of how this can be achieved. It is important to emphasise that every step in this process must be conducted with tailored gender-specific and age- appropriate financial literacy strategies.

The overriding policy should be to create an environment conducive for increasing financial inclusion over the next ten years. Specifically, this involves increasing informal sector employment through the promotion of self-employment opportunities and using mobile money banking (m-banking) as the main policy tool to achieve this. In the short-run, m-banking must have the impact of providing the essential link in access to and use of microfinance institutions; that is, the technology should make it easier and cost effective to conduct transactions, save and borrow. Over the medium-term, this should lead to higher financial inclusion indicators. More informal sector employment opportunities captured in the formal financial system should contribute to a higher economic growth path in the coming decade. These efforts are already underway with MEP2 and Financial Literacy Strategies. However, similar to Kenya's experience, the importance of mobile money banking will reach prominence as the country embarks on two massive citizen registration systems. These inputs and the flow diagrams' respective steps are described in detail below.

Figure 9
Flow Chart: Mobile Money Banking, Financial Inclusion & Economic Growth



5.2.1 Mobile Money Inputs

M-banking is viewed as the key to unlocking the potential for financial inclusiveness in PNG. This is because mobile phones have not only become a part of poor people's everyday lives, 'but also because of the potential for it to become a low cost access account or delivery channel for financial information, services and transactions thus facilitating innovations including micro-payments (m-payments), electronic money (e-money), and a banking channel (m-banking).' (Duncombe et al., 2009, p. 2)

However, for mobile banking to be successful, there needs to be a system which can easily identify users. The experience of M-PESA in Kenya introduced in 2007 is an excellent example of how mobile phone technology has transformed the economic landscape of rural Kenyan households. Ngugi et al. (2010) review some key factors that led to the phenomenal growth in mobile money banking services. The authors argue that the major factor driving Kenyans' adoption of mobile phone technology was the actual introduction of mobile money banking services (p. 1) and that the success of M-PESA was largely because there was no need for bureaucratic banking procedures. Safaricom, the telecommunication company responsible for M-PESA, only required national identity cards and phone numbers.

In PNG's case, efforts to introduce an identification system had begun in late 2012 when GoPNG in collaboration with Huawei Technologies introduced plans to register citizens. According to the Steering Committee, the outcome of the National Electronic Identity Card System (NEICS) will see every PNG citizen issued with an identity card. The US$76 million project is aimed at addressing the problem of unregistered citizens to be stored in a central database called the Population Information Management System[11] (PIMS) to support preparations for the 2017 national elections. PIMS will contain biographical details of every citizen similar to those found on a birth certificate.

In addition, Digicel PNG has already commenced registration of the country's first biometric Subscriber Identity Module (SIM) in August 2014. This is an initiative of the National Information and Communications Technology Authority (NICTA) as part of its proposed SIM registration regulations. It signals a move towards addressing unverified or unregistered prepaid mobile phone users. The new biometric registration system will register customers aged 13 years and above with users below 13 signed under their parents. Similar to the NEICS, the draft NICTA regulations will be submitted to the National Executive Council and require every customer to be identified by name, gender, date of birth, residential address, and origin. Customers' finger prints and photos will also be taken. The other two mobile network operators (MNOs), Citifon Ltd – the mobile service provider of Telikom PNG and BeMobile Ltd, have yet to confirm their involvement.

These two identification systems constitute the missing input for mobile money banking particularly for rural households and urban informal dwellers. Understandably, both systems are mammoth projects, each with similar problems. Most important is the issues of privacy of user information and trust. Therefore, a clear and concise communication strategy outlining the purpose of these systems is imperative. Whilst BSP has endeavoured to address identification problems by deploying staff to rural areas and engaging village chiefs and pastors to verify customers, ANZ and Westpac chose the least cost approach to engage local agents. Perhaps BSPs moves are risky given the new ID initiatives but then perhaps it may be a while yet until the two systems are full proof. Despite this, these systems can be used to sufficiently reduce the red tape that currently hinders the unbanked population from entering the formal financial system.

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11. For more information refer to website:http://www.pngples.com/index.php/commentary-about-papua-new-guinea/263-the-national-id-system-the-entry-point.

5.3 Delivery Models

PNG's surge in mobile phone subscriptions occurred around 2007 and has since reduced significantly. Undoubtedly, the introduction of mobile phone banking will see a second wave of growth in the adoption of this technology. However, the main question is whether this mode of financial service delivery will impact on the unbankeds' decisions to borrow and save. Mobile phone banking per se does not equal financial inclusion; it is a means whereby we can create an environment conducive for individuals to make their own financial decisions. These decisions alone – to save and/or borrow within a formal setting - lead to financial inclusion. At this stage of financial development in PNG, these decisions are intrinsic to microfinance opportunities rather than traditional banks because of several factors.

In examining M-PESA's role, Ngugi et al. (2010) identifies four key factors that make traditional banking difficult in Kenya. These factors are also applicable to PNG: a largely illiterate population acts as the first barrier to opening traditional bank accounts; stringent bank regulation regarding identification for opening new accounts; a minimum balance requirement and, an unequal distribution of banking services between urban and rural areas with the former receiving the greater portion. Given this, what service delivery models of mobile banking should PNG take to emulate Kenya's success?

There are two main categories of m-banking models: a bank-based model and a non-bank based model.[12] In PNG, the delivery model of m-banking is largely a bank-based one-to-one arrangement where there is an exclusive arrangement between the bank and a mobile operator. Existing bank customers are typically the main target and customers conduct basic transactions using their mobile device. Over the past year, this customer focus has slowly begun to shift towards the rural sector. Armed with a Samsung tablet, BSP officers are opening new accounts in rural areas. Although this represents access to financial services, it does not necessarily mean that services are actually being used.

In contrast, in the non-bank model, a formal bank typically serves as a holder of deposits while the customer relationship is managed by a non-bank entity – usually a mobile operator. M-PESA is an example of this model in which customers do not have any contractual obligations with the regulated

12. Please see the following website for a good discussion on these two m-banking models and their different arrangements: https://itunews.itu.int/en/1664-Mobile-banking.note.aspx.

financial institution and conduct transactions at a retail establishment that serves as an agent for the service. Non-banked models generally target the unbanked and customer's money is recorded in a virtual account on the server of the non-bank entity. Two mechanisms are usually used to conduct transactions: a point of sale network and a phone based system. In a point of sale network, customers must visit a participating retail agent every time they want to conduct a transaction. In a phone-based system customers have to visit a retail agent in order to deposit cash or convert stored value back into cash.

BPS's efforts are commended but the sheer scale of operations is daunting and the costs involved in reaching geographically dispersed populations by traditional banking methods is very high and thus unsustainable. Consequently, using a variant of non-banked models may is feasible. The variant model, which is already being used, combines a formal bank and a mobile network operator. The functions and responsibilities of each are shown in Table 7.

Table 7
Non-Bank Model Variant: MNO/Bank Joint Venture

Churn reduction	Definite reduction in churn
Regulatory and licensing constraints	Banks generally facilitate regulatory compliance
Brand	MNO brand
Banking system	Some required
Distribution chain for cash handling	MNO and Bank
Transactional risk	Half of the risk
Cost revenue	High initial cost

Source: Bank of Papua New Guinea.

The added information from the ID systems would also address the ID issues faced. In an MNO/Bank Joint venture model, there would be a definite reduction in churn[13] and banks would typically facilitate regulatory compliance with the MNO retaining the branding rights of the product. The introduction of Digicel in 2007 has significantly improved telecommunication outreach and with Digicel's niche market of accessing uncharted geographical landscapes, the financial inclusion agenda has never looked brighter with m-banking. The biggest challenges now are to make a safe, reliable and trusted product. The distribution chain for cash handling would typically be carried out by both facilitators and both would share some transactional risk.

13. Churn rate is the percentage of subscribers to a service that discontinue their subscription. MNO's aim to reduce their churn rate.

5.4 Implementation Plan

Whilst the plans described in Section 2 and the main policy tool of m-banking described above provide a guide for financial inclusion going forward, it is important to reiterate that implementation of infrastructure that is needed to facilitate these plans take time. For financial inclusion in general, the six Working Groups, described in Section 2, whose job is to formulate strategic activities and plans, are only just being put in place. In addition, CEFI - the coordinating agency, has only just recently appointed its Director and establishing databases to capture and monitor the national Strategy. The road towards its full operationalisation is progressing well.

The general financial inclusion agenda has been implemented through a range of activities including MEP2, creation of additional micro banks specifically targeted at women and financial literacy workshops. The Bank of PNG has played a pivotal role in driving these initiatives and facilitating its regulation. However, whilst the Bank of PNG has conducted 2 financial inclusion expos beginning last year, the educational outreach so far has been limited to only major centres: Port Moresby and Kokopo. Moreover, the roll-out of the National Youth Savings Campaign, an initiative to foster a 'savings' attitude among young children and adults between the ages of 6-25 years, is slow to take form despite agreements among relevant stakeholders. Additionally, the Financial Capabilities Survey has just recently come under scrutiny and fallen behind schedule due to budget overruns. Despite these teething problems, the established MEP2 funded by the ADB is progressing well.

For m-banking in particular, the telecommunications infrastructure and ID systems are also at initial implementation stages but already give promise to a wider distribution of financial inclusion to the unbanked relative to traditional banking methods. Digicel Cellmoni has been an outstanding example of this outreach and is currently the only MNO authorised by the Bank of PNG to collect and transfer money through mobile phones. Digicel has more telecommunications coverage relative to the state owned Telikom PNG. To increase competition, BeMobile and Citifon must also develop business strategies to tap into this market although BeMobile subscribers can also access their accounts held at commercial banks. In this instance, the Independent Consumer & Competition Commission (ICCC) and BPNG are must ensure competition and monitor regulation of this new industry. Figure 9 shows a schematic diagram of an implementation plan which must be used simultaneously with education strategies.

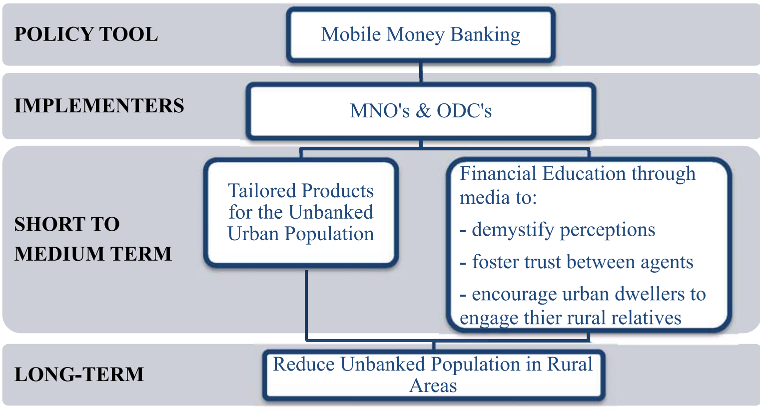
The policy tool is mobile money banking which has been taking place in urban areas as it is the urban workforce that supports much of their rural families. Education strategies to engage urban users should encourage them to engage their rural relatives to join. This may help to foster trust in the sense that if their relatives are using it then it is taken as relatively safe. This has been the case in PNG where the focus has been in urban/semi-urban areas.

Given telecommunications improvement, BSP has also made significant contributions in its TokMoni m-banking product into rural areas whilst the other two commercial banks' presence is slowly making inroads. However, despite technological advances and good plans, the role that customer's perceptions and the rate of adaptation of m-banking plays is a critical factor in determining the success of m-banking. For example, in PNG, there still appears to be a deep rooted religious fear of the electronic identification system as representing the 'mark of the beast.'[14] Media reports attest that people's incorrect beliefs about using microchips inserted into citizens as a means to identify them is symbolic of the prophesy in the Book of Revelations citing the mark of Satan the Devil. Furthermore, the Financial Surveys have indicated that issues relating to the trustworthiness of agents facilitating m-banking services are of great concern as customers are very secretive about their money holdings and thus are concerned about the safety of their funds and account details when held by agents.

In dealing with such issues, the government has raised public awareness of the ID systems through local media and BSP has also taken the initiative of issuing bank cards. Their research has shown that the possession of a bank card is associated with a Bank and is thus considered trustworthy.

14. http://www.emtv.com.pg/news-app/item/electronic-identification-not-the-biblical-mark-of-the-beast-666.

Figure 10
Implementation Plan



6. Conclusion

The financial inclusion agenda in PNG is financially and operationally challenging because of the country's geographical terrain, poor road networks and isolated pockets of remote communities. Traditional banking methods have had little impact for 85% of the population who are unbanked, living mainly in rural areas and largely engaged in the informal sector. In order to achieve economic growth over the next ten years, the overriding financial inclusion policy must be to prioritise the creation of self-employment opportunities. These opportunities are enhanced with microfinance initiatives and provide a chance for the unbanked to make financial choices about whether to spend, save and/ or borrow.

PNG is a heavy cash-based economy and Papua New Guineans are very secretive about their monetary wealth. Thus, implementing methods of financial inclusion will largely depend on how well implementers can tailor products to address the need for financial services and most importantly, the issue of trust regarding cash security. Given the gains made in telecommunications infrastructure and subsequent high penetration rate of mobile technology, m-banking is highlighted as the main policy tool that stakeholders can effectively use to address the financial needs of the unbanked. The delivery model of MNO/

Bank joint venture allows for a more collaborative approach to m-banking and can create competition amongst implementers of this service particularly between banks. Competition between MNOs is perceived to be limited given that Digicel has set up most if not all the infrastructure. Nevertheless, the role of regulation is imperative in ensuring that consumers receive service at a price they can afford.

However m-banking per se is not equated to instant financial inclusion but only as a means to achieve it with the ultimate aim of economic growth. At every step of the implementation phase, gender specific financial education strategies must be developed to demystify some notions about technology and foster trust between agents. Only until greater understanding of the benefits that this entails will m-banking become a successful tool for financial inclusion initiatives for self-employment generating a potential for economic growth in PNG over the coming decade.

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Chapter 7

ADVANCING INCLUSIVE FINANCIAL SYSTEM IN THE NEXT DECADE: MICROFINANCE IN THE PHILIPPINES

By
Al Benedict B. Magday[1]

1. Background

1.1 Country Information

The Philippines is an archipelago of 7,107 islands with a total land area of approximately 300,000 square kilometers and is bordered by the Philippine Sea to the east, the South China Sea to the west. Most of the mountainous islands are covered in tropical rainforest and volcanic in origin. Due to the volcanic nature of the islands, mineral deposits are abundant such as copper, nickel, chromite, and zinc.

As of 2013, the Philippines have become the world's 12th most populous nation, with a population of over 99 million. The population's median age is 22.7 years with 60.9% aged from 15 to 64 years old.

Despite a challenging year in 2013, the Philippine economy continued to exhibit resilience. Disciplined macroeconomic policies and structural reforms have helped the Philippine economy sustain 60 consecutive quarters of positive GDP growth since 1999, with the last seven quarters posting year-on-year output growth of above six%. With a GDP growth of 7.2% in 2013, the country was hailed as one of the fastest-growing in the ASEAN region during the period.

The favourable inflation environment has also continued to support non-inflationary economic growth in the country. Meanwhile, the country's BOP position continues to record a surplus in 2013. Underpinning this sustained resilience is the robust performance of the country's current account, which has posted surpluses since 2003. The county's healthy current account position is supported by the sustained increase in overseas Filipinos (OFs) remittances, business process outsourcing (BPO) revenues, as well as tourism receipts.

1. Bank Officer II, Department of Economic Research, Bangko Sentral ng Pilipinas.

The country is also catching up with neighbouring peers in terms of FDI performance. The country continued to enjoy a vote of confidence among foreign investors given the strong macroeconomic fundamentals. Net foreign direct investment (FDI) inflows in 2013 rose to US$3.9 billion from US$3.2 billion in 2012. The bulk of gross equity capital placements of US$664 million during the period—which originated primarily from Mexico, Japan, the United States, British Virgin Islands, and Singapore—were channeled mainly to manufacturing; water supply, sewerage, waste management and remediation; financial and insurance; real estate; and mining and quarrying.

1.2 Financial System

Another anchor of the sustained robust performance of the domestic economy is the sound and stable condition of Philippine banks. The state of the country's financial system, at present, is grounded on the structural and regulatory reforms pursued by the BSP over the years.

Following the Asian Financial Crisis and the recent Global Financial Crisis, the BSP has incorporated in its policy agenda the lessons learned during these crisis episodes. Such policy frameworks proved to be effective to the extent that banks in the country are now in much better shape compared to previous years. Meanwhile, banks in the country have also been keen on accomplishing their tasks and improving their risk management capabilities.

The non-performing loans (NPL) and non-performing asset (NPA) ratios of universal and commercial banks (U/KBs) have significantly declined since 2001, signifying the improving quality of banks' assets and loan portfolios. Meanwhile, the country's banking system is also adequately capitalized, with the capital adequacy ratio (CAR) of U/KBs remaining well above the BSP's regulatory requirement of 10% and the Bank for International Settlements (BIS) standard of 8%.

1.3 Need for Inclusive Financial System

Access to financial services is important for every household and business. Some evidence indicate that access to basic financial services such as savings, payments and credit make a positive difference in people's lives. Financial inclusion, therefore, carries the potential for improving the well-being of the poor and the growth of micro, small and medium enterprises. In addition, a growing body of literature suggests that greater financial inclusion contributes to financial stability and economic development and is critical for achieving inclusive growth.

An inclusive financial system is not only pro-growth but also pro-poor, which along with other interventions, reduces income inequality and poverty. Financial exclusion, on the other hand, leaves the disadvantaged and low income segments of society with no choice other than informal options, making them vulnerable to financial distress, debt and poverty.

The BSP, therefore, recognises financial inclusion as a worthy policy objective that can be pursued alongside the promotion of stability and efficiency in the financial system.

2. Financial Inclusion Policies and Institutions

2.1 Brief History of Financial Inclusion Policies and Programmes

In 2000, the Bangko Sentral ng Pilipinas (BSP) was mandated by the General Banking Law to recognise microfinance as a legitimate banking activity and to set the rules and regulations for its practice within the banking sector. In the same year, the BSP declared microfinance as its flagship programme for poverty alleviation. Since 2000, the BSP has been proactive in the development of microfinance using a three pronged approach: i) To provide the enabling policy and regulatory environment, ii) To increase the capacity of the BSP and banking sector on microfinance operations, and iii) To promote and advocate the development of sound and sustainable microfinance operations.

The United Nations declared 2005 as the International Year of Microcredit to highlight the role of microfinance in poverty alleviation and economic development. Through BSP's advocacy, 2005 was also declared as the Philippine Year for Microfinance through Presidential Proclamation 719 and Senate Resolution 124.

In 2006, the BSP focused its microfinance initiatives on increasing the scale and scope of microfinance in the country, specifically within the banking sector. The BSP endeavoured to build on the previous year's (the 2005 International Year of Microcredit) gains and momentum to further develop microfinance.

In 2007, the microfinance industry was characterised by innovation, dynamism and continued growth. The BSP remained responsive to these changes while maintaining the focus of its microfinance initiatives on increasing the scale and scope of microfinance in the country, specifically within the banking sector.

In 2008, the microfinance industry saw continuous growth and dynamism with the backdrop of an enabling policy and regulatory environment. New players, a wider range of products and services, technological innovations and applications have driven much of the microfinance developments in the country.

In 2009, the First Annual Global Microfinance Index and Study declared the Philippines as the best in the world in terms of its microfinance regulatory framework.[2] Overall, the Philippines ranked third in the world following the microfinance leaders, Peru and Bolivia.

In 2010, the Economist Intelligence Unit (EIU), in its “Global Microscope on the Microfinance Business Environment”, ranked the Philippine regulatory environment for microfinance as the best among 54 countries in the world. In terms of overall microfinance business environment, the Philippines moved up the rank, occupying the number two position in 2010, from being number three in 2009. The EIU cited the BSP’s regulations that expand the range of microfinance products that banks can offer to their clients as the main reason for the upward ranking of the Philippines. This citation affirms that the BSP’s regulatory approach and initiatives in microfinance and financial inclusion are making an impact, and are truly benefiting the microfinance market.

In 2011, there was mainstreaming of financial inclusion in the domestic and international policy agendas, in light of growing recognition of the importance of financial inclusion as a policy objective. Along with this, the Philippine Development Plan (PDP 2011-2016) laid out its vision for the financial sector as a “regionally responsive, development-oriented and inclusive financial system which provides for the evolving needs of its diverse public”.

To date, the BSP continues to build a more inclusive financial system that is responsive to the needs of the Filipino people especially those who are underserved and unserved. The existing financial inclusion strategy recognises the need for a wider range of products, expanded network of financial service

2. This Study by the Economist Intelligence Unit looked at 55 countries and measured each country’s state of regulatory framework, investment climate and institutional development.

providers, extended virtual reach through innovative delivery channels, lower barriers to access and use of financial services and ensuring that consumers are informed and protected.

2.2 Major Plans, Policies and Programmes on Inclusive Finance

An enabling policy and regulatory environment is essential in promoting the development of microfinance in the country. The BSP has issued various circulars that provide incentives for banks to engage in microfinance as well as ensure that its practice is done in a viable, sustainable and prudential manner. The BSP is also continuously reviewing and amending its policies and regulations to ensure that they remain responsive to the growing needs of the microfinance sector.

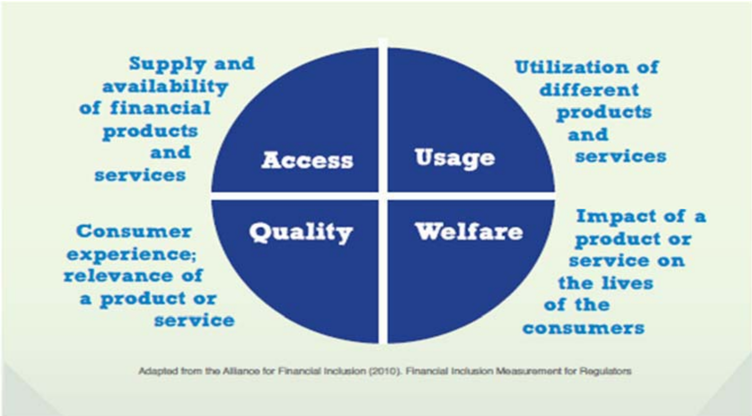
Overall, the BSP pursues the development of an inclusive financial system by looking at a holistic approach based on four key areas: (1) Regulation and Supervision, (2) Advocacy, (3) Financial Education and Consumer Protection and (4) Data and Measurement.

2.3 Institutions Engaged in Formulation and Implementation of Financial Inclusion Polices and Programmes

There are no authorities or organisations that are explicitly mandated or tasked to lead financial inclusion initiatives in the Philippines. The BSP, as the supervisor of the banking system (which accounts for more than 80% of the resources of the financial system), has been actively pursuing financial inclusion.

Considering the importance of the support of and partnership with other agencies and organisations, the BSP is planning to champion financial inclusion across various sectors by convening relevant stakeholders to draft a National Strategy for Financial Inclusion. This strategy is consistent with what is envisioned in the PDP. The proposed financial inclusion strategy aims to provide a framework to enable government and the private sector to take a coordinated and systematic approach towards a clear vision of building a financial system that is accessible and responsive to the needs of the entire population and that will lead to broad-based and inclusive growth.

Meanwhile, the BSP created a Data and Measurement Working Group within the Inclusive Finance Steering Committee (IFSC), a bank-wide committee that was constituted to ensure a coordinated focus in pursuing programmes supportive of financial inclusion. There is also institutionalised information sharing with other departments within the BSP as well as with other agencies that are handling inclusion-relevant data (e.g., non-banks, e-money, cooperatives, microfinance NGOs).



3. Current Status of Financial Inclusion

There are four commonly used lenses through which financial inclusion can be measured, namely: access, quality, usage and welfare.

Financial inclusion data may be derived from two main sources, namely: supply-side and demand-side. Supply-side data capture information obtained from financial service providers such as banks and other financial institutions. Demand-side data, on the other hand, are collected from actual and potential users of financial products and services.

The access and usage dimensions can usually be obtained from supply-side information. The quality and welfare dimension, while important, are more complex topics both conceptually and in terms of measurement, which require demand-side surveys and the use of qualitative indicators. At present, most of the available information has been on the supply-side while adequate demand-side information is lacking and may not be in sufficient depth to measure inclusion.

3.1 Access

3.1.1 Number of Banking Offices and Automated Teller Machines (ATMs)

The Philippine banking system's overall physical network continued to expand. The number of domestic banking offices and ATMs increased by 4% to 9, 375 from 9,015 offices and 15% to 12, 224 from 10, 658 ATMs in 2012 from 2011, respectively.

Table 1
Number of Banking Offices and ATMs per Region from 2011-2012

Region		Banks[1/, 2/]			ATMs[2/]		
		2011	2012	Growth	2011	2012	Growth
	NCR	2,892	2,993	3% ▲	4,725	5,324	13% ▲
	CAR	146	148	1% ▲	142	162	14% ▲
I	Ilocos Region	401	413	3% ▲	307	356	16% ▲
II	Cagayan Valley	272	286	5% ▲	149	165	11% ▲
III	Central Luzon	940	975	4% ▲	879	1,066	21% ▲
IV-A	CALABARZON	1,350	1,406	4% ▲	1,535	1,748	14% ▲
IV-B	MIMAROPA	189	206	9% ▲	102	140	37% ▲
V	Bicol Region	281	315	12% ▲	215	261	21% ▲
VI	Western Visayas	531	543	2% ▲	471	518	10% ▲
VII	Central Visayas	584	627	7% ▲	781	921	18% ▲
VIII	Eastern Visayas	172	174	1% ▲	164	181	10% ▲
IX	Zamboanga Peninsula	181	190	5% ▲	159	176	11% ▲
X	Northern Mindanao	328	328	0%	296	327	10% ▲
XI	Davao Region	338	355	5% ▲	400	480	20% ▲
XII	SOCCSKSARGEN	192	195	2% ▲	207	259	25% ▲
XIII	Caraga	199	201	1% ▲	106	115	8% ▲
	ARMM	19	20	5% ▲	20	25	25% ▲
Philippines		9,015	9,375	4% ▲	10,658	12,224	15% ▲

Legend: Top 3 Bottom 3
▲ *Increase* ▼ *Decrease*

[1/] *Head offices, regular branches, microfinance-oriented branches, extension offices, OBOs, and MBOs*
[2/] *Domestic banks and ATMs*

3.1.2 Number and Percent Share of Unbanked Cities and Municipalities

At the national level, the number of unbanked cities and municipalities increased to 611 in 2012 from 609 in 2011 increasing by 0.33%. Most regions (11 out of 17) have banking coverage that is better than the national coverage.

Table 2
Number and Percent Share of Unbanked Cities and Municipalities per Region from 2011-2012

Region		Total number of cities & municipalities (a)	No. of unbanked cities/municipalities (b)		% Share (b/a)		Remarks
			2011	2012	2011	2012	
	NCR	17	0	0	0%	0%	100% coverage
	CAR	77	50	51	65%	66%	▼
I	Ilocos Region	125	34	35	27%	28%	▼
II	Cagayan Valley	93	25	24	27%	26%	▲
III	Central Luzon	130	10	10	8%	8%	No improvement
IV-A	CALABARZON	142	9	9	6%	6%	No improvement
IV-B	MIMAROPA	73	27	27	37%	37%	No improvement
V	Bicol Region	114	41	39	36%	34%	▲
VI	Western Visayas	133	28	29	21%	22%	▼
VII	Central Visayas	132	49	48	37%	36%	▲
VIII	Eastern Visayas	143	100	103	70%	72%	▼
IX	Zamboanga Peninsula	72	45	45	63%	63%	No improvement
X	Northern Mindanao	93	33	34	35%	37%	▼
XI	Davao Region	49	10	10	20%	20%	No improvement
XII	SOCCSKSARGEN	50	17	17	34%	34%	No improvement
XIII	Caraga	73	21	21	29%	29%	No improvement
	ARMM	118	110	109	93%	92%	▲
Philippines		1,634	609	611	37%	37%	▼

Legend: Top 3 Bottom 3
▲ *Improvement* ▼ *Number of unbanked cities/municipalities increased*

3.1.3 Number of Micro-Banking Offices (MBOs)

MBOs continued to increase in number. The highest growth rate was noted for the period from March to June 2012, where growth spiked at 18%. The number of cities and municipalities with MBOs likewise increased, indicating wider reach. There is also an upward trend in the number of municipalities without regular bank offices but with MBOs. This suggests that banks are increasingly establishing presence in municipalities where it is not economically viable to set up a full-blown branch thereby promoting access to financial services for people living in remote areas.

Table 3
Number of MBOs in the Philippines from Q4 2011 – Q4 2012

	Q4 2011	Q1 2012	Q2 2012	Q3 2012	Q4 2012
Number of MBOs	251	272	320	344	370
% Increase		8%	18%	8%	8%
Number of cities and municipalities with MBOs	138	157	192	217	232
Number of cities and municipalities without head office/branches but with MBOs	37	37	46	49	50

3.1.4 Number of Alternative Financial Service Providers (FSPs)

Aside from banks, the number of alternative access points also increased by 20% to 46,218 in 2012 from 38,397 in 2011 where the numbers suggest a significant area of opportunity. It shows the potential of expanding the reach of financial services especially in areas with no banks.

Table 4
Number of FSPs in the Philippines from 2011-2012

Financial Service	Provider	2011	2012	Growth
Savings and credit	NSSLAs, Credit Cooperatives	174	2,834[1/]	▲
Credit only	NBFIs, Pawnshops,	16,828	17,458	▲
Remittance	RAs, E-money agents	9,073	11,874[2/]	▲
Others	ATMs, MCs/FXDs	12,322	14,052	▲
TOTAL		38,397	46,218	▲

Legend: ▲ *Increase* ▼ *Decrease*

[1/]The number of NSSLAs increased to 195 in 2012. Data on cooperatives were collected starting 2012, through data sharing arrangement with the Cooperative Development Authority (CDA)

[2/]2011 count was based on BanKO agents only. 2012 count was based on BanKO and GCash agents. The count excludes agents that are pawnshops, RAs, MCs/FXDs.

Looking at the geographic distribution of banks, it is skewed toward areas with a large population and/or low poverty incidence. Alternative FSPs, on the other hand, seem to prove otherwise. They are available even in areas with a small population and/or high poverty incidence. Because of their presence in areas that are not served by banks, there will be a significant reduction in the percentage of unserved municipalities. Of the 611 unbanked municipalities, 395 municipalities (65%) have access to alternative FSPs. This indicates that only

216 municipalities (equivalent to 13% of 1,634 cities and municipalities and 4% of the total Philippine population) are left unserved. It may be noted that the decrease in the number of cities and municipalities with banks in 2012 to 1,023 compared to 1,025 in 2011 was due to the closure of some mismanaged rural banks based on the annual supervision examination conducted by the BSP.

Table 5
Number of Cities and Municipalities in the Philippines with Banking Offices

	2011		2012	
	Number of cities and municipalities	% to Total	Number of cities and municipalities	% to Total
With banks	1,025	62.7%	1,023	62.6%
Without banks	609	37.3%	611	37.4%
Without banks but with other access points	237	14.5%	395*	24.2%
Without any access points	372	22.8%	216*	13.2%

Population living in banked/unbanked cities and municipalities

	2011		2012	
	Population	% to Total	Population	% to Total
With banks	78,331,407	84.8%	78,397,188	84.9%
Without banks	14,003,706	15.2%	13,937,925	15.1%
Without banks but with other access points	6,988,638	7.6%	10,253,721*	11.1%
Without any access points	7,015,068	7.6%	3,684,204*	4.0%

**The significant change from 2011 to 2012 is because of the inclusion of credit cooperatives and more complete data on e-money agents which were not included in 2011 due to data unavailability.*

3.1.5 Access Indicators

As to the access indicators, bank density remains at 6 banking offices per city/municipality. On the average, there is one bank and 2 ATMs for every 10,000 Filipino adults. This shows that the banking system's overall physical network is being felt all over the country. Banking operations are effectively serving the banking needs of the poor and low income clients, especially those living in the countryside.

Table 6
Access Indicators from 2011-2012

Indicator	2011	2012	Growth
Average number of banking offices per city/municipality	5.5	5.7	4% ▲
Number of banks per 10,000 adults	1.4	1.4	No improvement
Number of ATMs per 10,000 adults	1.7	1.9	12% ▲
Number of banks per 1,000 sq. km*	64	66	3% ▲
Number of ATMs per 1,000 sq. km*	75	86	15% ▲

*Based on habitable land area

Legend: ▲ *Increase* ▼ *Decrease*

3.2 Usage

3.2.1 Number of Bank Deposit Accounts

The total number of deposit accounts decreased by 4% to 41.8 million in 2012 from 43.7 million in 2011. This was driven mainly by the decline in the number of deposit accounts in NCR, which comprised 43% of the total number of deposit accounts in the banking system.

Table 7
Number of Bank Deposit Accounts per Region from 2011-2012

Region		Number of accounts			% share to total deposits	
		2011	2012	Growth	2011	2012
	NCR	20,760,746	18,034,013	-13% ▼	47.5%	43.2%
	CAR	691,921	703,202	2% ▲	1.6%	1.7%
I	Ilocos Region	1,535,986	1,465,862	-5% ▼	3.5%	3.5%
II	Cagayan Valley	833,007	864,716	4% ▲	1.9%	2.1%
III	Central Luzon	3,118,398	3,225,754	3% ▲	7.1%	7.7%
IV-A	CALABARZON	5,011,404	5,410,282	8% ▲	11.5%	13.0%
IV-B	MIMAROPA	622,751	611,971	-2% ▼	1.4%	1.5%
V	Bicol Region	1,069,547	1,136,831	6% ▲	2.4%	2.7%
VI	Western Visayas	2,004,831	2,069,560	3% ▲	4.6%	5.0%
VII	Central Visayas	2,366,588	2,491,121	5% ▲	5.4%	6.0%
VIII	Eastern Visayas	694,297	673,685	-3% ▼	1.6%	1.6%
IX	Zamboanga Peninsula	713,548	729,634	2% ▲	1.6%	1.7%
X	Northern Mindanao	1,217,503	1,206,832	-1% ▼	2.8%	2.9%
XI	Davao Region	1,404,229	1,475,493	5% ▲	3.2%	3.5%
XII	SOCCSKSARGEN	839,501	891,432	6% ▲	1.9%	2.1%
XIII	Caraga	687,830	677,398	-2% ▼	1.6%	1.6%
	ARMM	94,733	108,529	15% ▲	0.2%	0.3%
Philippines		43,666,820	41,776,315	-4% ▼	100.0%	100.0%

Legend: Top 3 Bottom 3

▲ *Increase* ▼ *Decrease*

3.2.2 Amount of Bank Deposits

In terms of the peso value of bank deposits, the total amount increased by 7% to P5.7 trillion in 2012 from P5.4 trillion in 2011. The amount of bank deposits grew in all the 17 regions. NCR accounted for 68% of the total amount of deposits in the banking system.

Table 8
Amount of Bank Deposit Accounts per Region from 2011-2012

Region		Amount of deposits (in billion pesos)			% share to total deposits	
		2011	2012	Growth	2011	2012
	NCR	3,639.7	3,890.9	7%▲	67.8%	67.7%
	CAR	51.0	54.9	8%▲	0.9%	1.0%
I	Ilocos Region	102.6	107.4	5%▲	1.9%	1.9%
II	Cagayan Valley	58.7	62.7	7%▲	1.1%	1.1%
III	Central Luzon	269.2	282.2	5%▲	5.0%	4.9%
IV-A	CALABARZON	365.6	396.7	8%▲	6.8%	6.9%
IV-B	MIMAROPA	29.1	31.8	9%▲	0.5%	0.6%
V	Bicol Region	63.1	68.2	8%▲	1.2%	1.2%
VI	Western Visayas	155.3	160.9	4%▲	2.9%	2.8%
VII	Central Visayas	261.8	281.6	8%▲	4.9%	4.9%
VIII	Eastern Visayas	44.8	48.8	9%▲	0.8%	0.8%
IX	Zamboanga Peninsula	48.5	52.3	8%▲	0.9%	0.9%
X	Northern Mindanao	80.1	85.8	7%▲	1.5%	1.5%
XI	Davao Region	113.5	116.0	2%▲	2.1%	2.0%
XII	SOCCSKSARGEN	53.6	62.7	17%▲	1.0%	1.1%
XIII	Caraga	29.9	38.0	27%▲	0.6%	0.7%
	ARMM	4.4	5.5	24%▲	0.1%	0.1%
Philippines		5,371.0	5,746.3	7%▲	100.0%	100.0%

Legend: Top 3 Bottom 3
▲ *Increase* ▼ *Decrease*

3.2.3 Amount of Bank Loans

The total amount of bank loans increased by 5% to P3.34 trillion in 2012 from P3.19 trillion in 2011. On a regional basis, growth was observed in 9 regions while there was a decline in the remaining 8 regions. NCR accounted for 87% of the total amount of loans outstanding in the banking system.

Table 9
Amount of Bank Loans per Region from 2011-2012

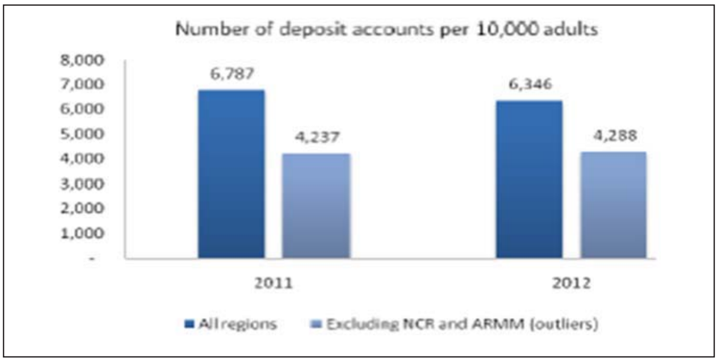
Region		Amount (in billions)			% share	
		2011	2012	Growth	2011	2012
	NCR	2,765.76	2,908.34	5% ▲	86.7%	87.0%
	CAR	10.46	7.07	-32% ▼	0.3%	0.2%
I	Ilocos Region	21.81	20.69	-5% ▼	0.7%	0.6%
II	Cagayan Valley	18.27	20.09	10% ▲	0.6%	0.6%
III	Central Luzon	71.82	71.77	-.07% ▼	2.3%	2.1%
IV-A	CALABARZON	70.53	67.11	-5% ▼	2.2%	2.0%
IV-B	MIMAROPA	8.74	8.78	1% ▲	0.3%	0.3%
V	Bicol Region	21.72	19.82	-9% ▼	0.7%	0.6%
VI	Western Visayas	31.08	38.60	24% ▲	1.0%	1.2%
VII	Central Visayas	62.06	69.03	11% ▲	1.9%	2.1%
VIII	Eastern Visayas	11.14	12.27	10% ▲	0.3%	0.4%
IX	Zamboanga Peninsula	11.11	14.55	31% ▲	0.3%	0.4%
X	Northern Mindanao	20.06	23.34	16% ▲	0.6%	0.7%
XI	Davao Region	32.26	33.78	5% ▲	1.0%	1.0%
XII	SOCCSKSARGEN	20.39	17.27	-15% ▼	0.6%	0.5%
XIII	Caraga	12.59	9.70	-23% ▼	0.4%	0.3%
	ARMM	0.72	0.44	-39% ▼	0.0%	0.0%
Philippines		3,190.52	3,342.64	5% ▲	100.0%	100.0%

Legend: Top 3 Bottom 3
▲ *Increase* ▼ *Decrease*

3.2.4 Usage Indicators

As of 2012, there were 6,346 deposit accounts for every 10,000 adults or equivalently, 6 out of 10 adult Filipinos had a deposit account in banks.

Figure 1
Usage Indicators from 2011-2012



4. Data Presentation and Analysis: Microfinance

4.1 The BSP and Microfinance

Since 2000, the BSP has been proactive in the development of microfinance in the banking sector. The BSP experience in microfinance proved that low income segments can be effectively served by the formal financial system given appropriately designed and affordably priced products and services.

The BSP's policy for advocating microfinance is to be able to reach a larger number of entrepreneurial poor. The BSP is encouraging the establishment of microfinance-oriented banks, and microfinance operations in existing banks. The BSP also emphasizes that microfinance is a serious business and institutions that want to engage in it should be serious, well-prepared and committed to upholding the best practices and high performance standards.

Another driving force of the BSP in promoting microfinance can be seen in its mandate where rural and thrift banks which fall under BSP supervision, are channels of microfinance, with the infrastructure to provide such services to the countryside. As long as the BSP closely monitors their operations, promoting microfinance in the banking sector is beneficial.

However, BSP's interest in the other sectors such as the Non-Government Organizations (NGOs) and cooperatives relate to the following: 1) transformation of non-bank financial institutions into banks, 2) other infrastructure needed for microfinance development (i.e., developing uniform set of standards), and 3) promotion of best practices for sustainable operations within banks, NGOs and cooperatives.

4.2 The National Strategy and Framework for Microfinance

Meanwhile, there is the National Strategy for Microfinance which envisions a viable and sustainable micro-financial market that will help provide poor households and micro-entrepreneurs with greater access to micro-financial services. It calls for a greater role by the private sector in providing credit and guarantee programmes vis-a-vis the non-participation of government line agencies. The emphasis is on the adoption of market-oriented financial and credit policies to ensure viability and sustainability.

The Framework covers all types of microfinance institutions with regulations focusing on portfolio quality, outreach, efficient and sustainable operations and transparent information. The basic premise is that all deposit taking institutions (banks, cooperatives) are subject to prudential regulation - microfinance NGOs collecting savings greater than the compensating balance are be subject to regulation and supervision; banks with microfinance operations are to remain under the regulation and supervision of the BSP; cooperatives are be under the supervision and the regulation of the Cooperative Development Authority (CDA); and NGOs while not regulated, are encouraged to submit information to the Microfinance Council of the Philippine (MCPI).

4.2.1 Micro-banking Offices (MBOs)[3]

To be able to reach a larger number of entrepreneurial poor, the BSP is encouraging the establishment of microfinance-oriented banks, and microfinance operations in existing banks.

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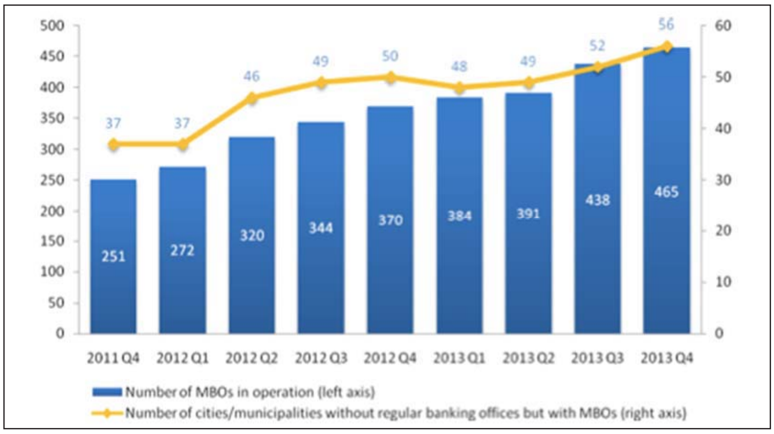
3. BSP Circular 694 (dated 14 October 2010) enables banks to establish presence in areas where it may not be immediately economically feasible to set up a full blown bank branch by allowing a simple branch called a micro-banking office (MBO). With MBOs, areas that are unserved or underserved will have access to a wide range of financial services ranging from credit, savings, remittances, foreign exchange, e- money conversion, bills payment and government pay-out benefits.

Figure 2
Number of MBOs in the Philippines from Q4 2011 – Q4 2014



MBOs continue to increase in number and outreach. The number of operating MBOs went up by 26% to 465 in 2013 from 370 in 2012. The number of Local Government Units (LGUs) that do not have a regular bank branch but are being served by MBOs increased to 56 LGUs in 2013 from 50 LGUs in 2012. As a result, MBOs areas that are unserved or underserved have gained access to a wide range of financial services ranging from credit, savings, remittances, foreign exchange, e-money conversion, bills payment and government pay-out benefits.

4.2.2 Microfinance Operations

At present, there is a wide range of products such as microfinance loans, micro-agricultural loans, microfinance housing loans, micro-deposits and micro-insurance that are available to a previously unbanked market.

Table 10
Microfinance Operations from 2012 - 2013

	2012	2013
Number of banks with microfinance operations	187	182
Number of microfinance borrowers	1,137,813	1,049,988
Amount of the microfinance loan portfolio (in billion pesos)	8.4	8.7

In 2013, there were 182 banks with microfinance operations serving 1.05 million borrowers with loans outstanding amounting to P8.7 billion. Compared with 2012, the number of microfinance banks and clients slightly decreased in 2013. Despite this, the microfinance loan portfolio managed to expand by 3%.

4.2.3 Microfinance Loans

Microfinance loan products such as microfinance plus and housing microfinance loans experienced growth in 2013. Housing microfinance loans increased by 9% to P263 million in 2013 from P242 million in 2012. Microfinance Plus loans, which are loans amounting to P150,001 – P300,000 specifically designed for growing microenterprises, climbed by 34% to P111 million in 2013 from P83 million in 2012.

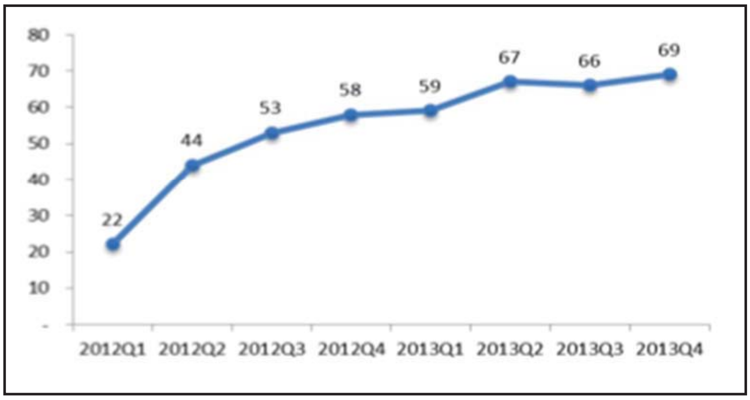
Table 11
Microfinance Products

Microfinance Product		2012	2013
	Microenterprise Loans	171 banks P6.9 billion	168 banks P7.4 billion
MF +	Microfinance Plus	17 banks P83 million	19 Banks P111 million
	Micro-Agri Loans	39 banks P496 million	33 Banks P295 million
	Housing Microfinance Loans	18 banks P242 million	16 Banks P263 million

4.2.4 Microfinance Deposits

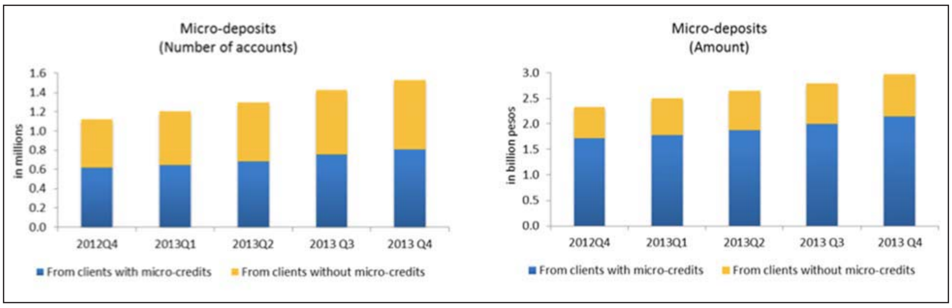
An increasing number of banks are offering micro-deposit accounts. The number of banks with micro-deposits increased by 19% to 69 banks in 2013 from 58 banks in 2012.

Figure 3
Number of Banks Offering Micro-deposits in the Philippines from Q1 2012 – Q4 2013



The total amount of micro-deposit accounts went up by 27% to P2.96 billion in 2013 from P2.33 billion in 2012. Meanwhile, in terms of volume, the total number of micro-deposit accounts surged by 36% to 1.5 million accounts in 2013 from 1.1 million accounts in 2012. This serves as a good indicator that the marginalised are starting to save. The positive trend in the number and amount of micro-deposit accounts suggests increasing acceptance of the low income market for a deposit product that removes the usual barriers faced in opening a bank account such as high maintaining balance and dormancy charges.

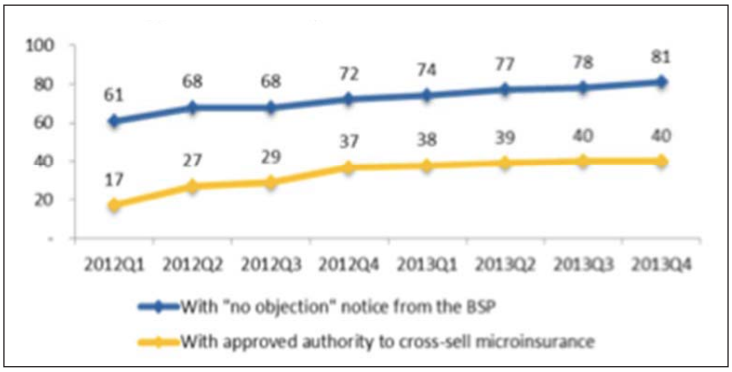
Figure 4
Number and Amount of Micro-deposits in the Philippines from Q4 2012 – Q4 2013



4.2.5 Microfinance Insurance

In 2013, there were 81 banks with no objection notice from the BSP to offer micro-insurance while 40 banks had already obtained authority to market, sell and service micro-insurance products.[4]

Figure 5
Number of Banks with Authority to Sell Microinsurance products from Q1 2012 – Q4 2013



The Insurance Commission (IC), micro-insurance coverage among Filipinos rose to 19.95 million (20.4% of the population) in 2013 from 3.1 million (3.4% of the population) in 2008 which makes the Philippines one of the top micro-insurance market in Asia.

Moreover, data from the Rural Bankers Association of the Philippines (RBAP) showed that the total number of insured clients by rural banks with micro-insurance rose by 153% to 1.4 million in 2013 from around 543,500 in 2012.

The strong support of the insurance providers and warm reception by policyholders were cited as significant factors contributing to the phenomenal growth of micro-insurance in the country.

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4. Banks wanting to become insurance agents need to obtain a “no objection notice” from the BSP and approved authority to cross-sell micro-insurance from the IC.

5. Plans for the Next Decade

5.1 Issues and Challenges

Financial inclusion remains a pressing challenge in the Philippines. The archipelagic nature of the country imposes geographical and physical barriers to financial access.

Moving forward, improving the collection, updating, and analysis of financial inclusion data is an immediate challenge. For instance, supply-side information on usage is limited on banks. There are valuable services and significant outreach of other financial service providers. Moreover, data on banks are constraint to deposits and loans which need more refinements to capture other details and information on usage. Constructing a more accurate picture of financial inclusion would require collecting additional data from the demand-side.

Moreover, there are no authorities or organisations that are explicitly mandated or tasked to lead financial inclusion initiatives in the Philippines. The BSP, as the supervisor of the banking system (which accounts for more than 80% of the resources of the financial system), has been actively pursuing financial inclusion. As the central monetary authority and banking system regulator, the BSP knows that the achievement of both financial stability and financial inclusion requires energy, imagination and serious attention.

5.2 Key Targets to be Achieved

An enabling policy and regulatory environment is essential in promoting the development of microfinance in the country. The BSP has issued various circulars that provide incentives for banks to engage in microfinance as well as ensure that its practice is done in a viable, sustainable and prudent manner. The BSP is also continuously reviewing and amending its policies and regulations to ensure that they remain responsive to the growing needs of the microfinance sector.

For microcredit to reach its full potential, it is essential to develop and strengthen credit bureaus and movable collateral registries. The private credit bureau[5] dedicated for microfinance borrowers continues to implement reforms and make appropriate improvements. Moreover, micro-credit will enter a period

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5. The Microfinance Data Sharing System (MiDAS) is a pilot credit bureau that allows participating MFIs to submit reports, send inquiries and retrieve information on borrower information. This credit bureau operates on the reciprocity of information wherein only those contributing MFIs can use the platform.

of advancement and innovation where development and testing of new models and innovative approaches will help broaden the outreach of microcredit. Among these are credit scoring models and online micro-lending.

Credit scoring is probably the next important technological innovation in microcredit. This approach uses quantitative measures to discriminate between good and bad microfinance loans. Scoring can improve estimates of risk and serve as a refinement tool in the lending process. Credit scoring is typically used for big loan accounts, but the time is ripe for similar tools to be employed in microcredit.

Digital micro-lending is another recent trend in microcredit. Some financial service providers are now using online tools including mobile platforms, in broadening their reach and extending the advantages provided by the internet and telecom networks. By combining microfinance techniques with social networking and SMS messaging, there are now paperless online lending platforms that provide micro-loans to consumers without compromising the basic principles of sound credit underwriting.

In addition, the BSP advocates increased awareness among the youth on the importance of savings, and encourages school children to save through various programmes. The BSP is also stepping up efforts in developing a comprehensive financial inclusion data framework to monitor progress and informed evidence-based policy making.

Lastly, considering the importance of the support of and partnership with other agencies and organisations, the BSP is planning to champion financial inclusion across various sectors by convening relevant stakeholders to draft a National Strategy for Financial Inclusion. This strategy is consistent with what is envisioned in the Philippine Development Plan 2011-2016. The proposed financial inclusion strategy aims to provide a framework for the government and the private sector to take a coordinated and systematic approach toward a clear vision of building a financial system that is accessible and responsive to the needs of the entire population, leading to broad-based and inclusive growth.

5.3 Agencies for the Achievement of Financial Inclusion Objectives

In the Philippines, policy has shifted the function of providing financial services directly to government financial institutions (i.e. Land Bank of the Philippines, Development Bank of the Philippines, etc.) that are competent to implement such programmes. Government agencies (Department of Social

Welfare and Development, Department of Interior and Local Government, etc.) previously handling these are to focus on areas of a greater competency such as capacity-building, social preparation, provision of infrastructure, etc.

This current microfinance framework is now focused on providing loans with the necessary credit discipline unlike the past credit programmes under the government agencies which were unsuccessful. Also, with the BSP actively pursuing the objective, the support needed is enhanced, enabling the regulatory framework for financial inclusion in the Philippines to grow. BSP also capitalises on the growing number of Micro Banking Offices to deliver financial services in underserved areas.

5.4 Further Advancing the Inclusive Financial System

Based on the current situation of financial system in the country, banking presence tends to be skewed towards higher-income and more populated areas considering the cost of setting up banking offices and operating such offices. Therefore, despite the achievements attained to provide financial access to the marginalized, there remains the challenge of limited financial services in the countryside.

To address this challenge, new regulations should be enacted to create opportunities for banks to go to the "unbanked areas". These regulations include the waiving of processing fees for banking offices that will be established in unbanked municipalities to lower the cost of the bank in setting up offices in such areas, to provide loans for educational, health and emergencies purposes, among others.

6. Conclusion

In summary, it can be seen that financial inclusion continues to improve as access to finance increases particularly in the number and reach of banks, ATMs and other financial service providers. Aside from physical access to financial services, the services themselves have become affordable and increased in quality, leading to actual usage and benefits for the marginalised.

However, to evidently claim that the expanded reach of access network resulted in increased usage of financial products and services, a regression analysis must be performed once data becomes available. This will show a clear correlation between access and usage data.

The BSP will continue to improve the collection of both supply-side and demand-side information on financial inclusion in order to produce more meaningful measurements to aid financial inclusion policymaking.

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Chapter 8

ADVANCING FINANCIAL INCLUSIVE SYSTEMS FOR THE NEXT DECADE: THE CASE FOR SRI LANKA

By
Roshan Perera[1]

"People were poor not because they were stupid or lazy. They worked all day doing complex physical tasks. They were poor because the financial institutions in the country did not help them widen their economic base."

Muhammad Yunnus

1. Background

There is growing evidence that developing financial institutions and financial markets and improved access to finance has a strong impact on economic development, poverty alleviation and economic stability. An inclusive financial system is able to reduce poverty, boost shared prosperity and support inclusive and sustainable development. Theoretical and empirical research has found increasing evidence of the role of finance in economic growth. According to Levine (2005), a well-functioning financial system would remove financial constraints faced by industries and firms and improve access to finance that is required for economic growth. Realising the importance of finance for growth, many countries are pursuing active strategies to develop their financial institutions and markets as well as improving the access to financial services and products for a wider segment of the population, particularly for low-income groups.

Financial inclusion facilitates greater participation by different segments of the population in the formal financial system. A large informal sector can affect the transmission of monetary policy as a large number of economic agents would base their financial decisions independent of the monetary policy actions of the central bank. With increased financial inclusion, the share of households and small businesses in the formal financial sector increases, thereby improving the effectiveness of the monetary policy transmission mechanism.

1. Deputy Director, Economic Research Department, Central Bank of Sri Lanka.

Financial inclusion can be broadly defined as the access to appropriate financial products and services at an affordable cost by all sections of society in general and to low- income groups in particular who are underserved or have been excluded from formal financial services. Financial inclusion aims to, broaden the reach of financial services to those who do not currently have access, to deepen financial services for those who have minimal access and to increase financial literacy and consumer protection so that those who are offered financial products can make an informed choice. Financial inclusion could also mean providing access to a broader range of financial products and services to those who currently having access to only basic financial products. The definition and scope of financial inclusion would vary depending on the level of economic and financial development in each country.

It is therefore, important to determine what constitutes an inclusive financial system. Broadly, when examining a financial system and developing a financial system that is inclusive, there are several areas that need to be looked at. Firstly, the products that are available should meet the needs of the poor. Secondly, they should be provided at a reasonable cost. In this regard, financial institutions would need to find ways of making their services more efficient while some of the administrative requirements may need to be relaxed for financial institutions catering to this segment of the population in order to make them more affordable and accessible. With regard to physical accessibility, in the past, this meant ensuring a sufficiently widespread bank branch network. Today, this would entail making use of advances in technology, particularly mobile phones and the Internet to provide a greater reach to the poor. Finally, it is important to ensure adequate protection is provided as this is one of the major impediments to the utilisation of financial services by low-income groups. This would mean developing a good regulatory and supervision framework covering financial institutions that particularly serve lower income segments of the market. Hence, the availability of safe savings products; credit schemes that are designed specifically for the poor and low-income households and enterprises; insurance products to help mitigate the risk of low-income households, farmers and micro small and medium enterprises; convenient payment mechanisms are all required for an inclusive financial system. However, it should be recognised that financial inclusion is not only for the poor. The non-poor for various reasons could also be excluded from financial services. A strategy for financial inclusion should also address this segment of the population.

The paper seeks to assess the current status of financial inclusion in Sri Lanka and to identify the issues and challenges that exist to expanding financial inclusion in the country. Section 2 discusses the financial inclusion and policies and institutions in Sri Lanka. Key indicators of financial inclusion in Sri Lanka are presented in Section 3. Section 4 presents some issues and challenges to advancing financial inclusion and Section 5 concludes.

2. Financial Inclusion Policies and Institutions

At the time of independence, the financial sector was dominated by foreign commercial banks that mainly served the foreign trade sector and the plantations sector in the economy. Consequently, during that period, the rural sector was poorly served. The establishment of the Central Bank in 1950 was a watershed development that led the rapid development of the financial sector in terms of institutions, instruments, services and geographical coverage. Several initiatives were undertaken to expand the outreach of banking facilities and to increase the flow of credit to the rural areas. The nationalisation of the Bank of Ceylon in the 1960s and the establishment of the People's Bank in 1961 led to a rapid expansion of bank branches around the country. The penetration of banking services into rural areas helped promote banking habits among the people. With the liberalisation of economic activity in 1977, rapid changes took place in the financial sector. There was greater participation of private sector in financial activities and foreign banks were once again permitted to establish branches in Sri Lanka. With the establishment of new commercial banks and the expansion of the branch network, banking activity developed and links with the global financial system were enhanced. The introduction of new financial instruments, adjustment of interest rates to reflect demand and supply conditions, relaxation of exchange controls, and permission granted to banks to establish foreign currency banking units (FCBUs) also took place during this period. Together with the developments in banking there has also been a gradual development of other financial institutions and services such as finance companies and specialised leasing companies as well as the development of the capital market. Consequently, a wide network of financial institutions was created to cater to the changing needs of a growing economy.

Although central banks generally do not engage directly in development activities, recognising the need to accelerate development and to create more regionally balanced growth, central banks in developing countries have played a more active role in stimulating economic activity. The Monetary Law Act No.50 of 1949 Section 108(1) contains provisions permitting the Central Bank of Sri Lanka to act as the agent of the government in guaranteeing, issuing or participating in the loans of banking institutions operating in the country. In 1974, the provision was revised permitting the Central Bank to directly guarantee loans, advances or other accommodations to small-scale enterprises by credit institutions operating in the country. The rationale for the inclusion of this role for the Central Bank was that given the stage of development in Sri Lanka at the time of independence, it was felt that there was a need to assist new businesses which may not have the required credit history to obtain financing from commercial banks coupled with the need to develop new and productive commercial enterprises. Over the years, the Central Bank has played a major role in the provision of long-term project lending and in facilitating lending in the regions. In order to better serve areas and activities that were not being adequately paid attention to by the prevailing financial system, the Central Bank established the Development Finance Department in 1974. The main focus of this department was development-oriented finance which entailed the evaluation and facilitation of medium- and long-term project loans mainly for the tourism industry and for exports. The Rural Credit Department was set up in 1981 to promote lending to the rural sector, mainly for agricultural activities. With the expansion of the branch network of commercial banks, particularly during the 1960s and 1970s, the Central Bank established three regional offices to facilitate economic activities in the regions. With the end of the conflict in 2009, two more regional offices were set up in the Northern and Eastern provinces in 2010. Despite the expansion of the branches of commercial banks, there was still a lack of services offered in rural areas. To address this concern, the Central Bank established 17 regional rural development banks (RRDBs) around the country in 1985. Subsequently, some of these institutions were merged to form 6 regional development banks (RDBs). In 2010, these were further consolidated into one Regional Development Bank (RDB). Another initiative of the Central Bank of Sri Lanka to improve financial inclusion has been the setting up a credit and debt management counselling centre to provide advice to individuals and companies on their credit problems and to address issues relating to the denial of access to finance.

Microfinance lending has played a significant role in providing funds to low-income segments of the population and has helped to develop a more inclusive financial service for the poor. The microfinance sector in Sri Lanka commenced in 1906 with the establishment of the Thrift and Credit Cooperative Societies (TCCS) under the Cooperative Societies Ordinance. With the decline of the TCCS, the Central Bank took the lead in initiating various microfinance schemes. The first commercial microfinance scheme, the Small Farmers and Landless Credit Programme (“Isuru”), was launched by the Central Bank in conjunction with the RRDBs in 1991. Several other microfinance projects were also initiated such as the Poverty Alleviation Microfinance Project (PAMP) I in 2000 to improve income levels and social conditions of the poor in project areas. PAMP II was initiated in 2009, focusing on the areas in the Northern and Eastern provinces that were affected by the conflict. The Central Bank has also from time to time initiated special credit facilities in the event of major disasters. "Susahana" a refinance scheme for those affected by the tsunami in 2004 was operated by the Central Bank which provided refinance facilities to PFIs who provided credit to small and medium enterprises in the coastal areas that were directly affected by the tsunami. A further two loan schemes with 100% refinance from the Central Bank were introduced for development activities in the Eastern Province in 2007 and for the resumption of economic activities in the Northern Province in 2009. "Saubhagya" is another credit line that has been initiated for new entrepreneurs and small- and medium-scale enterprises affected by natural disasters. A credit guarantee scheme covering all short-term loans given for cultivation of crops called the New Comprehensive Rural Credit Scheme (NCRCS) was introduced in 1986. The primary purpose of this scheme was to uplift the socio-economic conditions of micro- and small-scale farmers by providing working capital requirements at low cost through interest subsidy and credit guarantees. The government has played a major role in the provision of micro-credit. The Samurdhi Development Programme which commenced in 1995, replacing the former Janasaviya Programe, comprises a large network of Samurdhi Bank Societies through which savings and borrowing of its members take place.

Table 1
Performance of Major Microfinance Institutions - 2012

Microfinance Institute	Total Deposits (Rs mn)	Total Borrowing (Rs mn)	Total Assets (Rs mn)	Total Investments (Rs mn)	Total Loan Portfolio (Rs mn)
Samurdhi Societies/Banks	42,233	87,046	47,323	42,098	84,251
Department of Cooperative Development	76,378	29,395	67,585	20,100	43,350
Department of Agrarian Development	237	184	1,042	359	4,715
Regional Development Ban k	54,710	6,078	69,134	11,385	105,870
SANASA Development Bank	18,003	10,337	24,834	3,430	17,919
Total	191,561	133,040	209,918	77,372	256,105

Source: Performance Report 2012, Department of Development Finance, Ministry of Finance and Planning

In the 1980s and 1990s, several local and international NGOs began to engage in microfinance lending. In many of these cases, microfinance lending was done together with the other social and community development activities undertaken by the NGO. The tsunami which hit the country in 2004 resulted in a significant flow of foreign funds into the country, a large portion of which was channeled through MFIs. More recently, commercial banks have also entered the microfinance credit market. The microfinance scheme “Gami Pubuduwa” (Village Reawakening) which was set up by Hatton National Bank in 1988/89, is one of the oldest and largest microfinance schemes conducted by commercial banks. However, to address the low level of credit disbursements to the agriculture sector by formal lending institutions, the government in its budget for 2006, designated the agriculture sector as a priority sector for lending. Accordingly, all licensed banks were mandated to ensure that 10% of their credit portfolio was made to the agriculture sector and if a bank was not able to meet this target, they were to transfer the funds to the Central Bank to be re-loaned to designated sectors. In the government’s budget for 2012, banks were encouraged to set up dedicated SME centres in each district. Accordingly, several SME centres have been established to provide SME entrepreneurs with advisory and financial support.

Considering the distribution of bank branches in the country, around 35% of bank branches are located in the Western Province which is not surprising as the Western Province accounts for around 43% of GDP. However, to encourage the opening of bank branches in the regions, the Central Bank issued guidelines in 2007 mandating that for every bank branch that is opened in the Western Province, two branches need to be opened in the other regions. This has seen the opening of bank branches in the other provinces in the country. After the end of the conflict, there has been a significant rise in the number of bank branches being opened in the Northern and Eastern provinces. Access to financial services has also improved with developments in infrastructure, particularly the expansion of the road network into the rural areas.

Table 2
Banking Density by Province
(No. of Bank Branches)

	2000		2013	
	No.	Share (%)	No.	Share (%)
Province				
Western	930	32.4	1,213	35.4
Central	354	12.3	370	10.8
Southern	401	14.0	399	11.6
Northern	68	2.4	230	6.7
Eastern	101	3.5	262	7.6
North Western	391	13.6	306	8.9
North Central	160	5.6	204	5.9
Uva	192	6.7	186	5.4
Sabaragamuwa	295	10.3	261	7.6
Total	2,872	100	3,431	100

Developments on the technological front have also helped expand the reach of financial services in the country. The introduction of automated teller machines (ATMs), credit cards, electronic fund transfer facilities has played a significant role in increasing banking activity across the country. The digitisation of financial transactions commenced in the 1980s, following the liberalisation of the economy with the introduction of ATM cards in 1986 and credit cards in 1989. On the payments and settlements front, the establishment of the Sri Lanka Automated Clearing House (SLACH) in 1988, helped automate cheque clearing facilities, thus reducing the time taken to clear cheques and thereby improving the efficiency of banking services. The establishment of SLACH was followed by and facilitated by the introduction of the Sri Lanka Interbank Payment System (SLIPS) which is an electronic funds transfer (EFT) system for interbank transactions in 1994. The SLIPS system reduced the use of cheques and is used mainly for small value bulk transactions such as the payment of salaries and utility bills. This was upgraded to an online system in 2010 facilitating T+0 settlement facilities. With the introduction of cheque imaging and truncation system (CITS) in 2006, the time taken for cheque clearing was reduced further. This system enabled cheques in any part of the country to be cleared within T+1 days. This has significantly enhanced the access to finance through retail transactions. The real time gross settlement system (RTGS) was introduced in 2003 to facilitate the settlement of high value and time critical transactions while the introduction of the Scripless Securities Settlement System (SSSS) has helped develop the government securities market and expand securities trading in the secondary market.

The adoption of electronic banking systems such as the Internet banking and mobile phone-based banking has further helped expand banking activities. Banks commenced offering Internet banking products as early as in 1999. The advances in IT and payment systems throughout the country have reduced fees and charges relating to banking services and has helped increase the receipt of foreign remittances through formal banking channels. The Central Bank also granted permission to commercial banks to carry out agency banking through mobile phones. Commercial banks are able to carry out on-the-spot banking facilities such as depositing and withdrawing money and receiving remittances abroad through their agents located around the country. The widespread coverage of the mobile phone network in the country provides an opportunity to further expand the access to financial services even in the remotest parts of the country through the use of electronic retail payment methods such as payment cards and mobile phone-based payment mechanisms. In 2010, the Central Bank commenced licensing service providers of payment cards and mobile payment systems to ensure safe and efficient retail electronic payment systems. At present in Sri Lanka, several mobile payment schemes (e-money) have been initiated such as eZ Cash, eChanneling, eZ Pay. According to a recent survey conducted among urban poor households, the main uses for electronic payment schemes have been for the payment of utility and phone bills, remittances, retail payments, person-to-person fund transfers. However, the penetration of these e-money schemes has been low and the reasons cited were the lack of need, lack of awareness, lack of trust, difficulty of use, availability and affordability. Recognising the enormous potential of these electronic money schemes and the need to protect customer rights and regulate service providers involved in such businesses to ensure the safety of the payment system and the stability of the financial system, the Central Bank issued the Service Providers of Payment Card Regulations No. 1 of 2009 which was subsequently replaced with the Payment Cards and Mobile Payment Systems Regulations No. 1 of 2013.

Policies have been adopted from time to time to strengthen the financial sector. These institutional and legal reforms that have been adopted have contributed significantly to the expansion of financial services in the country. Recognising the vital role played by microfinance institutions in advancing financial inclusion and the need for better regulation and supervision of this sector, the Central Bank has drafted a Microfinance bill. Under the proposed legislation, a Microfinance Regulatory and Supervisory Authority would be created to license, regulate and supervise institutions engaged in microfinance business. The main objective of the legislation would be to ensure that the operations of MFIs safeguard the interest of depositors and customers.

The Sri Lanka Deposit Insurance Scheme was implemented in October 2010 replacing the voluntary scheme that had been in operation since 1987. All licensed banks and registered finance companies were registered as members of the scheme. An insurance premium ranging from 0.1 % to 0.15 % per annum against all demand and time and savings deposits of member institutions except for deposits of the government, directors, management personnel and other related parties, deposits held as collateral against accommodation and dormant accounts have to be transferred to the Deposit Insurance Fund by member institutions. In the event of the suspension or cancellation of a license of a member institution by the Monetary Board, compensation up to a maximum of Rs.200, 000 per depositor would be paid from the fund commencing 1 January 2012.

The Secured Transactions Act which provides for the establishment of a registry for moveable collateral such as machinery and equipment was passed in September 2009 and the Secured Transactions Register was established in 2011 under the Credit Information Bureau. The main objective of this legislation is to promote economic activity by improving the access to credit for small and medium enterprises (SMEs). Under this legislation creditors could give notice of their security interest in the moveable assets of debtors. Thus, creditors could determine if there are prior claims on assets being pledged as collateral and establish priority in terms of interest in the security. This legislation is expected to facilitate the extension of credit secured on moveable collateral, thereby improving access to finance for small and medium enterprises. The weakness of the scheme is that it is currently only a voluntary scheme and hence does not cover all moveable collateral assets. Expanding the coverage of the credit information bureau is another measure that has been proposed to lessen the issues relating to asymmetric information and thereby improving the access to credit.

Recognising that the lack of awareness is one of the key reasons for financial exclusion, the Central Bank has initiated various financial literacy programmes to disseminate information on financial services to various groups ranging from school children to farmers, women, small and medium entrepreneurs, and self-employed persons. Programmes are conducted on topics such as savings habits, budgeting, financial management, using credit wisely and the risk of unauthorised financial institutions. Entrepreneurship development programmes are also carried out to create awareness of the availability of financial facilities and to improve the technical and marketing know-how of entrepreneurs and farmers. De Mel, McKenzie and Woodruff, (2012) find that basic business training significantly improves the returns from credit, providing further rationale for financial literacy programmes as a means of enhancing financial inclusion.

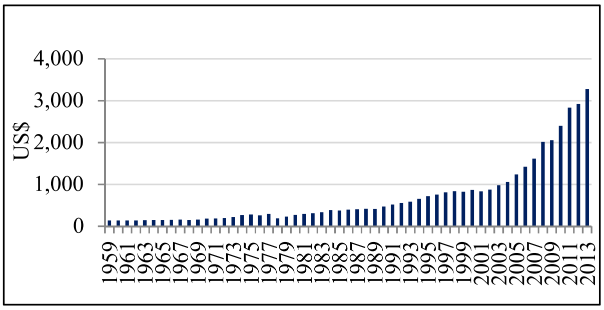
The easing of the monetary policy stance by the Central Bank from end-December 2012 and the steady decline in market interest rates since then, has also created a conducive environment for credit flows. Maintaining a low interest rate environment and favourable macroeconomic conditions will encourage credit disbursements to support economic activity.

3. Current Status of Financial Inclusion in Sri Lanka

3.1 Indicators of Economic and Financial Developments in Sri Lanka

The economy has steadily grown since the country gained independence in 1948. In 1959 when the country first began to compute national account statistics, the per capita GDP at current market prices was US$140. It doubled to US$273 million in 1980 after the liberalisation of the economy. It took more than a decade to double again. Per capita income exceeded US$1,000 in 2004. It thereafter took around 5 years to double to US$2,057 in 2009 and is expected to reach US$4,000 by 2016. Based on the findings of the Global Financial Inclusion Survey conducted by the World Bank in 2011, there is a positive relationship between per capita income and account penetration (Demirguc-Kunt and Klapper, 2012). They find that at per capita income levels above US$15,000 account penetration is almost universal with a few exceptions. However, at per capita income levels below US$2,200, they find that the relationship is much weaker. Sri Lanka, despite being classified as a lower middle income country, has a relatively high account penetration rate of around 69%.

Figure 1
Per Capita GDP: 1959 - 2013



Source: Department of Census and Statistics, Central Bank of Sri Lanka.

The economy in Sri Lanka has undergone a significant transformation since the country gained independence in 1948. At the time of independence, the share of agriculture to total GDP was over 45%. With the liberalisation of economic activity in the late 1970s, the share of the agriculture sector in total economic activity declined to around 30 % and by 2013, this share has declined further to around 11%. The corresponding shares of industry and services sector have risen to around 30% and 60%, respectively. However the share of labour force employed in the agriculture sector continues to remain high at around 30%. In terms of the regional distribution of GDP, the Western Province accounts for the largest share accounting for around 44 % of total GDP. However, the share of the Western Province has declined from 50% in 2006 with the contribution of the other regions gradually increasing.

Table 3
Sectoral Composition of GDP (Percentage)

	1980	1990	2000	2010	2013
GDP					
Agriculture	27.6	26.3	19.9	12.8	10.8
Industry	29.6	26.0	27.3	29.4	32.5
Services	42.8	47.7	52.8	58.0	56.8

Source: Department of Census and Statistics.

Table 4
Regional Distribution of GDP at Current Prices 2006-2012
(Share of GDP %)

Province	Western	Central	Southern	Northern	Eastern	North Western	North Central	Uva	Sabarag -amuwa
2006	50.1	8.8	10.0	2.8	4.9	9.1	4.0	4.3	6.1
2007	46.5	9.6	10.5	2.9	5.2	9.9	4.0	4.9	6.4
2008	45.4	9.8	10.5	3.2	5.6	9.9	4.7	4.5	6.4
2009	45.8	9.8	10.5	3.2	5.8	9.6	4.6	4.5	6.1
2010	44.8	10.0	10.7	3.4	6.0	9.5	4.8	4.5	6.3
2011	44.4	9.8	11.1	3.7	5.7	10.0	4.6	4.5	6.2
2012	43.4	9.8	11.5	4.0	6.3	9.6	4.7	4.0	6.1

Source: Department of Census and Statistics, Central Bank of Sri Lanka.

The financial sector in Sri Lanka has evolved with the changing needs of the economy. At the time of independence, the financial system mainly served the plantation economy. The activities of the financial sector have diversified significantly, thereafter. At present, the financial system in Sri Lanka comprise the Central Bank of Sri Lanka, licensed commercial banks (LCBs), licensed specialised banks (LSBs), licensed finance companies (LFCs), specialised leasing companies (SLCs), primary dealers (PDs), pension and provident funds, insurance companies, rural banks, stock brokers, securities market intermediaries, unit trusts and thrift and credit co-operative societies as well as financial markets, such as the foreign exchange market, money market, and capital market. The financial sector is mainly dominated by the banking sector which accounts for around 56 % of the total assets in the financial sector. The banking sector comprises 22 licensed commercial banks, 2 of which are state banks, 10 private domestic banks and 12 branches of foreign banks. The 6 domestic banks hold nearly 80% of the total commercial bank assets. In addition, there are 9 licensed specialised banks (6 state banks and 3 private banks) engaged in development finance and housing finance activities. Non-bank financial institutions such as registered finance companies and specialised leasing companies also form an important part of the financial system.

Table 5
Total Assets of the Financial System – 2013[(a)]

Financial Institution	Rs bn	Share (%)
Central Bank of Sri Lanka (CBSL)	1,246.0	12.1
Institutions Regulated by the CBSL	**6,872.6**	**66.6**
Deposit taking institutions	**6,594.5**	**63.9**
Licensed Commercial Banks	5,022.2	48.7
Licensed Specialised Banks	919.3	8.9
Licensed Finance Companies	653.0	6.3
Other Financial Institutions	**278.1**	**2.7**
Primary Dealers	213.6	2.1
Specialised Leasing Companies	64.5	0.6
Institutions not Regulated by the CBSL	**2,199.7**	**21.3**
Deposit taking institutions	103.4	1.0
Rural banks [(b)]	94.9	0.9
Thrift and Credit Cooperative [(b)]	8.5	0.1
Contractual Savings Institutions	**1,998.3**	**19.4**
Employees Provident Fund	1,300.0	12.6
Employees Trust Fund	178.5	1.7
Approved Private Provident Funds [(c)]	123.0	1.2
Public Service Provident Fund	36.4	0.4
Insurance Companies [(d)]	360.4	3.5
Other Financial Institutions	**98.0**	**0.9**
Stock broking companies [(e)]	10.3	0.1
Unit Trusts/Unit Trust Mgm Companies	55.8	0.5
Market Intermediaries [(e)(f)(g)]	29.5	0.3
Credit Rating Agencies [(e)]	0.3	0.0
Venture Capital Companies	2.3	0.0
Total Assets	**10,318.3**	**100.00**

Source: Central Bank of Sri Lanka.

Notes:
(a) Provisional.
(b) Registered with the Department of Cooperative Development.
(c) Registered with the Department of Labour.
(d) Regulated by the Insurance Board of Sri Lanka.
(e) Regulated by the Securities and Exchange Commission of Sri Lanka.
(f) Market Intermediaries include Underwriters, Margin Providers and Investment Managers.
(g) Excluding the assets of licensed banks, licensed finance companies and licensed specialised companies which are registered as market intermediaries.

Aggregate indicators such as money supply as a percentage of GDP, financial sector contribution to GDP, private sector credit as a ratio of GDP can provide some measure of the financial depth in an economy. In addition, measures such as stock market capitalisation and outstanding government debt and corporate debt securities as a percentage of GDP give some indication of the development in the financial markets. Based on these measures, we find that Sri Lanka still has a low level of financial depth compared to other emerging nations. Sri Lanka's money supply to GDP ratio is around 40% which is similar to the level in Indonesia (40%) and Philippines (59%) but significantly lower than that of Singapore (138%), Malaysia (142%), Thailand (125%) and South Korea (144%). A similar trend is observed in the ratio of private sector credit to GDP.

Table 6
Selected Indicators of Financial Depth

	1980	1990	2000	2010	2013
Depth - Financial Institutions					
Narrow Money (as a % of GDP)	14.2	12.3	9.4	7.3	5.6
Broad Money (as a % of GDP)	29.9	28.1	32.2	37.3	39.4
Financial Sector Contribution to GDP	3.0	4.6	7.6	8.9	8.7
Total Financial Sector Assets (a % of GDP)	101.7	112.8	129.0	119.38	118.95
Private Sector Credit by Banks (as a % of GDP)	19.1	20.2	29.0	26.6	29.2
Depth - Financial Markets					
Stock Market Capitalisation (as a % of GDP)	n.a.	11.5	7.1	39.4	28.4
Outstanding domestic private debt securities (as a % of GDP)	n.a.	n.a.	n.a.	1.5	0.9
Outstanding government debt securities (as a % of GDP)	14.7	21.1	27.0	42.8	41.8

Source: Central Bank of Sri Lanka.

Although it is recognised that financial inclusion is important for development, identifying the extent of financial inclusion or exclusion in a society has been much harder to assess. The number of bank branches and the geographic distribution of bank branches across the country are some indicators that are used to measure the access to financial institutions. However, mere access to financial services does not necessarily mean that they are utilised. For various reasons, people are excluded from access to financial services. For instance, people who are considered high risk will not be lent to by formal financial institutions. High cost of services, the non-availability of products required by people and the lack of awareness of products that are available are other reasons why people are excluded from financial services. In some instances, people are not comfortable approaching formal institutions to access services for fear of being rejected which leads to exclusion. There are other indicators that are used to assess the type of financial services and products that are available and the extent to which they are utilised such as the number of persons with savings and loans from formal institutions, the use of credit and debit cards and other e-money schemes which would give an indication of the access to payment systems services and the use of insurance products.

Table 7
Access to Financial Institutions

	1980	1990	2000	2005	2010	2012	2013
No. of bank branches & other outlets	632	802	2,876	3,685	4,911	5,416	3,442
Banking Density - No. of commercial bank branches per 100,000 persons	NA	NA	5.7	8.3	11.5	13.4	13.7
Total no. of ATMs	NA	NA	NA	918	2,240	2,390	3,122
No. of ATMs per 100,000 persons	NA	NA	NA	4.25	11	14	NA
Total no. of electronic fund transfer facilities at point of sales machines (EFTPOS)	NA	NA	NA	7,013	27,073	27,689	27,955
Mobile phone banking	NA	NA	NA		184,180	170,394	275,708
Telebanking	NA	NA	NA	766,687	45,196	39,901	34,569
Internet banking	NA	NA	NA		4,264,065	6,972,538	8,942,384
Total no. of credit cards	NA	NA	NA	628,989	778,549	891,170	951,625
Credit Cards per 100,000 persons	NA	NA	NA	3,244	3,770	4,684	NA

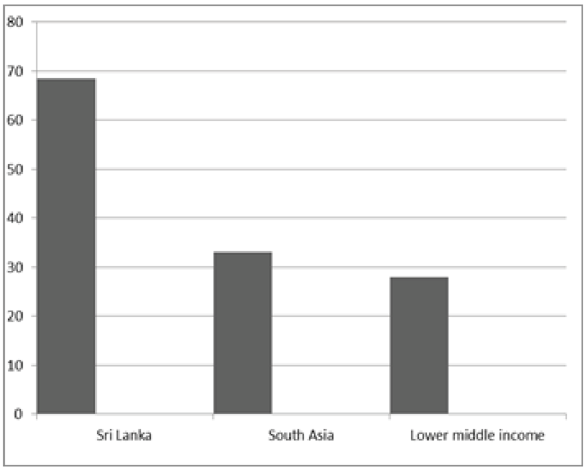
Source: Central Bank of Sri Lanka.

3.2 The State of Financial Inclusion in Sri Lanka Compared to the Region

The Global Financial Inclusion (Global Findex) Database is drawn from a survey of formal financial institutions covering more than 150,000 people in 148 economies representing more than 97 % of the world's population. The last survey was conducted in 2011 and covered around 1,000 people in each economy. The major findings of the study are summarised in Demirguc-Kunt and Klapper (2012). According to the survey findings, despite being categorised as a lower middle income country, Sri Lanka has a relatively high account penetration rate (69%) (see Figure 2) compared to the average for South Asia (33%) and for lower middle income countries (28%). The percentage of those with accounts does not vary significantly between urban (72%) and rural areas (68%). With respect to gender, 67% of adult females in Sri Lanka have an account compared to only 25% in South Asia and 23% in lower middle income countries (see

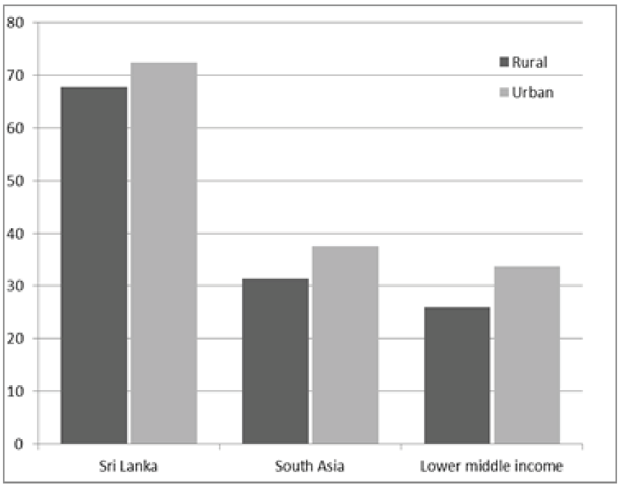
Figure 4). In terms of education, there was not much disparity with 63% of those with primary education or less having an account compared to 76% of those with secondary education or higher (see Figure 5). The disparity was much greater in the case of South Asia with only 28 % of those with primary education or less having an account versus 51 % with secondary or more education. The use of accounts to receive wages, government payments and remittances was relatively low in Sri Lanka as in South Asia and lower middle income countries (see Figure 7). While 28% had saved in a financial institution within the last year, only 18 % had obtained a loan from a financial institution in the past year in Sri Lanka (see Figure 8). Although these rates are relatively low compared to those having accounts, it is still better than the averages for South Asia where only 11% respondents had saved in a financial institution in the past year and only 9% had obtained a loan during the past year.

Figure 2
Adults with an Account at a Formal Institution
Overall (%)



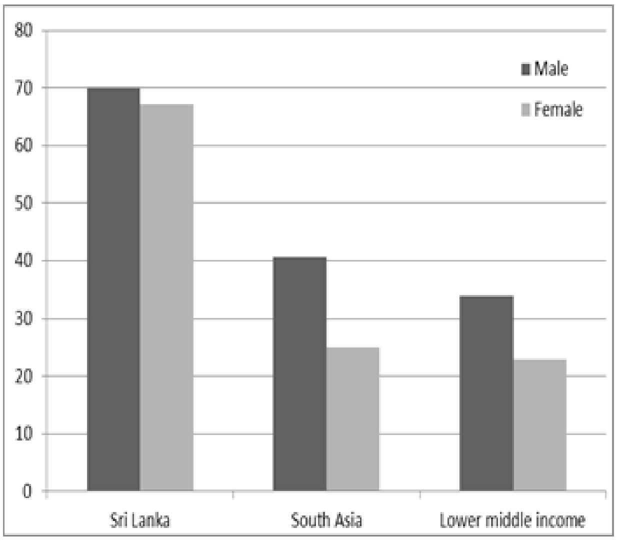
Source: Global Findex Database, World Bank 2013.

Figure 3
Adults with an Account at a Formal Institution by Urban/Rural Residence (%)



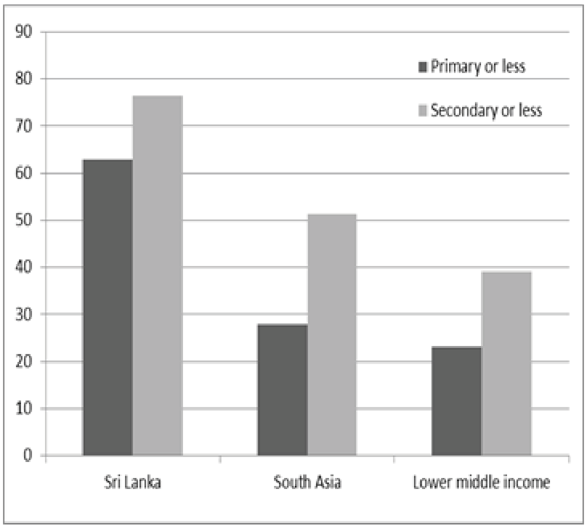
Source: Global Findex Database, World Bank 2013.

Figure 4
Adults with an Account at a Formal Institution by Gender (%)



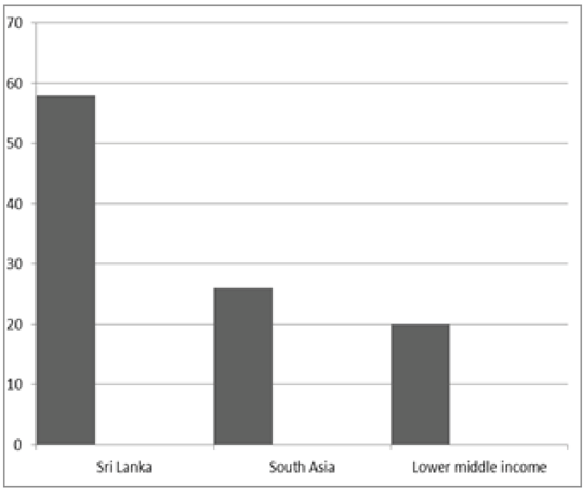
Source: Global Findex Database, World Bank 2013.

Figure 5
Adults with an Account at a Formal Institution by Education Level (%)



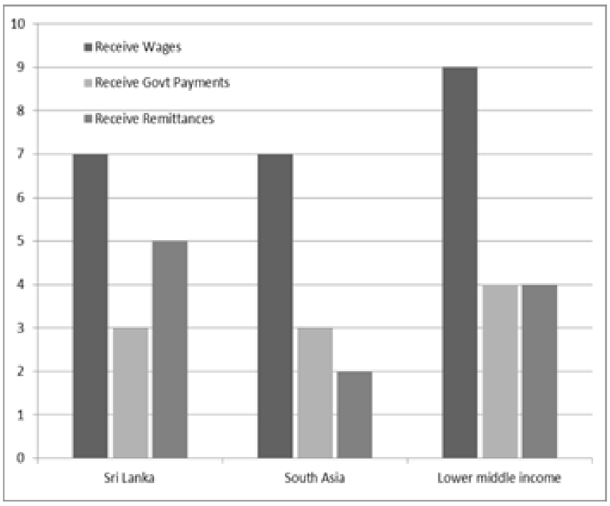
Source: Global Findex Database, World Bank 2013.

Figure 6
Adults with an Account at a Formal Institution Income, Bottom 40 percent (%)



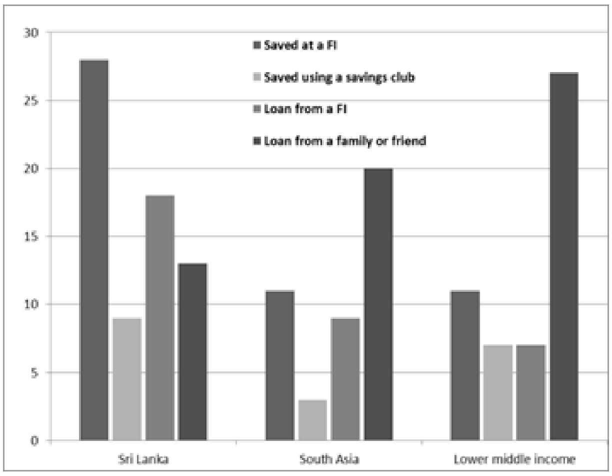
Source: Global Findex Database, World Bank 2013.

Figure 7
Adults with an Account at a Formal Institution Use of Accounts (%)



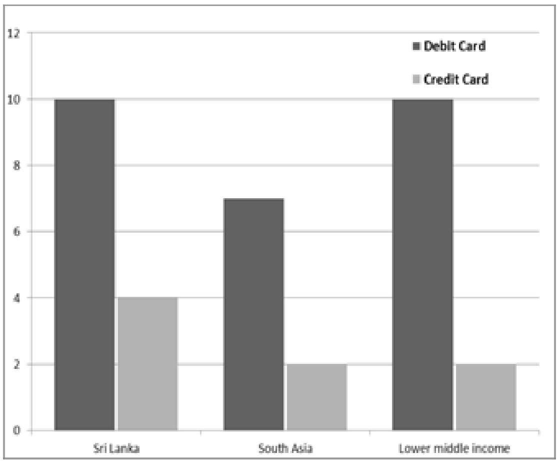
Source: Global Findex Database, World Bank 2013.

Figure 8
Savings and Loan Information (%)



Source: Global Findex Database, World Bank 2013.

Figure 9
Debit and Credit Card (%)



Source: Global Findex Database, World Bank 2013.

3.3 The State of Financial Inclusion across Regions in Sri Lanka

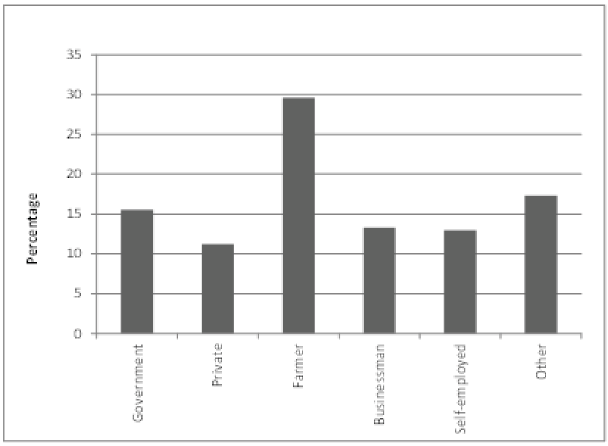
A survey to assess the level of financial inclusion was conducted by the Central Bank of Sri Lanka during the period July to October 2013. The survey covered 1,200 households in six of the nine provinces and 18 of the 24 districts in the country in both urban and rural areas. Unlike the survey conducted by the World Bank, this survey included both formal and informal financial institutions. The survey included 35 questions covering areas such as demographic information, information relating to employment, income and ownership of assets, information relating to interactions with financial institutions including information on savings and access to credit. The survey also collected information relating to the use of Internet, mobile phones and other electronic payment and banking methods. The main objectives of the study were to assess the level of financial inclusion in the regions and to identify the main issues with regard to the access to financial services. The information collected from the survey will be utilised to develop a strategy to improve the level of financial inclusion among all segments of the population and all regions in the country.

3.3.1 Main Characteristics of the Sample Population

The sample comprised 78% males and 22% females. Of those surveyed, 78% were employed while 22% were unemployed. Of those employed, around

30% were engaged in farming, 15% were employed by the government and 13% were engaged in business and another 13% were self-employed, while 11% were employed in the private sector (see Figure 10).

Figure 10
Type of Employment

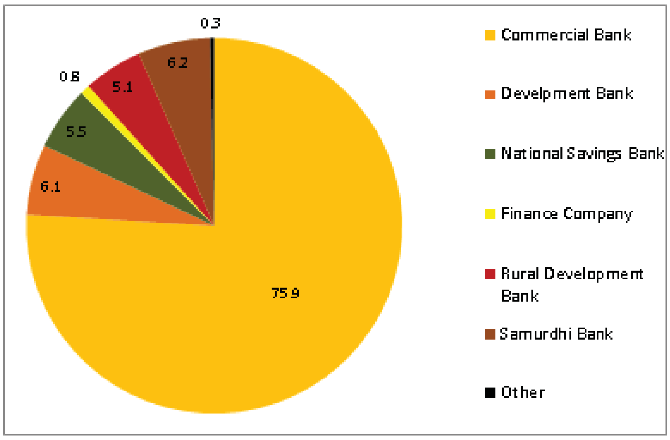


Source: Financial Inclusion Survey 2013, Central Bank of Sri Lanka.

3.3.2 Findings on Access to Finance

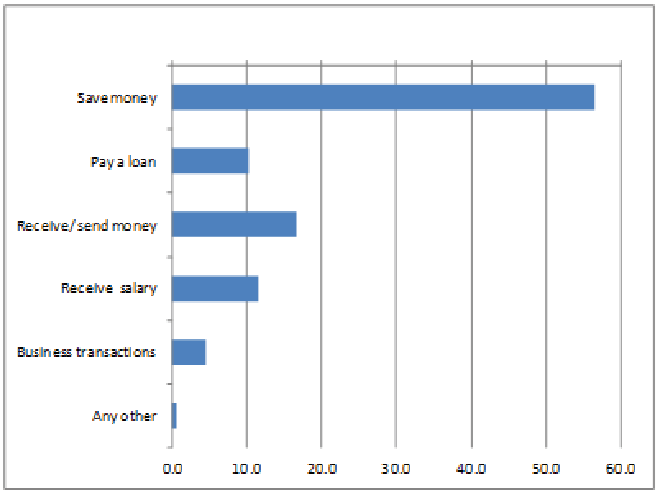
According to the survey, 84% of respondents had an account of which more than 76% were maintained at a commercial bank, 6.2% had deposits at the National Savings Bank (NSB), 6.1% at development banks, while 5% each had deposits with Rural Development and Samurdhi Banks respectively (see Figure 11). Around 70% of those who maintained accounts had deposited money within the past 12 months. The main reason cited by those who had not made a deposit within the last 12 months was that they did not earn sufficient income to save (see Figure 12). This suggests that having a safe place to keep funds was the main reason for maintaining an account.

Figure 11
Type of Financial Institution in which Account is Held



Source: Financial Inclusion Survey 2013, Central Bank of Sri Lanka.

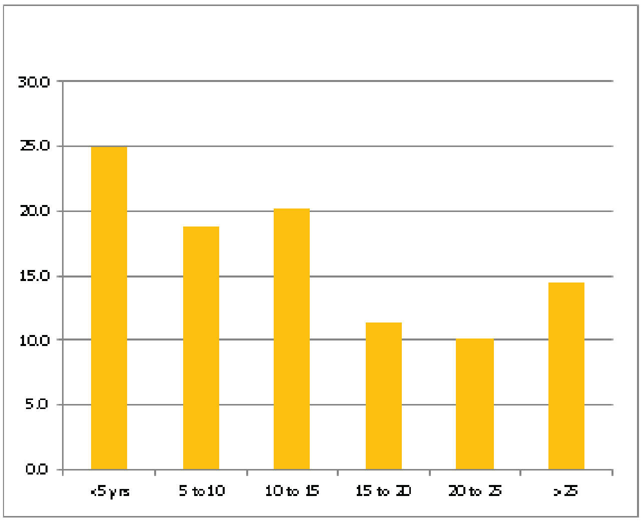
Figure 12
Reasons for Maintaining an Account (%)



Source: Financial Inclusion Survey 2013, Central Bank of Sri Lanka.

Note: Respondents were allowed to provide multiple reasons for maintaining accounts.

Figure 13
No. of Years since Opening an Account (%)



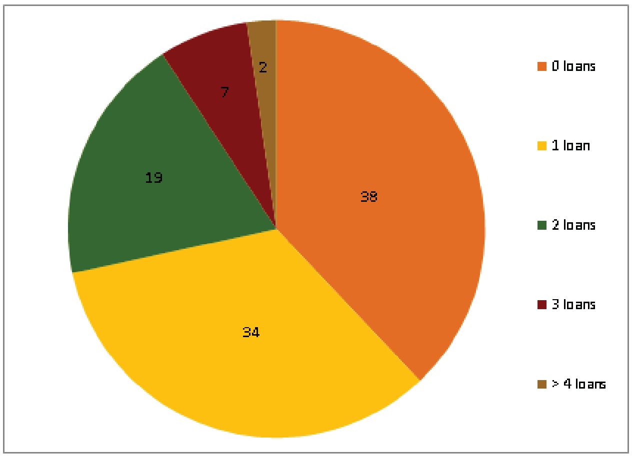
Source: Financial Inclusion Survey 2013, Central Bank of Sri Lanka.

3.3.3 Findings on Access to Credit

Data from the Household Income and Expenditure Survey 2009/10 conducted by the Department of Census and Statistics was used to examine the indebtedness of households. The sample of the survey covers 22,581 households in all districts excluding Mannar, Kilinochchi and Mullathivu districts in the Northern Province[2]. The survey collected information on the indebtedness of households to formal financial institutions such as banks and finance companies and informal arrangements such as loans from money lenders, retail outlets etc. According to the findings of the survey, 62% of respondents had obtained a loan of which 54% were from banks and finance and leasing companies (see Figures 14 and 15).

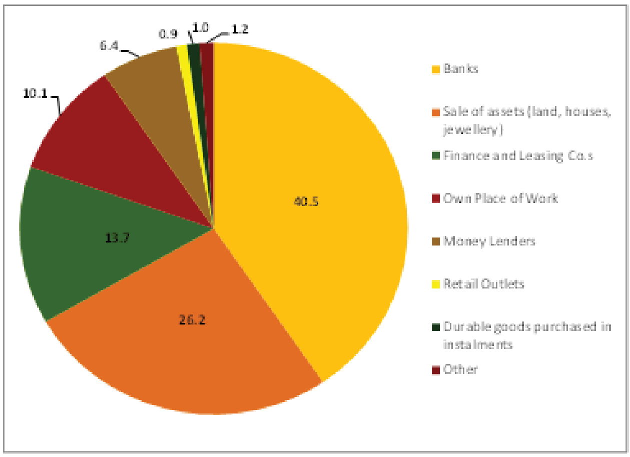
2. For more information on the sampling methodology please refer the Household Income and Expenditure 2009/10 Final Report, Department of Census and Statistics, Sri Lanka.

Figure 14
Access to Credit (%)



Source: Household Income and Expenditure Survey 2009/10.

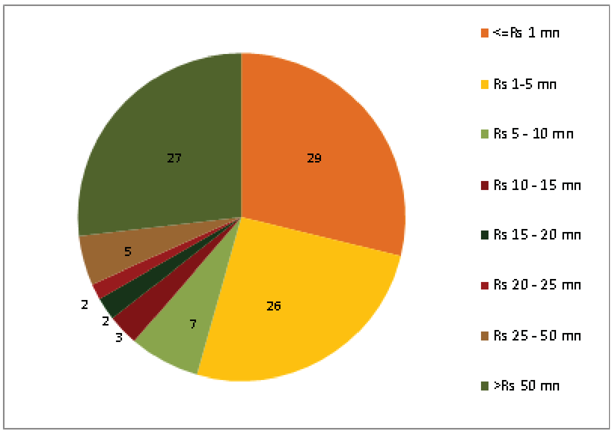
Figure 15
Source of Loans Obtained (%)



Source: Household Income and Expenditure Survey 2009/10.

A breakdown of credit outstanding from the formal sector which includes commercial banks, specialised banks, finance companies and leasing companies is given in Figure 16. Around 29% of total outstanding credit comprises loans that are less than Rs. 1 million and 26% are loans that are less than Rs. 5 million indicating a large proportion of loans fall into the small and medium categories.

Figure 16
Breakdown of Outstanding Credit by Size of Loan as at 30 November 2014(%)



Source: Credit Information Bureau.

3.3.4 Findings on Use of Electronic Forms of Banking Facilities and Payment Schemes

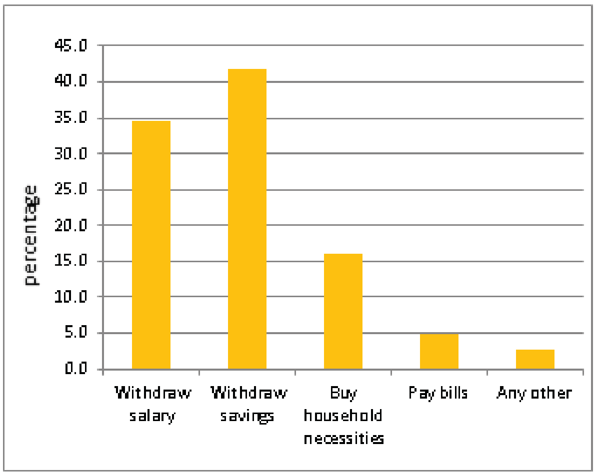
The level of usage of electronic forms of banking schemes and payment methods was relatively low in the households sampled (see Table 7). Only 31% of households that responded had an electronic card, of which the majority was a debit card (84.5%). A very small share had a credit card (15.5%). The main purposes cited for using electronic cards (see Figure 17) were to withdraw savings (41.9%) and salary (34.5%).

Table 8
Use of Technology for Money and Banking Purposes

	Yes	No
Use of electronic card	30.7	69.3
Use of Internet banking facilities	1.6	98.4
Use of mobile phones to send/receive money	0.9	99.1

Source: Financial Inclusion Survey 2013, Central Bank of Sri Lanka.

Figure 17
Purpose for Using Electronic Card (%)



Source: Financial Inclusion Survey 2013, Central Bank of Sri Lanka.

3.3.5 Level of Insurance Penetration

According to the World Insurance Report 2012, prepared by Swiss Re, insurance penetration (total premium as a percentage of GDP) which measures the level of insurance activity is only 1.2% in Sri Lanka. This is relatively low given the size of the Sri Lankan economy and in comparison to the average for Asia which is 5.8% and 6.6% for the world. The main reason for the low level of insurance penetration in Sri Lanka is that insurance is considered an instrument for risk mitigation rather than an instrument for savings and investment. The relatively low income as measured by per capita GDP, the availability of free health and the general lack of awareness of the benefits of insurance are some of the reasons for the low level of insurance penetration in the country. Further, insurance density which is the ratio of insurance premiums to the total population was only US$33 in Sri Lanka compared to the average of US$314 for Asia and US$661 for the world.

A direct link between demand for life insurance and interest rates and inflation has been observed. In the 1970s, with the emergence of high inflation and interest rates, the attractiveness of life savings policies declined, lowering penetration rates in North America and Europe, while increasing in Japan.

However, with the decline in interest rates and inflation in those countries in the 1980s, demand for life insurance increased. In relation to non-life insurance, penetration worldwide has steadily increased with the growth in vehicles. The same trends are expected to be seen in countries such as Sri Lanka with the rise in per capita incomes and the decline in interest rates. With inflation and interest rates being maintained at low and stable levels, there is expected to be an increasing demand for alternative savings products such as life insurance. An ageing population will further boost demand for life insurance in countries such as Sri Lanka. Further, with the growth in per capita incomes, the emergence of a rising middle class and increasing wealth is also expected to increase demand for general insurance.

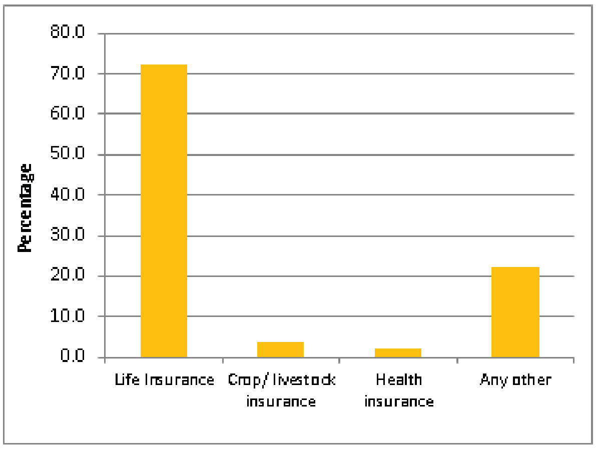
Table 9
Insurance Penetration and Density in Selected Asian Economies

Country	Insurance Penetration[(a)] (in per cent)			Insurance Density[(b)] (Premiums per capita US$)		
	Total Business	Life Business	Non Life Business	Total Business	Life Business	Non Life Business
Sri Lanka	**1.2**	**0.5**	**0.7**	**33**	**15**	**18**
India	4.1	3.4	0.7	59	49	10
Indonesia	1.7	1.1	0.6	60	40	20
Malaysia	5.1	3.3	1.8	502	328	175
Philippines	1.3	0.8	0.4	30	20	10
Singapore	5.9	4.3	1.5	3,106	2,296	810
South Korea	12.1	6.9	5.3	2,785	1,578	1,207
Chinese Taipei	18.2	15.0	3.2	3,760	3,107	652
Thailand	4.4	2.7	1.7	222	134	88
Vietnam	1.42	0.63	0.78	22.0	9.8	12.2
Japan	11.0	8.8	2.2	5,169	4,138	1,031
Asia	**5.8**	**4.3**	**1.6**	**314**	**229**	**85**
World	6.6	3.8	2.8	661	378	283

Source: Swiss Re, Sigma 3/ 2012, World Insurance in 2012.
Notes:
(a) Insurance penetration is the total insurance premium as a percentage of GDP.
(b) Insurance density is the ratio of insurance premiums to the total population.

In the survey carried out by the Central Bank of Sri Lanka, around 22.7% of respondents had an insurance policy. Over 70% of the insurance policies taken were in respect to life insurance (see Figure 18).

Figure 18
Type of Insurance Policy Obtained (%)



Source: Financial Inclusion Survey 2013, Central Bank of Sri Lanka.

4. Plan for the Next Decade

The rationale for promoting financial inclusion is not only due to equity considerations; access to affordable financial services is also required for inclusive. Given the important role that financial inclusion plays in realising sustainable development, reducing poverty and boosting shared prosperity, it is necessary to strive for the improvement in the level of financial inclusion in the country. While significant progress has been made towards enhancing the level of financial inclusion in the country as indicated by the various measures of financial inclusion, some areas may need to be strengthened and developed, particularly as the country seeks to graduate to a higher level of per capita income.

4.1 Develop a Formal Strategy for Financial Inclusion

Several initiatives have been taken to promote financial inclusion in the country in past few decades. However, it may be necessary to draw up a formal strategy for financial inclusion to take the country to the next decade. A strategy for financial inclusion may include the following (Financial Inclusion

Strategies Framework, World Bank, 2012): (1) Collecting data to better understand the baseline or starting point in terms of key indicators of financial inclusion that would help policy makers and financial institutions to better design products and delivery mechanisms; (2) Determining objectives and setting measureable targets to be achieved within a given timeline; (3) Developing a strategy or action plan to achieve the objectives and targets set out. A national level taskforce may be set up to coordinate and monitor the implementation of the strategy; (4) Setting out the regulatory and policy actions and the developments to the financial infrastructure that are required to enhance financial inclusion while ensuring the maintenance of financial system stability; (5) Setting up a mechanism to monitor the progress of the strategy and the achievement of the set targets for financial inclusion. This would include the conduct of regular surveys on financial inclusion and evaluation of products and delivery mechanisms introduced to enhance financial inclusion. The findings from these surveys and evaluations would help refine the strategies, thereby improving their effectiveness in enhancing financial inclusion. A strategy for financial inclusion may also seek to focus on some identified priority sectors in the economy, such as SMEs in keeping with the development objectives of the country.

4.2 Establish a Credit Guarantee Corporation

Considering the important role that small and medium enterprises (SMEs) play in the economy, a credit guarantee corporation could be set up to reduce the financial constraints faced by SMEs that do not have sufficient collateral to obtain credit from formal financial institutions. Formal financial institutions are reluctant to extend credit to SMEs for various reasons such as asymmetric information, the lack of acceptable collateral, high administrative costs and the perception that they are high risk. In addition, SMEs are generally not able to provide information on their credit worthiness and often lack appropriate accounting records. As collecting this information can be costly and not cost effective given the typical size of loans to SMEs, formal financial institutions tend to avoid lending to this sector due to problems of adverse selection and moral hazard. Banks are also reluctant to lend to SMEs due to the lack of collateral and problems that arise when trying to register the type of collateral provided by SMEs. The Monetary Law Act contains provisions under Section 108(1) to permit the Central Bank of Sri Lanka to act as the agent of the government in guaranteeing, issuing or participating in the loans of banking institutions operating in the country. To strengthen the role of the Central Bank further, the MLA was amended in 1974 to permit the Central Bank to directly guarantee loans, advances or other accommodations granted to small- scale enterprises by credit institutions operating in Sri Lanka. The Central Bank has operated various credit guarantee schemes covering the agriculture sector and specific industries such as the apparel sector and gems and jewellery sector. Most of the credit guarantee schemes operated by the Central Bank were in conjunction with either a refinance scheme or an interest subsidy loan scheme. However, due to various reasons such as the need for collateral, legal action being taken against defaulters and other stringent requirements, the full potential of credit guarantee schemes has not been realised (de Alwis and Basnayake, 2009). Hence, there is a rationale for establishing a credit guarantee corporation that will encompass all sectors of the economy. According to Basel regulations, the risk weight for lending to SMEs is 75%. However, if these loans are provided with a credit guarantee, the risk weighting assigned would be lower, providing an incentive to banks to lend to this sector.

4.3 Develop Appropriate Products

Financial institutions need to be encouraged to develop products that suit the needs of the poor. The products whether they are savings products, instruments of borrowing or insurance products should be easily accessible and be available at low cost. The literature finds a positive correlation between the access to savings instruments and savings (Ashraf et al., 2010b), investment (Dupas and Robinson, 2009) and consumption (Dupas and Robinson, 2009; Ashraf et al., 2010b). Appropriately designed savings products targeting small savers would encourage those with low incomes to save. Further, in a low interest environment, developing alternative savings products may help ensure that in an ageing society, retirees would be able to enjoy a basic standard of living even after retirement. Further, an ageing society is expected to place additional strain on the public health system. Given the budgetary constraints faced by the government, it would be necessary to develop a comprehensive health insurance system to ease the pressure on the public health system and ensure that everybody has access to affordable medical services. Weather-related insurance to protect the income of farmers from adverse climatic conditions is another area that needs to be encouraged.

4.4 Strengthen the Regulatory Environment

One of the important lessons we learnt from the recent global financial crisis was that financial instability has a disproportionate effect on the poor, as people with low levels of income and savings have less ability to mitigate risk. Hence, countries with low levels of income need to pay special attention to preserving financial stability even as they seek to deepen and broaden their domestic financial sectors, while increasing their integration with the global financial system. Sri Lanka has developed a strong regulatory framework to protect the rights of savers and borrowers in the formal financial system. The establishment of a deposit guarantee scheme; financial literacy programmes are further measures that have been taken to safeguard customers and maintain public confidence in the formal financial system. The informal microfinance sector has also played an important role in providing credit and encouraging savings among low-income persons, thus helping to improve income levels and reduce vulnerabilities caused by unexpected events. However, the large number of microfinance institutions (MFIs) with relatively small capital base has led to inefficiencies and high transaction costs due to the lack of economies of scale. Growth in this sector is not possible without capital while investors and lenders are more comfortable providing funds to regulated entities. One of the barriers to growth in the microfinance sector has been the absence of a single regulatory framework encompassing all microfinance institutions. Some microfinance institutions are regulated under separate legislation and by different institutions. For example, the Regional Development Bank by virtue of it being a classified as a licensed specialised bank is regulated by the Central Bank; the Samurdhi Bank Societies are regulated by the Samurdhi Authority; and the Cooperative Rural Banks are regulated by the Department of Cooperatives. However, a large number of microfinance institutions remain outside the regulatory framework. Since ensuring adequate protection to savers and borrowers is vital to ensure confidence in the financial system and to encourage more participation in the formal financial sector, it may be necessary to revisit the proposed legislation to bring the large number of microfinance institutions into some regulatory framework.

4.5 Develop a Database of Microfinance Borrowers

Financial institutions, both domestically and internationally, have many times been found guilty of over-extending credit to customers. The sub-prime crisis in the U.S. is a good example where policies to promote financial inclusion and reduce income inequalities may have contributed to one of the worst global financial crises (Raghuram Rajan, 2007). This risk is particularly acute in the case of microfinance institutions, due to the availability of a large number of microfinance lending institutions and products. In this regard, credit information bureaus can play an important role by maintaining a database of all outstanding loans to individual borrowers to prevent multiple lending and over borrowing. A database similar to what is maintained by the Credit Information Bureau (CRIB) could be established covering all loans provided by MFIs so that lending institutions are aware of the loans outstanding to individuals before they approve further loans. Issuing directions to MFIs that a single borrower at any given time may obtain a loan from a maximum of two MFIs may also be proposed to curb possible over borrowing by individuals.

4.6 Encourage Secured Transactions (Lending) based on Movables

Several theoretical models find that the availability of collateral is a binding constraint on financing, and it is found to be more severe in underdeveloped financial markets (Liberti and Mian, 2010). Empirical studies have also found that insufficient collateral is one of the main reasons firms are rejected when they apply for bank credit (Fleisig et al., 2006). One of the serious constraints faced by SMEs in Sri Lanka in accessing credit from the formal financial sector is the non-availability of acceptable colleateral such as land and building. Significant default and enforcement risk, double collateralisation of the same asset to multiple lenders and high transaction costs associated with these forms of assets have deterred banks from accepting moveable assets as collateral and significantly increased the cost of funds secured against these forms of assets. Given that movable assets are the main type of collateral available especially to SMEs, the need for establishing collateral registries has been recognised. A collateral registry for movable assets performs two major functions: firstly it informs parties about the existence of a security interest in movable property and secondly, it establishes the priority of creditors. In Sri Lanka, a Secured Transactions Act was enacted in 2009 which came into effect from 1 August 2011. Under this legislation, a lender who offers credit to a debtor on the collateral of a moveable property which belongs to the latter would need to register his ‘security interest’ in this register upon execution of the loan transaction. The creditor, however, does not take possession of the goods but is able to legally enforce his/her security interest over the asset and secures a legal right to dispose of the asset only in the event of loan default. The Credit Information Bureau of Sri Lanka (Bureau) has been entrusted with the responsibility of maintaining a Secured Transactions Register. Currently, registration is only voluntary. However, considering the experience of several countries that have implemented this measure, it may be necessary to insist on mandatory registration of movable assets to ensure that it is effective as a tool for improving the access, particularly of SMEs, to finance from the formal sector (Love, Inessa; María Soledad Martínez Pería and Sandeep Singh, 2013).

4.7 Improve Financial Literacy

Financial literacy is an important component of financial inclusion. All users of financial services, from the financially excluded poor, to the middle income groups and high net worth individuals, everyone who is associated with the financial system needs to be financially literate, albeit to different degrees and in different aspects. In the case of the financially excluded poor, it may be necessary to address the barriers for participation in the financial system. In the case of the middle class, it may be necessary to improve awareness about the financial market and the availability of alternative savings and investment products. While most would be operating a bank account, their participation in the capital market may be very low on account of their lack of knowledge. Financial literacy, in this case may need to focus on creating awareness about the capital market and the ability for the equity investments to provide relatively higher returns compared to other investments, over a longer time horizon, particularly in a low interest rate environment. Apart from the Central Bank and the government, civil society and all other stakeholders also need to get involved in the task of advancing financial literacy among all segments of society.

4.8 Maximise the Use of Technology

Advancements in information technology (IT) have played a role in the development and growth of the financial sector in Sri Lanka. Improvements to the payments and settlements system, such as introduction of automated RTGS systems and Cheque Imaging and Truncation systems have helped improve the efficiency and speed of the payment system. The receipt of remittances through various money transfer systems has also been enhanced following the advancement of IT systems in the whole island. The facilitation of payment cards, mobile phone-based payment systems as well as electronic money system is also expected to ensure a fast, safe and efficient payment system. The role of technology in advancing financial inclusion is well documented. IT can be used to develop comprehensive and reliable credit information systems which are vital for efficient credit delivery and credit pricing. IT can also be used to develop products that are tailored to particularly segments of the population and to reach, particularly, underserved areas. IT can also play a significant role in educating customers through the dissemination of information. Leveraging on the power of IT and optimising the use of the existing financial infrastructure would be necessary to increase the level of financial inclusion going forward. The introduction of a Common ATM Switch (CAS) in July 2013, which is the first phase of a project to introduce a Common Cards and Payments Switch (CCAPS), was an important first step in this regard. This will enable a more efficient and effective utilisation of the domestic ATM network, thereby reducing the cost of domestic transactions as well as the outflow of foreign exchange in the form of charges to international card associations for clearing and settlement of domestic ATM transactions. At present, there are seven commercial banks that have joined the CAS and all banks are expected to join the Switch within a reasonable time. The other phases of the implementation of the CCAPS include the setting up of a Common Electronic Fund Transfer Switch, Common Mobile Switch, Common Shared Switch and Common Point of Sales Switch. The main objective for establishing a CCAPS is to create a single platform for electronic retail payments in the country, thereby facilitating the sharing of payment infrastructure and reducing the cost of transactions.

4.9 Wholesale Funding by Banks to Financial Institutions Engaged in Lending to Small and Medium Enterprises

Commercial banks should be encouraged to make available wholesale funding to financial institutions engaged in microfinance activities so that they could on-lend those funds to segments of the market that are outside the reach of commercial banks. The responsibility for loan appraisal, operating and maintaining accounts will be carried out by the microfinance institution. This would provide financial institutions that are lending to SME with access to low cost funds. Since there is a risk that this could expose the banks to over financing in the sector, banks could be encouraged to lend by way of consortiums.

5. Conclusion and Policy Recommendations

Sri Lanka's progress in relation of financial inclusion has been impressive. Since the 1950s, the Central Bank and the government have undertaken various policy measures to enhance the level financial inclusion in the country. The growth of formal financial services has been impressive during the past few decades. Based on accepted measures of financial inclusion such as account penetration and access to credit, Sri Lanka has achieved a high level of financial inclusion for a country categorised as a lower middle income country. In relation to other measures such as the use of electronic forms of payment and the uptake of insurance products for health care and agriculture, there is still room for improvement. Policy interventions together with the improvements in income levels are expected to broaden and deepen the financial sector and result in further improvements in financial inclusion in the country.

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Chapter 9

ADVANCING INCLUSIVE FINANCIAL SYSTEM IN THE NEXT DECADE: ASSISTING THE SMES AND UNDERPRIVILEGED MINORITIES IN ACCESSING FINANCIAL RESOURCES IN CHINESE TAIPEI

By
Shu-Chen Lin* and Tzu-Hsien Chen*

1. Background

Under the government's appropriate development strategies, the economy of Chinese Taipei grew substantially with a moderate level of CPI growth rate and even distribution of income over the last decade. GDP per capita increased from US$11,982 in 2004 to US$20,952 in 2013, and the value of GDP enlarged from US$252.67 billion to US$489.26 billion. Meanwhile, the value of total international trade expanded from US$180 billion to US$575.34 billion, while CPI rose by around 1.28% annually during the same period, showing a moderate level compared with other countries.

In terms of income distribution, the Gini coefficients was 0.29 in 2012 and 0.288 in 2013, lower than the warning line at 0.4, indicating that income disparity was not a serious problem in Chinese Taipei (Chart 1). Still, the ratio of per capita disposable income share of highest 20% to that of lowest 20% as of 2013 was 4.08 in Chinese Taipei, lower than 14.68 in the US (2012), 5.13 in Japan (2009), 5.43 in South Korea (2013), and 12.1 in Singapore (2013).

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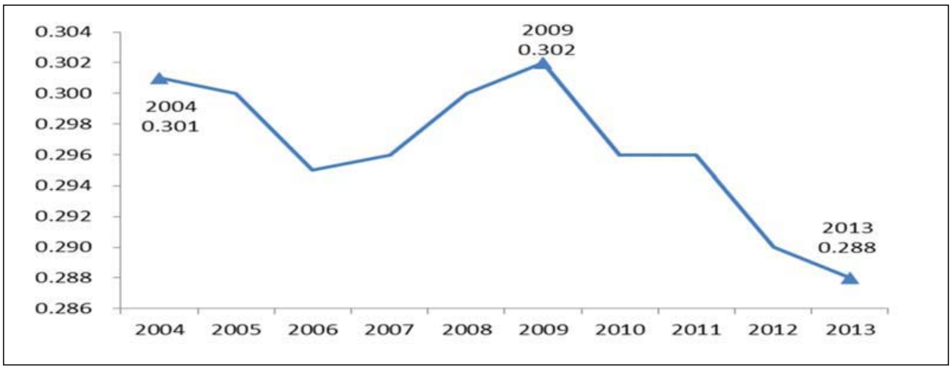
Chart 1
The Gini's Concentration Coefficient for Chinese Taipei



Source: Directorate-General of Budget, Accounting and Statistics (DGBAS), Executive Yuan.

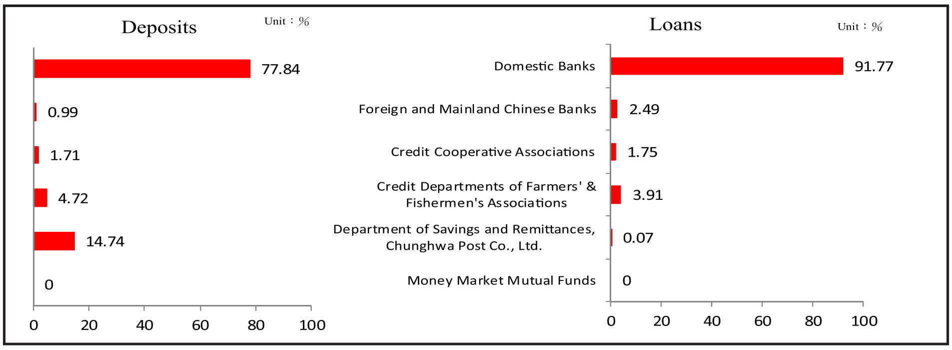
Given the above favourable factors, combined with the government policies on financial liberalisation, the scale of Chinese Taipei's financial market also expanded in the last 10 years, with total assets of financial institutions doubling, loans increasing by 41.5% and deposits growing by 57.1%. Moreover, total capitalisation of the stock market rose by 75%. In terms of the number of financial institutions, there were 399 financial institutions at the end of 2013, including domestic banks, foreign banks and community financial institutions such as the Credit Cooperative Associations and the Credit Department of Farmers' and Fishermen's Associations. Table 1 below indicates that while the number of branches increased slightly from 2000, the number of head offices actually reduced as a result of merger and consolidation. As to the market share, domestic banks remained the main financial service providers, with deposit ratio at 77.84% and loan ratio at 91.77% at the end of 2013 (Chart 2).

Table 1
Number of Chinese Taipei's Financial Institutions

	End of 2000		End of 2013	
	Head Office	Branch	Head Office	Branch
Domestic Banks	53	2,693	40	3,442
Foreign and Mainland Chinese Banks	39	70	31	39
Credit Cooperatives Associations	48	394	24	257
Credit Departments of Farmers' and Fishermen's Associations	314	1,022	303	867
Chunghwa Post Co., Ltd	1	1,305	1	1,322
Total	455	5,854	399	5,927

Source: Financial Statistics Monthly, CBC.

Chart 2
Market Shares of Deposits & Loans by Category of Financial Institutions at the End of 2013



Source: Financial Statistics Monthly, CBC.

The financial inclusion in Chinese Taipei is relatively well developed as a whole, but there are still slight gaps between men and women, and the low-income and high-income groups, indicating that Chinese Taipei still needs to promote financial inclusive system for underprivileged minorities. For instance, the ratios of men and the high-income obtaining loans from financial institutions in the past 12 months were both 10%, slightly higher than those of women and the low-income both at 9%, in 2011. Furthermore, given that most farmers and fishermen are economically disadvantaged, it is necessary to help them access financial resources.

On the other hand, although small and medium-sized enterprises[1] (SMEs) have been playing an important role for Chinese Taipei's economy and society, they often lack sufficient collaterals, transparent accounting system and financial knowledge, and thus have difficulties in getting loans from financial institutions. Therefore, there is a strong need for the government to formulate policies to

1. According to "Standards for Identifying Small and Medium-sized Enterprises" promulgated by the Ministry of Economic Affairs, SME is an enterprise in the manufacturing, construction, mining or quarrying industry with paid-in capital of NT$80 million or less, or with less than 200 regular employees. For other industries beyond the abovementioned fields, SME means an enterprise with sales revenue of NT$100 million or less in the previous year, or with less than 100 regular employees. Micro enterprise refers to an enterprise with no more than 5 regular employees.

foster the SMEs. The Additional Articles of the Constitution of the Republic of China declared that the State shall assist and protect the survival and development of private SMEs in 1997.

2. Financial Inclusive Policies for SMEs and Underprivileged Minorities in Chinese Taipei

2.1 Policies for SMEs

There were 1.33 million SMEs in Chinese Taipei as of the end of 2013, accounting for 97.64% of the total number of enterprises. In 2013, Chinese Taipei's SMEs provided 8.58 million jobs, or 78.3% of overall employment and the share of the sales made by SMEs was 29.44%[2]. However, Chinese Taipei's SMEs had financing difficulties due to insufficient accounting transparency and collaterals, which prevented them from getting loans from financial institutions. In this regard, the government formulated significant policies and measures as below:

- Establishing the Small and Medium Enterprise Credit Guarantee Fund of Taiwan (the Taiwan SMEG) to take charge of credit guarantee system.
- Providing policy loans[3] to reduce borrowing costs.
- Implementing a specific plan to encourage banks to extend SME loans.

2.1.1 Establishing the Taiwan SMEG to Take Charge of Credit Guarantee System and to Strengthen SMEs' Credit Conditions

The Taiwan SMEG, a non-profit legal entity, responsible for Chinese Taipei's SME credit guarantee system, was established in 1974 under the competent authority of the Small and Medium Enterprise Administration (SMEA), Ministry of Economic Affairs. As SMEs are generally disadvantaged to get loans from financial institutions, the primary function of the credit guarantee system is to share credit risks with financial institutions, thereby strengthening their willingness to extend loans to SMEs.

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2. The number of enterprises and employees and the amount of sales value referred to are from the "White Paper on Small and Medium Enterprises in Taiwan, 2013", and the figures applied are as of the end of 2013.
3. Policy loans are usually provided by industrial competent authorities with low interest rate or interest subsidies, aiming to cultivate important industries.

According to the Act for Development of Small and Medium Enterprises enacted in 1991, the government shall coordinate with financial institutions and credit guarantee institutions to enhance their respective functions of providing financing and guaranty to small and medium enterprises. The Taiwan SMEG's funding sources are mainly from the SMEA and financial institutions, accounting for about 80% and 20%, respectively.

The Taiwan SMEG provides two types of credit guarantee services, indirect guarantee and direct guarantee, which account for 99% and 1% of total credit guarantees, respectively. The indirect guarantee is a process in which SMEs make loan applications to financial institutions, and the financial institutions in turn request the Taiwan SMEG to provide guarantee thereon. The direct guarantee is a process where SMEs, with positive business potentials but higher risk concerns, require credit guarantee commitment from the Taiwan SMEG directly and then apply for loans from financial institutions. If SMEs fail to repay loans for a specific period, the Taiwan SMEG will cover the loss of financial institutions based on specific coverage ratios. To avoid borrowers from defaulting intentionally, the Taiwan SMEG demands financial institutions to exercise cautions in reviewing the financial and operation conditions of SMEs and establish some requirements about guaranteed loans such as the flow of funds and the history of borrowers' repayment.

The guarantee fees should be paid by SMEs based on each SME's credit risk. Currently the average guarantee fee was 0.55% of outstanding loans covered by the Taiwan SMEG. The coverage ratio of guarantee also depends on the credit risk of each SME and is determined by the Taiwan SMEG. The average coverage ratio was nearly 80% in recent years.

2.1.2 Providing Policy Loans to Reduce SMEs' Borrowing Costs

Chinese Taipei's government provides various types of policy loans to SMEs, either through interest subsidies or setting lower interest rates to assist the development of specific industries and reduce SMEs' borrowing costs, such as "Key Service Industry Loan Guarantee," "Loans for the Sports Service Industry," "Loans for Innovative SMEs" and "Loans for Tourism Development." Besides policy loans, the SMEA and part of municipal governments also cooperated with the Taiwan SMEG to provide a number of business start-up loans for SMEs and set up co-investing funds to help entrepreneurs start up their own businesses.

2.1.3 Banking Authority Launched the "Plan for Increasing Loans to SMEs by Domestic Banks" to Encourage Banks Extending Loans to SMEs

The Financial Supervisory Commission (FSC)[4] launched the "Plan for Increasing Loans to SMEs by Domestic Banks" (hereinafter "the Plan") in July 2005 to encourage domestic banks to help SMEs in need of working capital. Through the Plan, the FSC sets target increment amount based on outstanding loans each year and offers incentives for banks, including shortening the FSC's approval process for banks' applications for new businesses. To date, the targets have been achieved in almost all stages except for the 4th stage because of the global financial crisis in 2008 (Table 2).

Table 2
The Plan for Increasing Loans to SMEs by Domestic Banks

	The 1st Stage (2005/7-2006/6)	The 2nd Stage (2006/7-2007/6)	The 3rd Stage (2007/7-2008/6)	The 4th Stage (2008/7-2009/12)
Target Increment Amount	200	200	200	300
Achieved Increment Amount	322	206	278	**35.2**
Rate of Achievement	161%	103%	139%	**12%**
	The 5th Stage (2010)	The 6th Stage (2011)	The 7th Stage (2012)	The 8th Stage (2013)
Target Increment Amount	150	200	220	240
Achieved Increment Amount	355	399	380	313
Rate of Achievement	237%	200%	173%	131%

2.2 Policies for Underprivileged Minorities

Lifting underprivileged minorities out of poverty has become the global key issue recently. It has been widely accepted that helping minorities build up their own businesses is conducive to improving income distribution and stabilising the society.

Considering that most farmers and fishermen are economically disadvantaged, Chinese Taipei's government conducted policies to help them obtain financial resources, including establishing the Credit Departments of Farmers' and Fishermen's Associations (CDFFAs) to expand financial channels, setting up an agricultural credit guarantee system and providing policy-oriented special

4. Chinese Taipei's banking authority.

agricultural loans. On the other hand, the government also introduced several programmes to assist other underprivileged minorities, such as the youth, women, the low-income and the elderly, in getting financial services. The programmes involved providing loans, offering micro-insurance and launching the experimental scheme of “Civilian Bank” in the essence of the Grameen Bank.

2.2.1 Policies for Farmers and Fishermen in Rural Areas

The first credit department of Farmers’ and Fishermen’s Associations was established in 1944 to offer financial services to farmers and fishermen. Its main objectives are to help them build-up their savings habit, provide loans and facilitate the development of the local economy in rural areas and fishing villages. As of the end of 2013, there were 303 head offices and 867 branches of the CDFFAs. Thus, the CDFFAs are the primary channels through which farmers and fishermen access financial services.

In order to help farmers and fishermen receive loans from financial institutions, the government founded the Agricultural Credit Guarantee Fund (ACGF) in 1983 to assist those who lack collaterals to obtain working capital. The sources of funding are from the government, financial institutions and members of the CDFFAs, which contribute 65%, 30% and 5% of total funds, respectively. To help enhance the credit conditions of farmers and fishermen who pay the guarantee fees, the Fund shares credit risk with financial institutions especially the CDFFAs when financial institutions extend loans to farmers and fishermen. The average guarantee fee was 0.35% of outstanding loans covered by the ACGF and the coverage ratio was nearly 80% as of the end of 2013.

The ratio of loans secured by the credit guarantee through the CDFFAs was 88.25% at the end of 2013, indicating that the CDFFAs are the most important institutions through which farmers and fishermen access financing.

Besides the abovementioned policies, the Council of Agriculture has embarked on offering agricultural loans to farmers and fishermen since 1973, such as “The Business Start-Up Loans for the Youth Engaged in Agriculture” and the “Loan for Fishery Industry in Guidance and Assistance of Management” in order to help them obtain funds to sustain their businesses as well as reducing their financial burden.

2.2.2 Financial Inclusive Policies for Other Underprivileged Minorities

Aimed at helping underprivileged minorities access financing and enhancing employment, the government offers business start-up loans to qualified individuals such as the youth, women, the elderly, the low-income and the unemployed. In addition, to increase the willingness of financial institutions to extend loans, the policy loan programmes are implemented with the credit guarantee system. The loans are typically small amounts with lower interest rates and higher coverage ratio of credit guarantee (Table 3).

Table 3
Business Start-Up Loans for Qualified Individuals in Chinese Taipei

Target	Loan Programme	Effective Date	Maximum Amount (NT$ 10 thousands)
The Youth	1.Young Entrepreneurs Financing Loan 2.Taipei City's Young Entrepreneurs Financing Loan	Jan. 2014 Jun. 2011	1,200 300
Women and the Elderly	Phoenix Micro-startup Loan	Mar. 2007	100
The Economically Disadvantaged	1.New Taipei City's Entrepreneurs Financin Loan 2.Yunlin County's Entrepreneurs in Financia Hardship Loan	Feb. 2009 Sep. 2013	100 50
The Unemployed	Business Start-Up Loan for the Unemployed	Dec. 2009	100

Source: SMEA and Taiwan SMEG.
Note: The Ministry of Labor launched the "Phoenix Women Entrepreneurs Micro-Loan" in March 2007, and the loan was integrated with the "Micro Enterprises Start-Up Loan" as the "Phoenix Micro-Startup Loan" in February 2009.

On the other hand, the FSC and the Life Insurance Association have encouraged insurance companies to provide micro-insurance with lower rates and insurance coverage for small amounts for low-income families and the underprivileged minorities since July 2009. Moreover, the Ministry of the Interior started an experimental scheme of civilian banks in July 2012 based on the Grameen Bank spirit, aimed to help the disadvantaged minorities cultivate their savings habit, enhance their credit conditions, provide them with easier access to funds to start businesses and ultimately lift them from poverty. Relevant future development are discussed in Section 5.

3. Current Financial Inclusion Status for SMEs and Underprivileged Minorities in Chinese Taipei

3.1 Financial Inclusion Status as a Whole in Chinese Taipei

Financial inclusion indicators contain the penetration rates of accounts at financial institutions, credit cards, debit cards, deposit and electronic payments. By comparing the financial inclusion indicators of Chinese Taipei with those of the global average, it is found that Chinese Taipei has a higher level of financial inclusion than the global average. The indicators showed that Chinese Taipei's residents were by and large able to access financial resources easily in 2011. The number of bank branches per 100,000 adults was 22, higher than the global average of 12. Meanwhile, the number of ATMs per 100,000 adults was 165, also a lot higher than the global figure of 34 (Table 4).

Table 4
Financial Inclusion Indicators in Chinese Taipei in 2011

Items	Chinese Taipei	World
Account at a Formal Financial Institution (%, age 15+)	87%	50%
Loan from a Financial Institution in the Past Year (%, age 15+)	10%	9%
Credit Card (% , age 15+)	46%	15%
Debit Card (% , age 15+)	37%	30%
Electronic Payments (% , age 15+)	29%	14%
Deposit at a Financial Institution in the Past Year (%, age 15+)	46%	22%
Bank Branches per 100,000 Adults	22	12
Branches of Financial Institutions per 100,000 Adults	39	-
ATMs per 100,000 Adults	165	34

Source: Global Financial Inclusion Database (2011) and World Development Indicators (2012) of the World Bank.

Note:

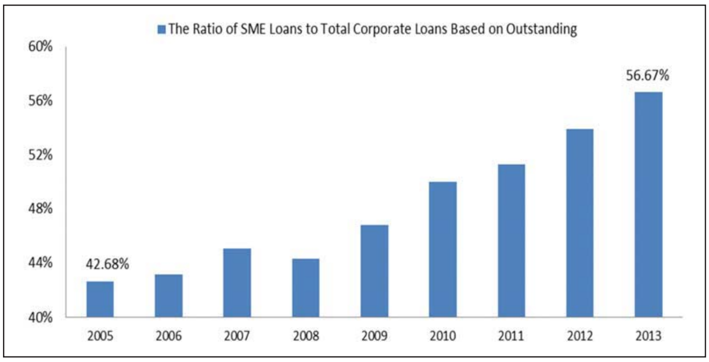
1. "Loan from a financial institution in the past year" refers to those who were reported to borrow money from a financial institution in the past 12 months.
2. The last three indicators are the data of 2012 and the remaining indicators are calculated by the figures of 2011.

3.2 Financial Inclusion Status for SMEs

3.2.1 SME Loans Extended by Domestic Banks

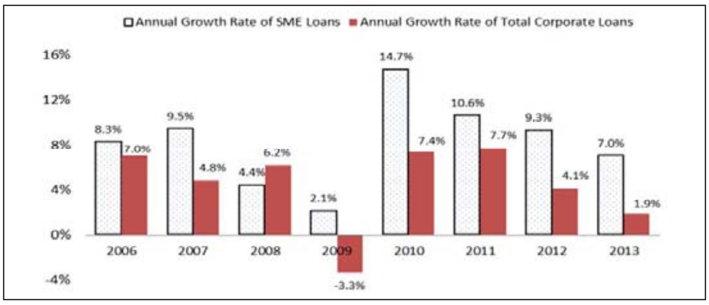
The primary financing channel for SMEs is domestic banks. In recent years, the SME outstanding loans by banks grew at a stable pace due to the Plan implemented by the FSC aimed at encouraging banks to grant more SME loans. The ratio of SME loans to total corporate loans has increased yearly, from 42.68% in 2005 to 56.67% at the end of 2013, showing that there was a significant improvement for SMEs to acquire loans from a formal financial institution (Chart 3). In addition, the annual growth rate of SME loans has been higher than that of total corporate loans in recent years. Taking the growth rate of 2013 for instance, the annual growth rate of SME loans was 7%, higher than that of total corporate loans, 1.9% (Chart 4).

Chart 3
Status of SME Loans Extended by Domestic Banks



Source: FSC.

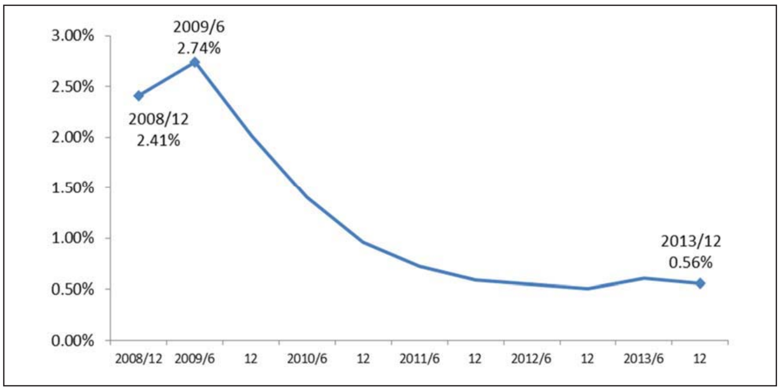
Chart 4
Annual Growth Rate of SME Loans and Total Corporate Loans



Source: FSC.

Despite the high growth rate of SME loans, the credit quality remained at an appropriate level. Chart 5 shows that the NPL ratio of SME loans reached the highest level of 2.74% as of June 2009 due to the financial crisis and has decreased gradually since then. The ratio remained in the range of 0.5% to 0.6% for the year of 2013.

Chart 5
NPL Ratio of SME Loans



Source: FSC.

3.2.2 Financial Inclusion Indicators for SMEs in Chinese Taipei

On average, the number of SMEs covered by each branch of banks and financial institutions entitled to extend SME loans (community financial institutions were included) were 368 and 261 at the end of 2013, respectively. In addition, each branch of financial institutions provided financial services such as deposit, remittance and loan origination for about 206 SMEs (Table 5).

Table 5
Financial Inclusion Indicators Regarding SMEs at the End of 2013

Items	Numbers
Number of SMEs per Bank Branch	368
Number of SMEs per FI Branch Entitled to Extend SME Loans	261
Number of SMEs per FI Branch Entitled to Provide Financial Services	206

Sources: CBC, FSC.

3.3 Financial Inclusion Indicators for Underprivileged Minorities

3.3.1 Financial Inclusion Status for Farmers and Fishermen

Even though the market share of the CDFFAs was less dominant, with a deposit share of 4.72% and a loan share of 3.91% at the end of 2013, the CDFFAs nonetheless played an important role in helping farmers and fishermen access financial resources due to their locations in rural and remote areas. Out of 365 towns, there were 163 towns, accounting for 45% of total towns, with no banking branch to provide financial services, indicating that there were still 2.71 million people unbanked. Yet, these people can access financial services from the CDFFAs. On average, there were at least 3 branches of the CDFFAs in each town. Hence, the CDFFAs can be regarded as community banks to balance the development between rural and urban areas.

3.3.2 Financial Inclusion Indicators for Other Underprivileged Minorities

According to the World Bank data, women were more disadvantaged in terms of accessing financial resources than men globally. Women face disproportionately financial access barriers that prevent them from participating in the economy. In this regard, many countries have been working on promoting financial inclusion for women to help achieve gender equity. In principle, there is no serious gender disparity when it comes to gaining financial resources in Chinese Taipei. For example, the gender gap (calculated by deducting the female ratio from the male ratio) for bank account, credit card and debit card (also called ATM cards) penetration were -2%, -6% and -6%, respectively, better than the global average gaps of 8%, 3% and 5% in 2011. On the other hand, even though it was slightly harder for women to obtain loans than men, the gap was narrower than the global average (Table 6).

Table 6
Financial Inclusion Indicators by Gender and Income in Chinese Taipei in 2011

Female (1)	Male (2)	Gap (2)-(1)	Global Averag Gap	Low-Income (3)	High-Income (4)	Gap (4)-(3)	Global Average Gap
Account at a Formal Financial Institution (%, age 15+)							
88%	86%	-2%	8%	82%	91%	9%	17%
Credit Card (% , age 15+)							
49%	43%	-6%	3%	35%	54%	19%	8%
Debit Card (% , age 15+)							
40%	34%	-6%	5%	26%	44%	18%	17%
Loan from a Financial Institution in the Previous Year (%, age 15+)							
9%	10%	1%	2%	9%	10%	1%	3%

Source: World Bank, Global Financial Inclusion Database (2011).
Note: Low-Income refers to those with income at the bottom 40%; High-Income refers to those with income at the top 60%.

Nevertheless, the gaps for account penetration and loan origination between the low-income at the bottom 40% and the high-income at the top 60% exist in Chinese Taipei, which were 9% and 1% in 2011, albeit narrower than the global average of 17% and 3%, respectively. However, the gap for credit card penetration was 19%, wider than the global average of 8%. The reason was that Chinese Taipei's banks suffered huge losses due to loose approval standards in 2006 and have subsequently turned more conservative in issuing credit cards to the low-income groups. The gap for debit card penetration was slightly wider than the global average, but specifically, the debit card penetration of the low-income group was 26%, higher than the global average of 21%, while that of the high-income was 44%, also better than the global average of 38%.

In summary, considering there are still gaps between the low income and the high income individuals, there is room for Chinese Taipei to improve its financial inclusive system.

4. Data Presentation and Analysis

The main goal of this section is to provide an assessment of the performance of the public sector in assisting the SMEs and underprivileged minorities to secure credit from the financial sector. To simplify the analysis, we define financial resources here as indirect finance or loans extended by financial institutions. Therefore, investments of financial institutions in securities (e.g., commercial papers, mutual funds or equities) issued by the SMEs will not be considered nor discussed in this research.

In view of the difficulties for the SMEs and underprivileged minorities to obtain financial resources because of their lack of comprehensive financial statements and sufficient collaterals, the government set up guarantee funds to provide support. As mentioned in the previous sections, such a credit guarantee mechanism is established mainly via the Taiwan SMEG and the ACGF.

The Taiwan SMEG carries out credit guarantee programmes mainly to foster the development of SMEs. In addition to its regular programmes, it also provides credit guarantees for loans extended to young entrepreneurs, micro entrepreneurs and start-ups. Special guarantee programmes to promote employment are also implemented, in line with the government policies. These programmes are all designed to provide disadvantaged groups and local small/micro firms with working capital and start-up funds. In contrast, the ACGF is designed to effectively support groups engaged in the sectors of agriculture, forestry, fishery and animal husbandry, generally regarded as underprivileged minorities in a developed industrial economy.

As mentioned, both guarantee funds play a support role, in cooperation with contracted financial institutions to provide credit guarantee for loans directly or indirectly. In the following analysis, we delve on the performance of the above two funds.

4.1 Data Set and Data Source

The data coverage includes two types of information. One is loans extended to all sectors by monetary financial institutions (i.e., banks and credit departments of farmers' and fishermen's associations). The other is loans supported or covered by credit guarantees. To give a clearer picture of their roles in the development of the economy, a comparison, such as one with GDP or the population employed by the SMEs and by farmers and fishermen, can be added as and when necessary.

All data are annual and updated. With regard to starting points of the time series, the loan data of the Taiwan SMEG and the ACGF began in 1974 and

1984, respectively, the same years in which they were established. However, limited by data availability for direct and indirect loans, and loans extended to the SMEs,[5] a comparison using such data would have to start from 1986 at the earliest. Furthermore, data on loans extended by credit departments of farmers' and fishermen's associations can only be retrieved at the website of the CBC from 1987, and the data on their annual growth rates begins at 1988.

As for data source, most of the data are retrieved from the relevant authorities. For example, for loans covered by credit guarantees, data is obtained from the Taiwan SMEG or the ACGF. However, some data, such as loans extended to all sectors, may have more than one source, each with its own definition. As to which one is adopted for this paper, it depends on the availability of other comparison data sets. For example, considering that the Banking Bureau, FSC is the sole authority in charge of compiling statistics of loans extended to the SMEs, it will be less complex to use loans extended to all borrowers from the same data source, instead of using data from the Bank. In contrast, because the Bank provides a wider time range of data on loans extended by credit departments of farmers' and fishermen's associations, it is felt that it would be a better choice to use the same source when making a comparison using loans extended by all the monetary financial institutions.

4.2 Small and Medium Enterprise Credit Guarantee Fund

According to data from the FSC, the annual changes of loans extended by banks to all borrowers and to the SMEs show nearly identical patterns (Chart 6). Their close relationship can also be proven by the strong correlation coefficient between the two time series, which was as high as 0.9 during the period of 1987 to 2013. Such a result may imply that banks have extended loans to the SMEs without discrimination.

However, as shown in Chart 6, the share of loans extended to the SMEs exhibited a downward trend, decreasing from 37.4% at the end of 1986 to 23.0% at the end of 2013. The decreases were mainly caused by a change in the funding strategies of the SMEs as they gradually increased funding via direct finance (Chart 7). It is very clear from the two charts that the share of loans extended to the SMEs moves almost in a corresponding trend with that of the weight of indirect finance. Despite that, indirect finance (borrowing from financial

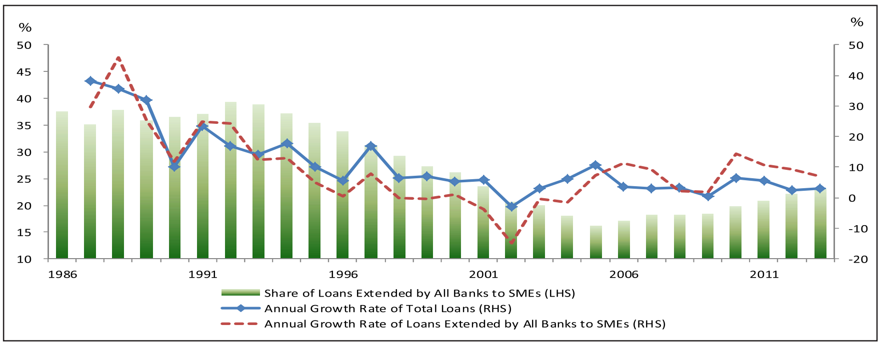
5. The source for data since 2004 is the Financial Supervisory Commission, instead of the Ministry of Finance, after the transfer of related responsibilities.

institutions) remains the key financing channel for the SMEs, which accounted for 48.7% of the total liabilities of the SMEs at the end of 2012.[6]

As of the end of 2013, the total outstanding loans extended by banks to the SMEs were NT$4,776.7 billion,[7] or US$159.5 billion,[8] while loans supported by the Taiwan SMEG accounted for 17.8%.

The main objective of the Taiwan SMEG is to provide credit guarantees to those eligible, but short of collateral, SMEs for external financing. However, the Taiwan SMEG also has a duty to take care of other disadvantaged groups, though that only occupies a very small portion of its whole guarantee business. From its inauguration in 1974 to the end of 2013, the Taiwan SMEG has offered credit guarantees for 5.3 million cases, amounting to NT$8.2 trillion in total. The guaranteed clients have obtained NT$11.3 trillion in various forms of credit from

Chart 6
Annual Growth Rate and Share of Loans Extended to SMEs



Source: Banking Bureau, Financial Supervisory Commission.

banks, which accounted for 4.2% of GDP for the same period.[9] More than 338,077 SMEs have benefited from the services of the Taiwan SMEG, exceeding a quarter of the total number of SMEs at the end of 2013.[10]

6. Based on the "Survey of the Financial Conditions of Private and Public Enterprises, the Republic of China (Taiwan)," 2013.

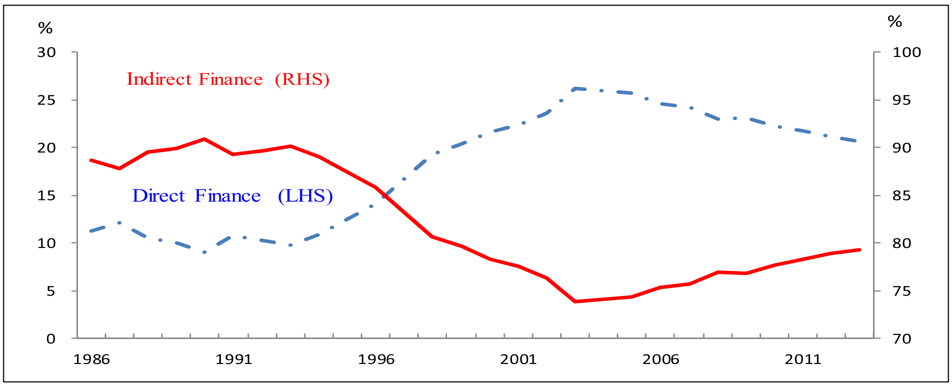
7. Based on the "White Paper on Small and Medium Enterprises in Taiwan, 2014."

8. Based on an exchange rate of NT$29.95 per dollar as of the end of 2013.

9. In 2013, the nominal GDP was NT$14,561 billion or US$489 billion; from 1974 to 2013, the nominal GDP has accumulated to be NT$271.9 trillion or US$8.7 trillion.

10. The total number of SMEs at the end of 2013 was 1,331,182, according to data provided by the Fiscal Information Agency, Ministry of Finance.

Chart 7
Weights of Direct Finance and Indirect Finance

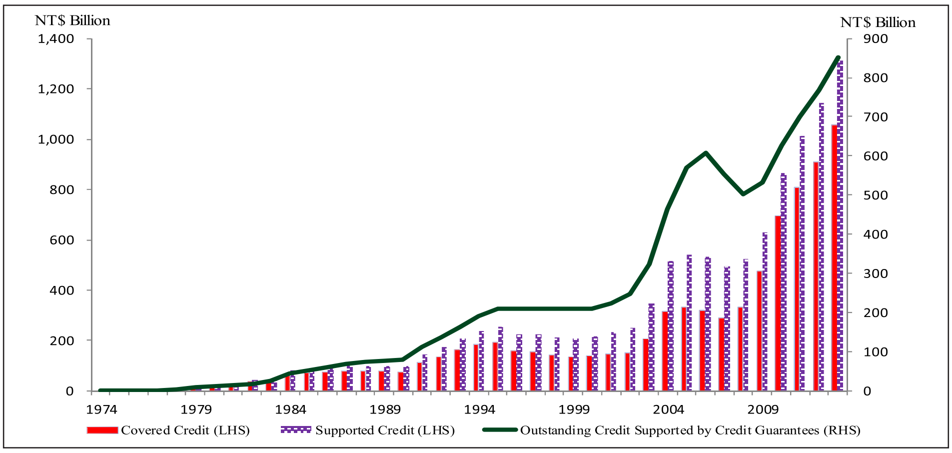


Source: Department of Economic Research, CBC.

The outstanding credit covered by guarantees posted NT$681.4 billion as of the end of 2013, whereas the total outstanding credit taken out under the guarantee mechanism (i.e., loans granted with the support of the SMEG guarantees) was 851.2 billion (Chart 8), with a coverage ratio of 80% on average. Among the credit guarantees, more than 99% were appropriated for the SMEs. Furthermore, the outstanding credit supported by credit guarantees for the SMEs accounted for 17.4% of the outstanding credit for SMEs offered by all banks.

As seen in Chart 8, the outstanding credit supported by credit guarantees exhibits a stable upward trend, with exceptions for the years of 2007 and 2008. The decrease in 2007 was mainly due to a reduction of NT$22.7 billion in the Package Credit Guarantees Facility resulting from the takeover of several contracted financial institutions. As for 2008, the credit extended under the Package Credit Guarantee Facility further shrank by NT$29.3 billion. The main cause was that the business environment for enterprises has been deeply impacted by the global financial crisis induced by the subprime mortgage crisis in the U.S., even though a series of special guarantee programmes have been launched to help the SMEs to cope with the hard times. Generally speaking, the increasing size of outstanding credit could indicate that the Taiwan SMEG has been playing a significant and vital role.

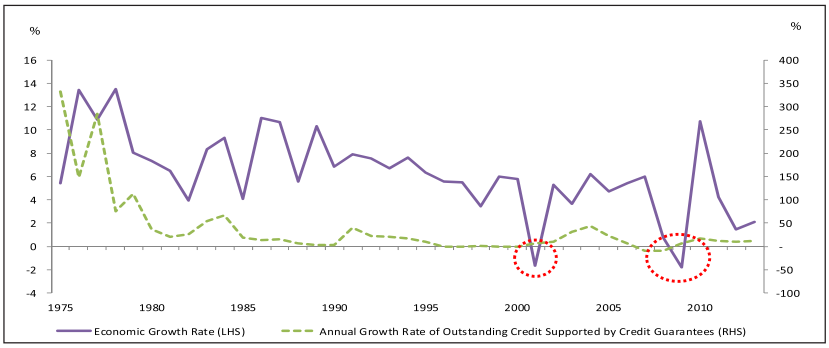
Chart 8
Credit Guarantees Offered to the SMEs



Source: Annual Reports, Small and Medium Enterprise Credit Guarantee Fund of Taiwan.

In contrast, as shown in Chart 9, the economic growth rate seems to closely track, with a slight lag, the annual growth rate of credit supported by credit guarantees in the first ten years (1975 to 1985). This may imply that the change in credit extended under guarantees has been one of the key drivers in economic growth during that period. Afterwards, the economic growth rate has exhibited more volatile movements, and posted two dramatic drops and turned negative, as shown by the circles in Chart 9. However, as credit extended by guarantees rose as a result of expanded support measures for the SMEs, the economic growth rate also rebounded significantly.

Chart 9
Annual Growth Rate of Supported Credit vs Economic Growth Rate



Source: Directorate General of Budget, Accounting and Statistics of the Executive Yuan; Small and Medium Enterprise Credit Guarantee Fund of Taiwan.

In summary, the Taiwan SMEG has achieved tremendous success in helping SMEs to obtain financing from financial institutions smoothly.

Furthermore, out of the total beneficiary SMEs of the Taiwan SMEG, 0.8% of them grew successfully to become large firms at the end of 2013. Among them, 281 firms were listed on the stock exchange, accounting for 32% of total listed companies; 382 firms were listed on the Gre Tai Securities Market (i.e., an over-the-counter (OTC) market), accounting for 58% of total OTC listings. In addition, 71% of the national awards, bestowed to successful SMEs, have gone to those SMEs guaranteed by the Taiwan SMEG (Table 7). For example, in the year of 2013, all 9 winners of the National Award of SMEs went to the Taiwan SMEG's guaranteed clients, truly an impressive achievement.

Table 7
Numbers of Winners of Various Awards

Item	Number of Total Awarded SMEs	Number of Total Awarded SMEs, Guaranteed by the Taiwan SMEG
National Award of SMEs	9	9
National Quality Award	2	1
Model Taiwan and Overseas Enterprises	10	8
Rising Star Award	6	4
Small and Medium Enterprise Innovation Research Award	29	21
Business Startup Award	12	5
Total	68	48

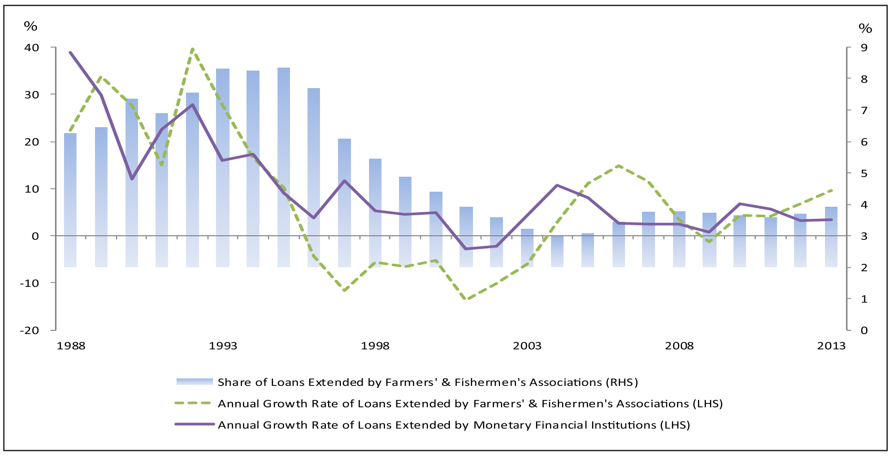
The SMEs guaranteed by the Taiwan SMEG accounts for 71% of total winners.
Source: 2013 annual report, the Taiwan SMEG,.

4.3 Agricultural Credit Guarantee Fund

Loans extended by the CDFFAs are the most important financing source for those engaged in the sectors of agriculture, forestry, fishery and animal husbandry. Other sources, such as banks, account for a minimal ratio of less than 1%. Therefore, it will not influence the analysis result if those parts of loans are ignored.

Chart 10 shows that the trends of the annual growth rates for total loans and for loans extended by the CDFFAs are almost parallel during the comparison period. However, the latter has shown more volatile movements than the former, especially when the share of loans extended to farmers and fishermen was trending downwards. The higher volatility for loans extended to farmers and fishermen is mainly due to the effect of a smaller amount, or a lower base, of such loans, whereas decreases in share are mainly because of the shrinkage of the population and productivity pertaining to those occupational groups. However, the correlation coefficient is still high at 0.7, which may imply that, for most of the time, farmers and fishermen have been able to obtain financing without obstacles.

Chart 10
Share and Annual Growth Rate of Loans Extended by Farmers' & Fishermen's Associations

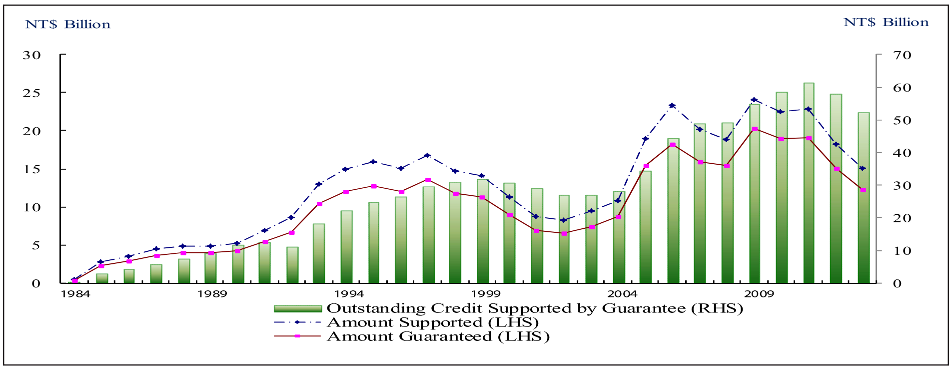


Source: Department of Economic Research, CBC.

The primary function of the ACGF is to provide assistance for farmers and fishermen, especially on their financing needs. In 1984, the ACGF has provided credit guarantees for 1,095 cases, amounting to NT$0.4 billion guaranteed and NT$0.5 billion supported. In the year of 2013, the guarantees have increased to 32,399 cases, amounting to NT$12.3 billion guaranteed and NT$15.0 billion supported. Meanwhile, farmers and fishermen have obtained NT$329.3 billion in loans from monetary financial institutions during 1984 to 2013, accounting for 0.1% of GDP for the same period. The credit guarantees have accumulated to be 493,086 cases with an amount of NT$306.7 billion. The ratio of credit guarantees is 93.1% on average.

The ACGF's guarantee business has been seriously impacted by the unsustainably high overdue ratios of this industry during 1998 to 2002, resulting from over-lending or unscrupulous lending in loans extended by the credit departments of farmers' associations (Charts 11 and 12). Both the amount of credit covered or supported and the outstanding of credit guaranteed exhibited successive downward trends. Nevertheless, the situation has improved when the government adopted some measures to address the issue.[11] Since 2005, the new authority, the Council of Agriculture, began to put a stronger focus on various special loan schemes to provide financial aid, including interest subsidies, to farmers and fishermen. The amount of credit guarantees could change dramatically, mostly depending on the sizes of schemes in progress. For example, a Typhoon Morakot special loan scheme was implemented in 2009, which resulted in a significant increase of NT$6.6 billion or 45% p.a. in special loans compared with the previous year. Later, when this special loan scheme was concluded, the total amount of credit guaranteed reduced sharply, as seen in right portion of Chart 11.

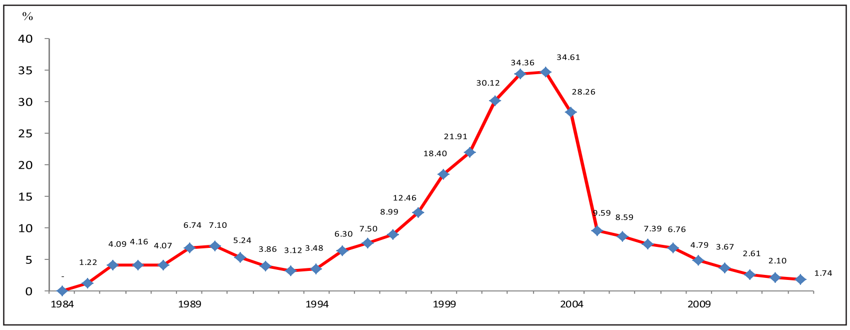
Chart 11
Credit Guarantees Offered by the ACGF



Source: Agricultural Credit Guarantee Fund.

11. The measures include creating a new agency, the Bureau of Agricultural Finance, in the Council of Agriculture, consolidation of credit departments of farmers' and fishermen's associations with banks, and establishing the Agricultural Bank of Taiwan.

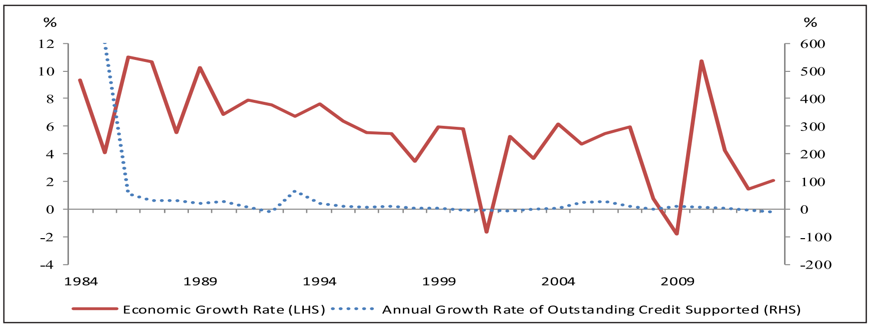
Chart 12
Overdue Ratios



Source: Agricultural Credit Guarantee Fund.

The relationship between economic growth and such credit guarantees is actually not very clear, mainly due to the insignificance of agriculture, forestry, fishery and animal husbandry relative to GDP (Chart 13). Productions by this industry accounted for only 6.3% of GDP in 1984, declining to as low as 1.8% in 2013. In terms of workforce,[12] it only accounts for 5.0% of total. As for the number of enterprises, it accounted for 0.9% of all enterprises while the amount of sales only has a small share of 0.10%. Nonetheless, this industry is still considered vital for the economy. According to the ACGF, its beneficiaries of its schemes number 0.5 million persons up to the end of 2013. Considering the total population engaged in this industry which was 0.544 million persons in 2013, the ACGF has made some major inroads.

Chart 13
Annual Growth Rate of Supported Credit by the ACGF vs Economic Growth Rate



Source: Direction workforce is 10.96 million in 2013, whereas the total population in Chinese Taipei is 23.37 million in 2013.-

12. The total workforce is 10.96 million in 2013, whereas the total population in Chinese Taipei is 23.37 million in 2013.

5. Plans for the Next Decade

During 2008 and 2009, Chinese Taipei's economy has been influenced considerably by the global downturn, which caused external demand to slump and domestic demand to contract. The annual GDP growth decelerated to 0.7% in 2008 and -1.8% in 2009, accompanied by a marked rise in unemployment,[13] thus seriously impacting the labour-intensive workforce, especially those in the disadvantaged group. The ratio of per household disposable income share of the highest 20% to that of the lowest 20% increased from 5.98 in 2007 to 6.34 in 2009. In view of the widened rich-poor disparity, the Executive Yuan set up the Task Force on Improving Income Distribution in August 2010, with a mission to achieve inclusive growth. As regards the financial inclusion part, a series of programmes have also been launched or enhanced, including continuing to foster the SMEs by meeting their financial needs via the credit guarantee mechanism of the Taiwan SMEG.

With those efforts, the ratio of per household disposable income share between the top and the lowest 20% began to exhibit a downward trend, decreasing from 6.19 in 2010 to 6.08 in 2013. In view of this indicator of rich-poor disparity and the satisfactory improvement it has demonstrated, the government judged that those measures have been effective and decided to maintain such policies in the next decade. The following sections will introduce three programmes, which are aimed at assisting the disadvantaged to obtain financial resources and executed by the government's task force to achieve financial inclusion. When the underprivileged minorities can access the needed financial resources more easily, their living standards or quality may be improved, and the poor-rich gap can be narrowed, thus fulfilling the objective of financial inclusion.

5.1 Micro-insurance

The Insurance Bureau, Financial Supervisory Commission, have introduced micro- insurance business in 2009 in line with the above-mentioned schemes.[14]

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13. It increased from 3.8% in Jan. 2008 to its highest level of 6.1% in Aug. 2009.
14. According to global reinsurer Swiss Re's Sigma study released in 2014, Chinese Taipei had the world's highest insurance penetration rate of 17.6% in terms of premiums in percentage of GDP in 2013, whereas its insurance density or insured amount per capita has reached US$3,886, the 12th highest worldwide and the third highest in Asia. Its total premium income was the 11th largest, accounting for 1.96% of the global market.

These types of insurance products are designed to enhance basic insurance coverage for the economically disadvantaged and facilitate the establishment of a sound social safety net. The target population typically comprise of persons ignored by mainstream commercial and social insurance schemes. Low income groups, such as the aborigines, fishermen, the physically challenged, families suffering unexpected hardships, and groups served by the social welfare organisations, are all included. It is expected that such products will provide the needed protection proportionate to possibilities and costs of the risks involved.

Micro-insurance is a kind of financial arrangement featuring low premiums and low coverage, without any subsidies from the government. The authority has been working with insurers to get them to launch micro-life insurance products. Currently, there are only the traditional one-year life insurance contracts and personal injury insurance contracts available. According to the Insurance Bureau, the premium of such products has been estimated to be 45% to 60% lower than those for ordinary ones while the coverage has been capped at NT$0.3 million for each. Therefore, for a whole package of these micro-insurance products, it would cost about NT$840 a year for a 40-year-old male. The authority expects that over 3 million people would be qualified to benefit from this scheme.

In order to encourage the insurance industry to fulfill its social responsibilities and enable the products to better serve the needs of the economically disadvantaged, the Insurance Bureau has introduced various measures (each year). For example, the Insurance Bureau holds campaigns to award the best insurers for promoting micro-insurance business annually. For those distinguished winners awarded in consecutive two years, the authority would allow them to file one additional application for insurance products requiring approval.

The first approved micro-insurance product was for personal injury. In the first year, the authority approved 2 micro-insurance products. As seen in Table 8, the Insurance Bureau has thus far approved the launch of 17 micro-insurance products. From November 2009 to the end of 2013, the insurers have sold micro-insurance contracts to a cumulative total of 53,696 policyholders. The total coverage under these policies adds up to NT$15.8 billion. Compared to the previous estimation of 3 million potential applicants, this is quite a long way before the products reach the targeted results. The regulation related to the micro-insurance business has been revised on 26 June 2014. Micro health care such as injury insurance contracts, with a coverage cap of NT$30,000, has been newly approved for sale. Newly added target groups include farmers and persons with special conditions. In addition, for the existing insurance products, the coverage ceiling has been raised from NT$0.3 million to NT$0.5 million. The revisions are expected to enhance the protection of the disadvantaged and make financial services more accessible to persons with disabilities.

Table 8
The Status of Micro-insurance Products

Year	Number of Products	Cumulative Numbers of Policyholders	Accumulated Amounts of Insurance Since November 2009 (NT$ Billion)
3920	2	334	0.10
3921	16	26,000	6.20
3922	16	35,921	10.40
3923	17	46,421	13.60
3924	17	53,696	15.83

Source: Insurance Bureau, Financial Supervisory Commission

Furthermore, to cope with an aging society, and in coordination with the implementation of government policy on long-term care insurance, the Insurance Bureau will adopt measures to encourage insurance companies to develop mortality insurance, annuity insurance, and long-term care insurance products to supplement social insurance provided by the government. It is expected that this policy could further enhance the basic insurance coverage and assist citizens in planning for retirement. Moreover, the authority has asked the ROC Bankers Association and the two national insurance associations to continue communicating with advocacy groups for the disabled in order to better understand their needs and provide them with more suitable financial services. It also encourages trust firms to fulfill their social responsibilities by providing special needs trust to protect the assets of people with disabilities.

5.2 Phoenix Micro-startup Loans

As women have always been regarded as a vital economic pillar because of the important roles that they play in families, alleviating their living conditions will be vital for economic growth and social stability. Therefore, the Ministry of Labour has launched the Women-Startup Phoenix Plan in 2007 to help women to start up their career. In 2009, the Ministry of Labour added middle-aged men between the age of 45 to 65 to the programme and renamed it as Phoenix Micro-startup Plan. Its main purpose is to boost labour-force participation, helping the targeted persons to start their own micro-enterprises, creating new jobs.

The loans are provided by financial institution funds and capped at a maximum of NT$1 million up to seven years. They are also guaranteed by the Taiwan SMEG, with the credit guarantee covering 95% of the total amount of these loans. No collaterals and guarantors are required in advance. Interest will be waived during the first two years of the loan period because the Ministry of Labour will offer full subsidies for interest. After that, a special low interest rate of 1.95% is required on the loans. In terms of other special disadvantaged groups, such as the rehabilitated from prisons, the victims of domestic violence, and those suffering occupational injuries, interest will be waived for as long as 3 years and will then be fixed at a rate of 1.5% from the fourth year. To be eligible for the programme, candidates must have undergone a government training course within the last three years and received start-up consulting and guidance, and the employees in their enterprises cannot exceed 5 persons (excluding the owner). The business type includes street vendors, farmers, fishermen, family artisans, B & B hosts, and so on.

In Table 9, it is shown that the number of borrowers for this programme reached a peak of 985 in 2009 but decreased by half to 445 in 2013. In respect of amount of loans, it reached the highest at NT$526.4 million in 2010, and dropped dramatically to NT$226.6 million in 2013. The initial amounts may reflect the difficulties mostly encountered during the period of 2009 and 2010, which caused the disadvantaged to be in urgent need of financial aid from the government. Afterwards, the difficult situations seemed to have abated, so the necessity to start up a career with the support of a government-backed scheme became less acute.

If classified by gender, age and occupation, the majority of these loans have gone to females, the age group of 30-44, and those running a business of wholesale and retail. According to the Ministry of Labour, the programme has created 32,000 job opportunities up to the end of 2013.

Furthermore, to assist women to secure their start-up funds, other authorities have also undertaken various measures to provide loans on favourable terms. For example, in 2013, the Ministry of Economic Affairs launched the 2013 Flying Goose Programme to help more women entrepreneurs by providing development services, such as incubation courses, team member type consultation, start-up funding, and so on, to increase the opportunities for female-owned start-ups and enhance their operational efficiency and competitiveness.

Table 9
Numbers of Borrowers and Amounts of Loans Extended to Micro Startup Phoenix Plan

Year	Numbers of Borrowers	Amounts of Loans (NT$ Million)
2007*	197	75.59
2008*	258	71.04
2009	985	444.81
2010	976	526.39
2011	717	417.61
2012	584	299.51
2013	445	236.58
Total	4,162	2,071.53

Source: The Ministry of Labor,
*: The data only include the program of Women-Startup Phoenix Plan.

5.3 Civilian Banks

To bolster care for the economically disadvantaged and expand the social safety net, the Ministry of the Interior, taking the Grameen Bank[15] spirit as a model, launched an experimental scheme of civilian banks in July 2012, in cooperation with the Credit Union League of the Republic of China as well as all other credit unions, taking advantage from their operation modes. Credit unions are mutual cooperative organisations, owned and controlled by their members. All members have the duty to deposit money periodically as shares of a credit union. They are required to do so for purposes of cultivating a savings habit, thus raising credits. However, they are also entitled to borrow money from the union to improve their lives and welfare.

The first stage of the scheme ended at the end of 2013. During this stage, the authority chose Taichung City, Changhua County, and Nantou County as pilot areas. The scheme focused on groups such as aborigines, new immigrants, medium- and low-income population, single parent families, and those economically disadvantaged. Up to 50 persons in total can be accepted under this programme. For those qualified and willing to be members of a credit union, they were obliged to deposit an amount of NT$500 to NT$1,000 into their personal accounts each month. The Ministry of the Interior would then offer the same amount of deposits

15. Grameen Bank originated in 1976 by Professor Muhammad Yunus. It is designed to provide banking services to the rural poor in Bangladesh.

into their respective accounts as subsidies. As long as the money becomes shares of a credit union, they cannot be withdrawn from the account. Therefore, the funds will inevitably accumulate gradually to become the members' assets and improve their credit standing. However, the participants were allowed to apply for micro loans, such as educational loans or startup funding, from the credit unions after the pilot stage ended. The cap of the loans was set at NT$0.3 million and the Ministry of the Interior would provide 3% of interest allowances annually. Furthermore, the Ministry of the Interior has also granted NT$0.1 million of life insurances, NT$0.2 million of accident insurances and related medical insurances for each participant. As of the end of this stage, all 56 participants have accumulated up to NT$2 million in deposits. The scheme has started to take shape and the financial assistance mechanism has been established in the city and counties mentioned.

The second stage of this scheme began on 1 January 2014 and will conclude at the end of 2014. At this stage, all conditions are the same as those in the first stage. However, the authority is trying to publicise its experience in the above mentioned counties and bring it to 4 other areas, namely Taoyuan County, Chiayi County, Tainan City, and Pingtung County. Those local governments are encouraged to draw up localised poverty reduction plans, which shall link financial resources with the local characteristics. It is expected that another 80 underprivileged families may be recommended to participate in the programme.

At this stage, the authority will evaluate whether the future development of this programme should be carried out by the local governments or the Credit Union League.

6. Conclusion

Assisting SMEs to secure financial resources has always a top priority of the government. The reasons are not only that the roles of the SMEs in Chinese Taipei's economic development are very important, but also that the employed population accounts for the majority of the labour force. According to the Manpower Survey Results by the Directorate General of Budget, Accounting and Statistics, Chinese Taipei's workforce totaled 11.0 million people in 2013, out of which 78.3% are employed by the SMEs. Therefore, the stability of the society depends highly on the living conditions of these people. To support the funding needs of the SMEs, the government has stipulated in the Act for Development of Small and Medium Enterprises that it shall coordinate with financial institutions and credit guarantee institutions to enhance their respective functions in providing financing and guaranties to small and medium enterprises.

Furthermore, the determination to safeguard those groups is also emphasised in the Additional Articles of the Constitution of the Republic of China. In Article 10, it is specified that the State shall assist and protect the survival and development of private small- and medium-sized enterprises.

From the past experiences, it has been recognised that the financial assistance for the SMEs from the financial institutions and the credit guarantee organisations has been remarkable. These exceptional results may explain why Chinese Taipei has a lower level of uneven distribution of wealth when compared with other major economies. For example, in terms of the ratio of per capita disposable income share in 5 equal divisions as of 2013, Chinese Taipei registered 4.08 times in comparison to 14.68 times in the U.S.A. (2012), 5.13 times in Japan (2009), 5.43 times in South Korea (2013), and 12.1 times in Singapore (2012). However, once the ratio increased during the financial crisis period, the government was prompted to adopt more measures to correct the widened disparity between the poor and the rich. These measures included enhancements in assisting SMEs to obtain funding and the establishment of the Task Force on Improving Income Distribution. Under the task force, various authorities in labour, civil affairs, finance, insurance, and so on, have proposed various programmes to improve income distribution. In this paper, only three sub-programmes, namely micro-insurance, Phoenix Micro-startup Loans, and civilian banks have been introduced, mainly because the focal point is on financial inclusion for underprivileged minorities. It is obvious that the decreasing ratios in these years have provided a very positive feedback for the measures mentioned. Therefore, they will continued to be implemented and improved upon going forward

Finally, we would like to emphasise that inequality in Chinese Taipei is actually not a very serious problem. As mentioned earlier, the main reason is that SMEs and their employees have been among the government's top priorities. Another reason is that there are many non-governmental organisations in Chinese Taipei such as the Tzu-Chi Foundation, which have been actively supporting the underprivileged in various ways. It is worth noting that most Taiwanese are culturally kind and charitable and always enthusiastic in helping people, especially the disadvantaged. For example, when the 921 earthquake struck in 1999, a tremendous amount of donations (in cash), amounting to NT$37.5 billion, flooded in from Chinese Taipei itself. According to the Wikipedia, the private donations were equivalent to one seventh of the government's total expenditure on 921 earthquake reconstruction. Such a huge proportion in private donations for natural disasters is rarely seen in the world. The omnipresent compassion symbolizes that redistribution of income or financial inclusion to a certain degree can be accomplished on the society's own initiative.

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