

Financially Inclusive Ecosystems: The Roles of Government Today

Financial inclusion today is about financial markets that serve more people with more products at lower cost. The term “microfinance,” once associated almost exclusively with small-value loans to the poor, is now increasingly used to refer to a broad array of products (including payments, savings, and insurance) tailored to meet the particular needs of low-income individuals. Two separate but related developments have spurred this more holistic approach to financial inclusion. First, a growing body of research is demonstrating that poor people use and need a wide array of financial products, not just credit. Second, innovative lower cost business models—especially electronic and agent banking models—hold the promise of reaching unbanked populations with a fuller range of products better suited to their needs.

Different products present different risks and delivery challenges, and it is unlikely that a single class of service providers will effectively provide all the products poor people need. A key challenge is how to create the broader interconnected ecosystem of market actors and infrastructure needed for safe and efficient product delivery to the poor. And many are asking what roles a government can or should play in the development of these financially inclusive ecosystems, especially in light of innovation in financial services delivery.

This Focus Note first describes the challenges of the broader financial inclusion landscape and then explores three promising roles government can play in developing more financially inclusive ecosystems.¹

The Broader Financial Inclusion Landscape

An estimated 2.7 billion adults worldwide do not have credit, insurance, or savings with a bank or other formal institution (CGAP and World Bank

2010). Yet, the more we learn about the financial lives of poor people, the clearer it is that low-income families need a wide array of financial services. After the low level of their incomes, the next most salient fact about poor people’s income is its variability. Most poor people do not earn a steady wage—earnings can differ substantially between seasons and even from day to day. A family may have comparatively more cash following harvest, but need to skip meals in the lean period just before. A market vendor may earn US\$20 on market day, but that may be all she has to sustain her family until the following week’s market. Emergencies, such as a sickness in the family, and large outlays, such as school fees, may come during lean times. Even in the best of times, poor people have less of a cushion to weather shocks.

As a result, poor households are astonishingly active money managers, using a large number of financial instruments to move money between times when they receive it and to prepare for other times when they will need to spend it. The now well-known study presented in *Portfolios of the Poor* broke new ground by demonstrating that poor households in Bangladesh, India, and South Africa use on average eight different kinds of savings, insurance, payment, and credit instruments throughout the year (Collins, Murdoch, Rutherford, and Ruthven 2009). In Bangladesh, one-third of households use more than 10 instruments, passing more than US\$1,000 through them throughout the year (per capita gross domestic product is estimated at \$1,700). Many instruments are used, put aside, and then taken up anew at a later time. In India, for example, the average low-income household enters a fresh financial arrangement every two weeks.

Most financial instruments are informal—i.e., they are not offered by a financial services provider with a recognized legal status.² Instead, the poor may

1 This Focus Note makes no effort to judge broad macroeconomic approaches—interventionist, laissez-faire, or pro-market activist—recognizing instead that there will be a variety of government approaches. (See de la Torre, Gozzi, and Schmukler 2007.)

2 There is a broad range of definitions of “formal” financial services, although all presuppose at least a minimum threshold that the provider should have a recognized legal status. This includes entities (and, in some countries, even some individuals) with widely varying regulatory attributes, subject to differing levels and types of external oversight (CGAP 2011b).

rely on storing money at home or participating in a savings club comprised of friends and neighbors. Despite the media attention the formal microcredit sector has received, most small loans taken by the poor are still from informal sources, such as the local moneylender, family, or a merchant. In the Indian state of Andhra Pradesh in 2009, three out of every four loans poor families took came from an informal source; an additional 18 percent came from quasi-formal self-help groups. Microfinance institutions (MFIs) and banks accounted for just 6 percent of active loans. Most loans were used to finance consumption needs, health costs, and agricultural inputs (IFMR 2010).

Informal instruments are often riskier and more expensive than formal alternatives. A recent revisit of *Portfolios of the Poor* households in South Africa found 27 percent of families reported losing money in the past year through an informal instrument, such as a savings club or savings in cash at home. The average reported loss was US\$113 (CGAP 2011a). In Ghana, doorstep savings (*susu*) collectors are commonly used; they charge 3 percent of monthly deposits and offer no interest. Compare this to a savings account with the local branch of an international microfinance bank, which charges the equivalent of US\$3 at account opening and pays interest for balances over US\$100. A local moneylender may charge in excess of 200 percent annual interest, whereas a credit card issued by a bank often charges a 24 percent annual percentage rate (APR).³ In short, poor households pay extra and suffer greater losses from the informal instruments that are often the only instruments available to them.⁴

The story of microfinance is, for most laypeople, synonymous with microcredit. The archetypal credit-constrained microentrepreneur has a business where lack of funds is the major blockage to growth and increased revenue. But how many of today's estimated 190 million active microcredit borrowers fit the profile of the archetypal microentrepreneur

(Reed 2011)? Evidence shows many borrowers come with a different set of characteristics: their business may not be able to use much capital, or even more commonly, they use the loan proceeds for consumption or to meet unexpected expenses.

The world's 1.6 billion working poor people fall into many segments with diverse needs. One study estimates that just over 10 percent are classic microentrepreneurs (Wyman 2008). Farmers and day laborers are more numerous, and their financial lives are different from that of microentrepreneurs. Farmers see vast swings in their income from season to season. Day laborers might see smoother income across the year, but on any given day they may not know if they will work. To point out one obvious difference, farmers need mechanisms to move money across many months; day laborers need much shorter term instruments. The typical microcredit loan—over 90 days with repayment beginning immediately—may not be appropriate for either.

Clearly, a wide range of financial products is needed to meet the needs of the different segments of the poor. Most of the progress so far has been limited to microcredit for two reasons. First, the lending business can be profitable even at very small scale. Upfront investment requirements are small, so barriers to entry are low. This is not the case with, say, insurance. The only way insurance can work is to have a large and diverse pool of customers, containing old and young, healthy and ill, people who experience fires and those who do not, and generally presenting a predictable, manageable stream of costs to the provider.

The second reason microcredit took off is that the risks inherent in the typical MFI business model were ones that often could be managed by a single institution. It took time to experiment and identify the ways to originate and manage a microloan portfolio, but by the 1980s multiple lending methodologies had been developed that

3 Unpublished analysis by IFMR Trust. APR is often defined as the yearly cost of a loan (including interest, fees, and insurance) divided by the balance due.

4 This does not mean that access to informal financial services does not serve the interests of financial inclusion and should therefore be closed off. Indeed, there is strong justification for permitting certain small institutions (such as small financial cooperatives that pose no systemic threat) to operate informally if their members have no access to safer options.

allowed an MFI to lend at acceptable risk using just its own staff.⁵

By contrast, most financial products have delivery, intermediation, and risk mitigation challenges that often can be more efficiently managed through a number of specialized institutions acting together rather than one institution acting alone. Skill sets, capacities, and tools needed to deliver products on the liabilities side of a bank's balance sheet are different than those needed to deliver products that fall on the asset side. As a result, businesses tend to develop specialties on either side of the balance sheet. Further, businesses providing the service to the end consumer are often not specialized in managing other parts of the value chain.

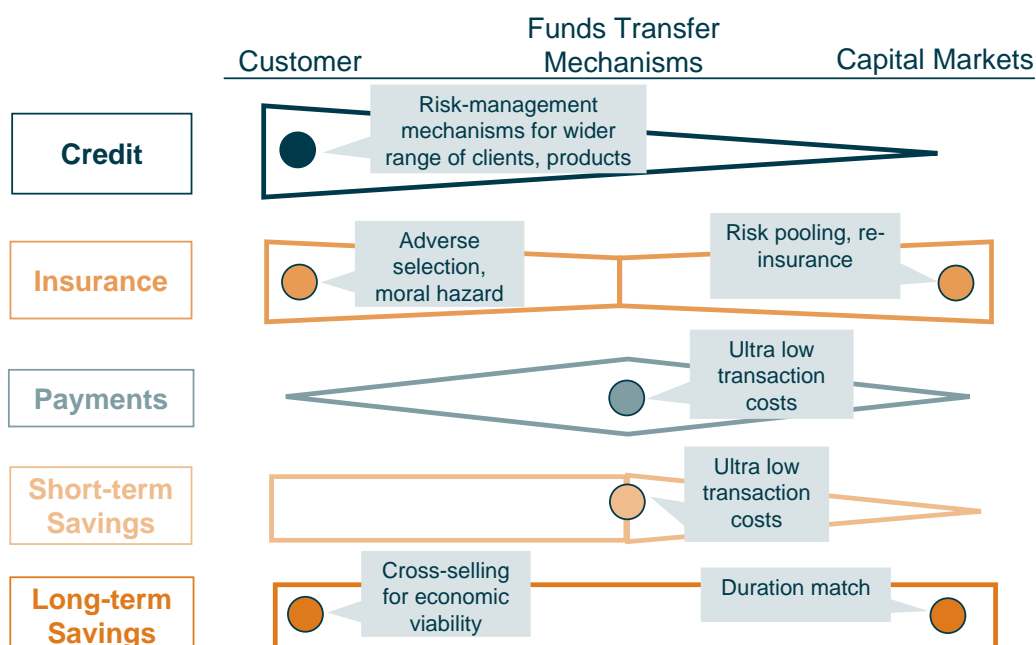
For example, insurance companies often function more effectively through use of specialized actuaries, independent agents selling policies, and reinsurers who aggregate risk. Payment service providers and providers of short-term savings products can benefit from access to a low-cost infrastructure of origination and delivery points

that permit money transfers and savings services at prices acceptable to low-income individuals sending and saving low values. Providers offering long-term savings services need prudentially regulated financial institutions for deposit intermediation. For credit products, reliable credit bureaus are needed, at least in markets with a substantial number of available providers and increasing market penetration. And loan aggregators can diversify risk by consolidating different loan portfolios with varying geographic and other risks. Different product types carry discrete commercial challenges for providers (see Figure 1).

An ecosystem involving multiple businesses may work better for poor people in terms of both increasing the range of options for services and making these options available to poor people in an affordable way. Such an ecosystem represents a shift from vertically integrated business models that limit efficiency and scale. However, these ecosystems do not always develop easily, or quickly, on their own. In fact, competitive forces may stifle the emergence of some cooperative relationships,

Figure 1: Commercial Challenges for Providers of Different Financial Products

Shape represents the bulk of time and money invested in the business model;
circles represent delivery challenges.



⁵ The problem of over-indebtedness demonstrates that the microcredit sector would benefit from, for example, other infrastructure, such as credit bureaus (CGAP 2010).

such as with payment service providers who have invested so heavily in distribution infrastructure that new entrants find it difficult to compete.

Government Roles Today

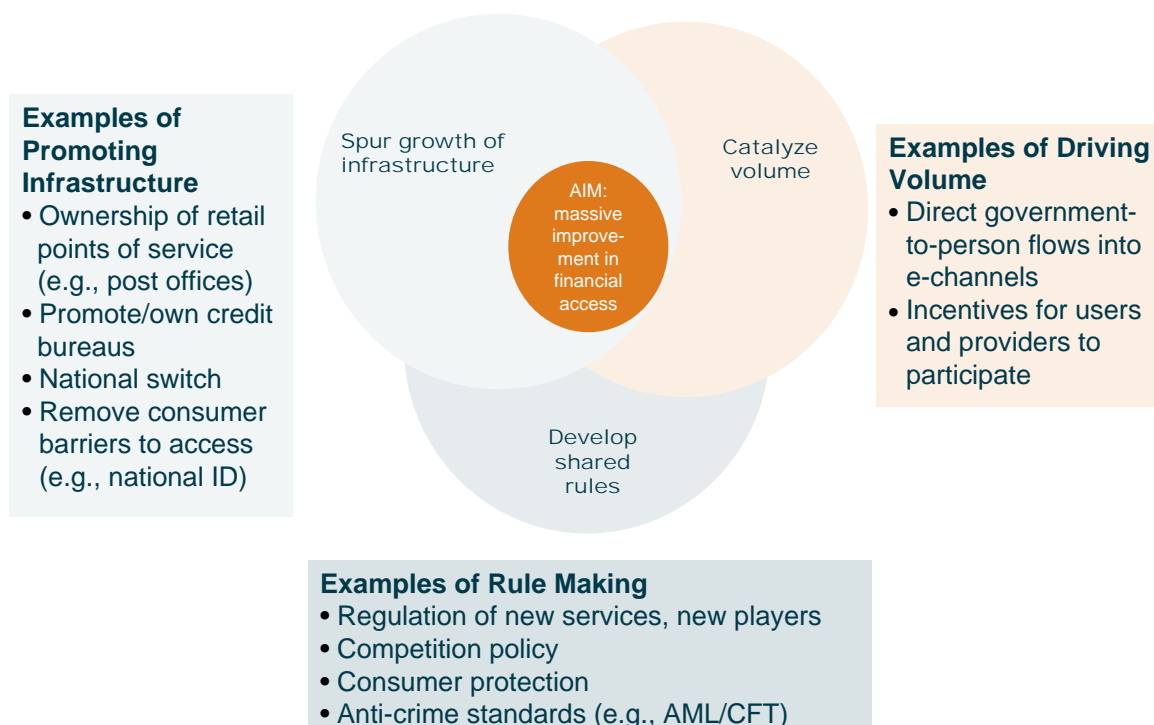
As governments become more actively involved in the financial inclusion agenda, a key challenge is defining *roles* for government in creating the broader and interconnected ecosystem of market actors needed for safe and efficient product delivery to the poor. This Focus Note explores three roles that have the potential for significant impact: (i) promoter of front- and back-end infrastructure, (ii) rules maker with respect to that infrastructure and its contribution to responsible market development, and (iii) driver of transaction volume.⁶ While each of these roles can have significant impact, the application of these roles in any given jurisdiction will depend on country-specific factors, such as customer demand, market structure and maturity, government philosophy toward the market, and supervisory and other governmental capacity. (See Figure 2.)

Government as Promoter of Retail- and Market-Level Infrastructure

Existing banking infrastructure does not adequately reach the world's poor. Bank branches are too expensive to construct in low-income areas and, even when present, rarely offer affordable services. Automated teller machines (ATMs) and point-of-sale (POS) devices have wider penetration but have been of little use to unbanked customers without the cards and accounts typically needed to access such delivery channels. Poor borrowers are unlikely to possess the types of collateral typically pledged in collateral registries. Nor do poor borrowers borrow from the types of lenders served by most credit bureaus. And even where cost and distance are not barriers, access to formal financial services is often blocked by the lack of perhaps the most basic component of a financially inclusive infrastructure—a reliable means of customer identification (ID).

Governments have attempted to bridge the financial infrastructure gap in a variety of ways, focusing on both front-end infrastructure (the point

Figure 2: Roles of Government in Financially Inclusive Ecosystems



⁶ There is a fourth role that governments play in promoting access to formal financial services: the role of owner (or subsidizer) of financial service providers. As this paper focuses on developing market-based ecosystems for financial inclusion, this fourth role is not discussed.

of contact with customers, including ATMs, POS devices, and increasingly, local businesses serving as retail agents of financial services providers) and back-end infrastructure (the backbone needed for efficient financial services, including payment switches, credit bureaus, and collateral registries).

In recent years, branchless banking—the use of retail agents and communications technology to deliver financial services—has reduced costs enough to permit retail infrastructure to reach previously unbanked populations at a price they can afford. Retail agents, plastic cards, and mobile telephones now reach areas that bank branches could not. Governments have tried—with mixed results—to promote agent networks, including the use of state-owned entities, such as post offices, to act as the customer interface for financial service providers.

In Brazil, for example, the post office acts as a banking agent for Banco Bradesco, one of Brazil's largest private banks. In Mexico, government-owned Diconsa (which wholesales goods to retailers in poor and remote areas) supplied 6,000 of its retail partners with POS devices to facilitate the disbursement of social payments through cards.⁷ In Burundi, mobile phone operator Econet provides customer access to its mobile funds transfer product Ekocash through Burundi's postal network. However, government entities acting as financial services agents are not always the best equipped to provide convenient, high-quality service. One African mobile network operator (MNO) that uses a government-owned postal network as its agent cites short opening hours, long lines, and the lack of a customer-focused work ethic as serious obstacles to consumer uptake of financially inclusive products.

Governments have long been involved in promoting market-level infrastructure, but rarely with an eye toward financial inclusion. Due to the systemic importance of large funds transfers, governments play an active role in the development and ownership of payment and settlement systems, such as real-time gross settlement systems, automated clearing houses

(ACHs), and other payment system components, including retail payment switches.

However, governments have become increasingly aware of the need for market-level infrastructure to serve financial inclusion. For example, over-indebtedness crises in some saturated microcredit markets has spurred new government interest in promoting reliable credit reporting with more comprehensive borrower information. In Bosnia, where participation in the sole private credit bureau was expensive and voluntary, inadequate credit information led to over-indebtedness and high loan delinquency rates. Mandating participation in a private credit bureau, however, would have been viewed as government unfairly favoring a for-profit entity. Consequently, the central bank expanded a state-owned Central Registry of Credits (CRK) and required all Bosnian financial institutions to provide data to CRK. Other regulators have not intervened in the same way. In Morocco, MFIs also had no reliable credit information but solved their dilemma for the time being by informally sharing information among themselves—ultimately reducing cross-lending rates from 35 percent to 15 percent in just 18 months.

Governments are also involved in creating unique forms of ID that can enable access to the financial system. An inability to comply with customer ID requirements is perhaps the largest single infrastructural obstacle to financial inclusion since many low-income individuals do not possess reliable forms of ID, effectively excluding them from formal financial services.⁸

Unique ID is increasingly viewed as a public good and a government responsibility. However, unique ID, whether in the form of a card or a number or other unique feature, is costly and time consuming to develop. Perhaps more importantly, governments have a number of competing interests in pursuing ID programs. Such ID programs can promote access to bank or e-money accounts, or more efficient welfare payments, but the same ID program can be used for other purposes (such as tax collection or political

⁷ While the Diconsa program would not meet the criteria of a financially inclusive government-to-person program it nevertheless lays the rails for more inclusive services.

⁸ For a more detailed discussion on the nexus between financial inclusion and customer ID requirements, see Isern and Koker (2009).

surveillance) that deter the poor and may limit ID effectiveness as a means of bringing poor people into the formal financial system (see Box 1).

Government as Rule Maker

A government's most obvious role—viewed by many as its primary role—is that of rule maker. As rule makers, governments determine not only what efforts may be undertaken to promote financial inclusion, but also by whom, how, and when. In addition to prudential and consumer protection rule making,⁹ this involves the potential to enable innovative financial inclusion business models, including permitting the entry of new actors into the financial service sector.

A government's role as the enabler of financially inclusive business models attracted increased attention during the rise of microlending in the 1980s and 1990s. Policy makers realized the potential of credit to benefit the lives of millions of poor households, but early on commercial banks remained generally uninterested in microlending. In many countries, the way governments used

their role as financially inclusive rule maker was by removing barriers to nonbank microlending (by measures such as exemptions from interest caps that made such lending otherwise unprofitable, or by adopting regulation explicitly authorizing formation and operation of various types of nonbank microlending institutions where such authority was previously lacking or ambiguous).

Although many of these institutions served many poor people well and quickly grew beyond donor dependence, attracting interest from a burgeoning range of wholesale suppliers of debt investment, the institutions could not, by definition, offer clients much-needed savings services. And those formed as nongovernment organizations could not attract equity investment. Increasingly, therefore, policy makers began enabling new business models that combine microlending with authority to accept retail deposits, by lowering minimum capital requirements and otherwise adapting prudential regulation so as to permit nondepository microlending institutions to transform and new "greenfield" depository institutions to be established.

Box 1. Unique IDs vs. Risk-Based Regulation

Countries as diverse as India, Indonesia, Rwanda, and Russia are at various stages of exploring or implementing unique ID programs. Further research is needed not only to evaluate the impact of unique IDs on financial inclusion but also, and perhaps more importantly, to compare such impact against the impact of other easier and less expensive mechanisms of overcoming the ID hurdle (e.g., risk-based regulation lowering ID requirements for certain low-value financial services). A number of countries, including the Philippines and South Africa, have already implemented such regulation and have been deemed compliant with international standards promulgated by the Financial Action Task Force

(FATF), the international standard-setting body for combating money laundering and terrorist financing. Other countries, including Fiji and Malawi, permit customer ID through letters issued by village leaders or other reputable sources. And Mexico permits anonymity with respect to low-value accounts capable of receiving foreign remittances.^a

However, while lower ID requirements can facilitate access to certain payments and savings products, they are unlikely to facilitate access to credit products, which increasingly rely on customer identity to verify repayment history.^b

a. Mexican regulators view the maximum account balance (approximately US\$400) to be sufficiently low and the functionality of the account sufficiently limited as to present low risk for money laundering and terrorist financing. For a more detailed discussion on risk-based approaches to anti-money-laundering and terrorist-financing measures, see FATF Guidance on Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion (June 2011) http://www.fatf-gafi.org/document/4/0,3746,en_32250379_32235720_48294212_1_1_1_1,00.html.

b. Note that the absence of a national ID system need not prevent or stall the development of credit reporting. In several markets, credit bureaus have developed sophisticated matching algorithms and programs to derive the identity of a person based on various pieces of data. In countries without national ID systems, the success of base-of-the-pyramid credit reporting depends initially on making the best of imperfect alternative customer ID approaches (Lyman et al. 2011).

⁹ These types of rule making are, of course, critical in establishing trust in formal financial services. Without this trust, financially excluded customers will not choose to use formal financial services over their existing informal options.

Today, as financial inclusion is understood to include a variety of products, regulators are again facing regulatory gaps that prevent the emergence of business models that could lower costs and widen access for low-income people. This is best exemplified by the current rise of branchless banking: technology-enabled financial services provided through retail agents. These services, primarily electronic funds storage and transfer, often rely on mobile telephone technology. As a result, regulators are challenged to define the role of MNOs and other actors not previously subject to financial regulation and supervision. In an increasing number of countries, regulators are enabling a variety of branchless banking models, including those that permit MNOs, subject to limited prudential regulation, to take the dominant role in directly providing electronic funds transfers.

In Kenya, for example, regulators engaged with MNO Safaricom for nearly two years before enabling the launch of M-PESA, Safaricom's funds transfer service. Since then, M-PESA has emerged as the epitome of branchless banking's potential. Through agreement with the central bank, Safaricom is required to protect customer funds in safe liquid assets (bank accounts and government bonds) and to isolate such funds from misuse and from Safaricom creditors through the use of a trust. M-PESA now uses 28,000 agents to reach 14 million customers, an estimated 50 percent of them previously unbanked (Jack and Suri 2010). Now partnering with institutions subject to full prudential regulation, Safaricom and other MNOs use the mobile channel to provide additional financial services, such as deposits, credit, and insurance. (See Box 2 for another example of government as an enabler.)

As branchless banking continues to expand financial access, the questions of payment systems interoperability and shared agents present challenges to developing rules for the broader ecosystem needed for fuller financial inclusion. In the context of new delivery mechanisms reaching the poor, interoperability typically refers to the ability of customers of competing financial service providers to transact with each other (e.g., a customer of one provider using her mobile phone to send money to the mobile wallet of her mother,

Box 2. Government as Enabler— The Philippines

Several years ago, Filipino regulators were presented with two electronic-money (e-money) schemes. One e-money product, Smart Money, was issued by a bank. The other, GCash, was issued by a nonbank subsidiary of Globe Telecom, one of the largest MNOs in the Philippines. Although GCash introduced a nonbank actor into what had been seen as the domain of licensed banks, the central bank of the Philippines, *Bangko Sentral ng Pilipinas* (BSP), chose to open the door to an innovative product with the potential to reach unbanked populations. Using its rule-making power as payment system overseer, BSP approved each model on an ad hoc basis, but only after confirming that each model mitigated identified risks. Based on its observations of the market's development over more than four years, BSP issued e-money regulations in 2009.^a The regulations are notable for regulating e-money as a service (and not by the legal character of the e-money issuer) while still imposing conditions to mitigate risks presented by nonbank e-money issuers. The regulations effectively created a level playing field between banks and nonbanks, ultimately enabling a greater array of actors and products with the potential to promote financial inclusion.

a. BSP Circular 649 (9 March 2009) <http://www.bsp.gov.ph/regulations/regulations.asp?id=2346>

a customer of a different provider). A closely related topic is agent exclusivity—the ability of a customer of one provider to use the agent of another provider for cash-in/cash-out services. Interoperability and nonexclusive agents can expand financial access by opening more access points to a greater a number of customers. They could also increase competition that could drive costs down, though this ultimately depends on pricing—freely negotiated or government imposed—for cross-network transactions. But what is the best path to interoperation?

Permitting exclusive platforms and agent networks can ultimately allow first movers or large actors to dominate the market, with the possible result of limited competition and artificially high prices. However, mandating interoperability too early in the growth of the market may discourage actors from entering the market due to concerns that competitors could “piggyback” off of a large start-up investment. A few governments have

imposed mandatory interoperability *ex ante*, sometimes even requiring connection to a state-developed and/or -owned central switch for funds transfer processing. Such efforts have often achieved lackluster results. Other countries are considering mandating interoperability *ex post*—often upon evidence that the dominance of large players is suppressing competition. And other governments have taken a less direct approach—encouraging the private sector to interoperate voluntarily, with the tacit understanding that the government can impose interoperability on perhaps less favorable terms if the voluntary approach does not produce the desired results.

Regulators struggle to identify which approach will work best in their setting. Kenya, for example, now finds itself confronting the interoperability debate. In 2007, the government permitted Safaricom to launch what is now one of the largest mobile-phone-based funds transfer services in the world, M-PESA. The number of M-PESA accounts surpassed the number of traditional bank accounts in Kenya in just three years. Regulators did not require Safaricom’s platform to be interoperable, and Safaricom was permitted to retain exclusive agents who were contractually prohibited from handling similar financial services on behalf of other providers, including banks.

Some now argue that despite M-PESA’s undeniable success and contribution to financial inclusion, regulators have effectively permitted a Safaricom monopoly (even though CBK has authorized other actors to enter the market). Without interoperability, competitors argue they are finding it difficult to attract customers away from a dominant, popular brand—and they complain that Safaricom used its head start to tie up the supply of potential agents.

Kenyan regulators have treated interoperability of the technical platform differently from the exclusivity of agents. With respect to the platform, Central Bank of Kenya Governor Njuguna Ndung’u has been very clear that it is too early to mandate interoperability, summing up the fundamental tension between interoperability and encouraging innovation: “Interoperability will help to reduce costs but if you reduce costs without following the rules of the game you will kill the innovation. There are

proprietary rights that you have to respect” (Mugwe 2011). He did not discount using the government’s rule-making power to mandate interoperability in the future but suggested that such a move should come only after there was a significant decrease in the number of unbanked customers in Kenya.

In contrast, Kenyan regulators are reportedly sympathetic to claims that Safaricom’s agent exclusivity provisions are anti-competitive. One of Safaricom’s competitors challenged Safaricom’s agent exclusivity before Kenya’s competition board, the Monopolies and Prices Commission. The Commission avoided a decision on whether Safaricom was abusing a dominant position and instead strongly suggested to Safaricom to come to a private agreement with the competitor for sharing agents—an agreement that has reportedly been concluded according to a Safaricom executive, though the details have not been made public.

Government as Driver of Transaction Volume

Driving transaction volume has the potential not only to bring more low-income individuals into the formal financial sector but also to lower the per-transaction cost of the retail/transaction infrastructure for various market actors.

Perhaps the government’s most powerful tool to drive transaction volume is government-to-person (G2P) payments—the spectrum of social transfers, wages, and pension payments made by governments to 170 million poor people worldwide (Pickens, Porteous, and Rotman 2009). G2P payments can promote financial inclusion when payments land in accounts that (i) enable recipients to store funds and use them for other transactions within the general purpose payments infrastructure (the “transactional account” requirement) and (ii) are accessible to customers in terms of cost and proximity (the “accessibility” requirement). At present, less than a quarter of G2P payments meet these requirements (Pickens, Porteous, and Rotman 2009).

Increasingly, however, governments are addressing the transactional account requirement by making electronic G2P payments into bank accounts—as

opposed to paying out in cash (which does not link to any account) or via electronic cards (which have no transactional ability because they operate within closed-loop systems or because recipients are required to withdraw the entire amount). However, electronic delivery into a bank account is not by itself sufficient for financial inclusion. In fact, governments can work against financial inclusion by mandating G2P payments into bank accounts that recipients cannot access easily or that do not offer good value-for-money. Branchless banking often solves the access problem, using technology and/or retail agents to overcome cost and proximity obstacles.

In South Africa, for example, half of the 15 million government payment recipients have their money paid into a bank account. South Africa's largest bank, ABSA, has created the Sekulula account specifically for social transfer recipients. Sekulula accounts have no minimum balance requirement, permit two free transactions per month, and provide a debit card that allows account holders to access their funds without having to travel to the bank. In India, beneficiaries of some G2P payments can elect to have such payments made onto an electronic card linked to a basic bank account. Withdrawals can be made at specified retail agents, saving customers the time and related expenses of withdrawing from a bank or post office.¹⁰ (See boxes 3 and 4 for discussions on G2P payments and their role in a financial inclusive ecosystem.)

Keeping the Momentum

Governments are increasingly interested in promoting financial inclusion. More than 45 countries have drafted financial inclusion strategies, and more than 100 countries track key inclusion indicators (CGAP and World Bank 2010). Government institutions from 78 countries have joined the global Alliance for Financial Inclusion, a regulator network launched in September 2009. Supra-national bodies are also focusing on financial inclusion. In 2010, the G-20 recognized financial inclusion as one of the key pillars of the global development agenda, not only endorsing its

Box 3. Can G2P Payments Subsidize a Financially Inclusive Infrastructure?

South Africa and India are promising, yet experimental, examples of the potential of government payments to bring increasing numbers of the poor into the banking system. But G2P payments potentially have another financial inclusion advantage: made in sufficient volume, they can drive down per-transaction costs of the branchless banking infrastructure. The success of branchless banking is based on high volume: without sufficient volume and the lower retail costs that come from scale economies, branchless banking models may not develop. G2P payments can encourage service providers to join fledgling payment systems, giving them the critical mass of players (and consequently transaction volumes) needed to make them viable. For example, in the 1970s, the ACH in the United States faced difficulties in getting banks to join its payment system. Not until the U.S. government offered to pay social security checks via ACH did banks begin to join ACH, and within 15 years, nearly all U.S. depository institutions joined the ACH network (Benson and Loftness 2010).

By acting as a major market participant, governments can promote the development of a payments infrastructure that ultimately lays the rails for providing services that go beyond G2P payments and their recipients.

Box 4. Electronic G2P Payments—Benefits to Government, Too

In addition to expanding financial access, electronic delivery of G2P payments can lower government transfer costs. For example, a recent study estimated that electronic payments could save the Indian government US\$15.8 billion a year. Compared to cash delivery, electronic payments reduced transaction costs, administrative overhead, and "leakage" (the diversion of benefits to unintended recipients).

Another example is Brazil's Bolsa Familia program, the largest conditional cash transfer system in the developing world reaching 12.9 million households. Electronic distribution, coupled with payment consolidation, lowered the government's delivery cost from 14 percent to 2.6 percent of distributed value (World Bank 2007).

Of course, cost savings to government is not tantamount to financial inclusion—even if G2P payments are delivered electronically, they may not land in transactional and accessible accounts. Governments should use electronic G2P payments to expand financial access, not just to lower costs.

¹⁰ Despite the potential of G2P payments made into financially inclusive accounts, customers often do not avail themselves of the transactional and savings capacity of such accounts, preferring instead to withdraw all payments in cash as soon as they are available.

Financial Inclusion Action Plan but also creating the Global Partnership for Financial Inclusion (GPFI) as an implementing body open to G-20 countries, non-G-20 countries, and other relevant stakeholders.¹¹ International standard-setting bodies, such as FATF and the Basel Committee on Banking Supervision, are also engaging in the financial inclusion agenda.¹²

Translating government interest into orchestrated strategies for the development of financially inclusive ecosystems is a key challenge. As discussed in this Focus Note, national government efforts to promote financial inclusion span a wide range of activities under three principal roles: (i) promoter of retail and market-level infrastructure, (ii) rule maker, and (iii) driver of transaction volume. These activities include establishing or supporting credit bureaus that include data on small loans; creating unique (and sometimes biometric enabled) IDs; developing proportionate regulation and supervision of small depository institutions; enabling new branchless banking business models; defining the role of nonbank actors; encouraging interoperability of payment systems; and channeling G2P payments in a financially inclusive manner. Each of these efforts requires some combination of research, funding, regulator and supervisor capacity building, and ongoing attention to ensure effective implementation. Substantial investment of resources and attention by national regulators and policy makers is needed.

The key is to identify what government initiatives work best under what conditions, taking into account local factors, such as market structure and maturity, government philosophy toward market intervention, and supervisory and other governmental capacity. Government actors need evidence from quantitative research, diagnostic tools, case studies, and consumer research to evaluate not only what options exist but also the likely impact of such options on financial inclusion. The development community can support government actors to focus their efforts on this new inclusive ecosystem by supporting

(i) demonstration effects to crowd-in the private and social sector players needed for a vibrant ecosystem for the poor and (ii) the provision of public goods, where the private sector cannot or will not invest or coordinate (such as regulation and basic infrastructure). A concerted effort by all stakeholders capitalizing on an unprecedented level of government interest and market innovation may make full financial inclusion a reality.

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¹¹ GPFI has three key implementing partners: CGAP, the Alliance for Financial Inclusion, and the International Finance Corporation.

¹² For a discussion financial inclusion and the work of international standard-setting bodies, see CGAP (2011b).

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