Cost Issues in Inclusive Finance

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Abstract

Financial inclusion has become a global policy agenda for quite some time. Several individual as well as collective initiatives have been undertaken by economies to achieve greater financial inclusion. As a result, some significant achievements have been made in increasing financial access and inclusion. However, the progress is slow and uneven across the countries due to various bottlenecks such as geographical difficulties, higher transaction costs, lack of awareness, unwillingness of banks and financial institutions, among others. On the other hand, higher cost has reduced the net benefit of financial services aimed at increasing the inclusion. In several developing economies in Asia and Africa, there is a situation that richer people living in urban areas get full range of financial services at lower costs while poor people living in rural areas have access to limited financial services and have to pay higher costs. Against this backdrop, this paper compares costs of inclusive finance and regular finance in selected countries in Asia and Africa. A country case of Nepal is presented as an example to show the cost situation in inclusive finance. The paper also tries to explore possible ways to reduce costs of inclusive finance.

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1. Background

Financial service is one of the basic needs in a modern society. Uneven distribution of financial services is associated with uneven distribution of socio-economic opportunities. For a society to achieve balanced growth and development, financial services should be inclusive. Financial exclusion generally deprives excluded section of the population from using their limited resources to uplift their livelihood, which in turn exacerbates inequality. Hence, various efforts have been made by countries all over the world to make the finance inclusive. Inclusive finance can be defined as availability of full range of financial services to each and every section of the population at a reasonable and equitable cost.

Financial exclusion exists mainly due to the geographical inaccessibility, low density of population, low economic activities, lack of connectivity and lack of awareness. Extending financial services to such areas is very difficult and involves high operating costs. It is natural for financial service providers to be reluctant to go to such areas. Hence, focused institutions such as microfinance institutions (MFIs) have been established to increase the financial inclusion. Use of technology has considerably helped in financial service expansion. However, there are two difficulties. First, the services provided are limited. For example, under the financial inclusion programs, mainly the microcredit and small payment services are provided. In most of the cases, these services are provided by different institutions. From this point of view, all types of financial institutions need to be established to provide full range of financial services. Secondly, due to high operating costs, interest and charges on financial services are extremely high. From financial service providers' point of view, this is quite natural. However, from service recipients' point of view, the costs are exorbitant.

Main objective of this paper is to further advance the debate on cost issues in inclusive financial system and explore the possible measures to reduce such costs. In this connection, the paper examines the extent and nature of the cost difference between inclusive finance and regular finance and. Specific focus of the analysis is on the credit side as credit is critical in uplifting the economic status of the service recipients.

The rest of this paper is organized as follows. Section 2 highlights the major financial inclusion initiatives implemented and progress made in increasing financial inclusion. Section 3 focuses on the cost of inclusive finance and compares it with regular financial services in selected countries. A country case of Nepal is presented in Section 4. Section 5 discusses some possible ways to reduce cost of inclusive finance. Finally, concluding remarks are provided in Section 6.

2. Major Financial Inclusion Initiatives and Progress Made

Well crafted plans, policies and programs with a longer term vision are the basic foundations for achieving higher level of financial inclusion. On the other hand, dedicated institutions which work in a coordinated manner to implement such plans, policies and programs are crucial. Similarly, appropriate delivery channels should be in place to achieve the financial inclusion targets. Use of technology may increase the effectiveness of inclusion efforts by making financial service extension possible and by reducing the cost (Shrestha, 2015).

Almost all the countries in the world have recognized the needs and benefits of financial inclusion. To advance the financial inclusion with deliberate efforts, several countries have formulated and implemented national financial inclusion strategies while others have implemented financial sector development strategies in which financial inclusion is one of the emphasized components. In recent years, some 50 countries have set formal targets and goals for financial inclusion (World Bank, 2014).

Strong institutions are required to implement financial inclusion policies and programs. In most of the countries, all types of banks and financial institutions are involved in increasing financial access and inclusion directly or indirectly. However, microfinance institutions are the major institutions focused on inclusive finance. In some economies, other specialized institutions also have been established.

To increase the degree of financial inclusion worldwide, several global initiatives have been undertaken by various agencies. 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 their traditional goals (United Nations, 2006). The G-20 Summit of 2010 announced the "Principles for Innovative Financial Inclusion" (Stein et al, 2011). The Alliance for Financial Inclusion issued the Maya Declaration in September 2011, which recognizes the critical importance of financial inclusion for empowering and transforming the lives of people all over the world. More than 100 institutions from 91 countries have adopted the Maya Declaration principles (Alliance for Financial Inclusion, 2017). The Centre for Financial Inclusion aims to build a movement that mobilizes stakeholders around the globe to achieve full inclusion by 2020 through the Financial Inclusion 2020 Project (Center for Financial Inclusion, 2015).

As a result of the implementation of various measures, some progress has been made in increasing the financial inclusion. According to the World Bank Findex data (Table 1), 51 percent of the world adult population had account at a formal financial institution in 2011, which increased to 67 percent in 2017. However, progress is uneven across the countries and various sections of the population. Adult population holding account at a financial institution increased from 32 percent in 2011 to 68 percent in 2017 in South Asia registering a growth of more than two folds. However, such population grew from 23 percent in 2011 to 33 percent in 2017 with an increase of 43 percent only in Sub-Saharan Africa.

Access to finance has increased more proportionately among female and poor section of the population in South Asia compared to that in Sub-Saharan Africa. Female population and poor population having account in financial institution stood at 64 and 65 percent, respectively in South Asia, which is close to the total adult population having such account (68 percent). These figures are at or above the world average. In Sub-Saharan Africa, female and poor section of population having such account remained 27 and 23 percent, respectively, which are significantly below the total adult population (33 percent).

Table 1: **Progress Made Toward Financial Inclusion**

(Percent of population aged 15+)

S.N.	Country	Financial Institution Accounts, Total		Financial Institution Accounts, Female		Financial Institution Accounts, Poorest 40%	
		2011	*2017*	*2011*	*2017*	*2011*	*2017*
South Asia							
1.	Afghanistan	9	15	3	7	1	14
2.	Bangladesh	32	41	26	32	19	33
3.	India	35	80	26	77	27	77
4.	Nepal	25	45	21	42	14	38
5.	Pakistan	10	18	3	6	5	13
6.	Sri Lanka	69	74	67	73	59	71
Sub-Saharan Africa							
1.	Ethiopia	-	35	-	29	-	22
2.	Ghana	29	42	27	38	18	33
3.	Kenya	42	82	39	78	19	70
4.	Malawi	17	34	17	30	11	21
5.	Mozambique		42		33		27
6.	Rwanda	33	50	28	45	31	39
7.	South Africa	54	67	51	68	40	61
8.	Tanzania	17	21	14	19	9	13
9.	Uganda	20	33	15	27	10	24
10.	Zambia	21	36	23	29	9	22
Average							
1.	South Asia	32	68	24	64	24	65
2.	Sub-Saharan Africa	23	33	24	27	13	23
3.	World	51	67	47	64	41	59

Data source: Global Financial Index Database 2017, World Bank

Table 2: **Ownership of Digital Instruments**

(Percent of population aged 15+, 2017)

S.N.	Country	Ownership		
		Debit Card	Credit Card	Mobile Money Account
South Asia				
1.	Afghanistan	3	1	1
2.	Bangladesh	6	0	21
3.	India	33	3	2
4.	Nepal	9	1	-
5.	Pakistan	8	1	7
6.	Sri Lanka	32	5	2
Sub-Saharan Africa				
1.	Ethiopia	4	0	0
2.	Kenya	38	6	73
3.	Malawi	11	1	20
4.	Mozambique	20	9	22
5.	Rwanda	5	1	31
6.	Ghana	19	6	39
7.	South Africa	34	9	19
8.	Tanzania	13	1	39

9.	Uganda	17	2	51
10.	Zambia	20	4	28
Average				
1.	South Asia	27	3	4
2.	Sub-Saharan Africa	18	3	
3.	World	48	18	

Data source: Global Financial Index Database 2017, World Bank

In South Asia, only 27 percent adult population has debit card, which is far below the world average (Table 2). Population in Sub-Saharan Africa having such card is even smaller accounting for only 18 percent. However, mobile money account holding is higher in Sub-Saharan African countries compared to that in South Asian countries. This shows the difference in the preference of the financial instruments in South Asia and Sub-Saharan Africa.

There are several common as well as country or region specific constraints towards achieving greater financial inclusion. Difficulty in physical access, low population density, high transaction costs and high interest and charges, documentation requirements, collateral-based lending and lack of collateral, mistrust in financial institution, unwillingness of banks to do retail banking, real and perceived risk in micro-lending and low level of financial literacy are common constraints to financial inclusion. A challenging geographical structure and security threat also act as barriers to financial inclusion in some of the countries.

3. Cost of Microfinance

Financial service is available at a price. Such price is expressed in terms of interest rate, fees and other charges. Interest is charged on all types of credit. Interest rate has to cover cost of fund, operating expenses, loan loss provisioning and profit. Interest rates on microcredit are higher than that charged by the banks mainly due to the higher operating costs and higher cost of fund. It inevitably costs more to lend and collect a given amount through thousands of tiny loans than to lend and collect the same amount in a few large loans. Higher administrative costs have to be covered by higher rates (Rosenberg et. al, 2013). A typical example of Indian case presented in Table 3 clearly shows that why microfinance interest rate is higher compared to that of a bank.

Table 3: **Example - Interest Rates in India**

(Percentage)

Components	*Bank*	*Microfinance*
Cost of Fund	8.0	10.5
Operating Costs	3.5	12.5
Loan Loss Provisioning	1.0	1.0
Profit	1.5	2.0
Interest rate	**14.0**	**26.0**

Source: ADB, 2016

Besides the interest, microfinance institutions collect various fees and charges. Hence, interest rate only does not reflect the total cost of the credit. As argued by Waterfield (2015), lenders have learned how to price products to look much less expensive than they are, making it very difficult for clients to compare prices with other lenders. According to Mitra (2009), many MFIs simply state that they charge only 15 percent flat rate of interest. But effective interest rate including processing fees, compulsory savings etc goes well over 100 percent per annum. To make the pricing of the microfinance transparent and comparable, Microfinance Transparency (MFTransparency) started to collect data on prices and compile the effective full annual percentage rate that included interest and all the fees and other charges. Such data are available for participating countries from 2009 to 2014 only as MFTransparency became defunct in 2015.

Data presented in Table 4 show that cost of microfinance is high in South Asia and very high in Sub-Saharan Africa compared to that of banks in the respective regions, although comparable data for interest rate of banks are unavailable. Baker (2013) argues that the cost of servicing loans is higher than for commercial banks because administrative charges for small amounts are proportionately higher than for larger amounts of money. Institutions have to charge an interest rate that will cover costs and continue to lend to future borrowers. The result is that the world's poorest people pay the world's highest cost for their loan. Sidhu (2015) argues that high cost on microcredit results in the poor becoming more indebted. Hence, poverty ends up being exacerbated with more people unable to bear the cost of interest rates on loans

Data in Table 5 show that a significant number of people do not have account because financial services for them are too expensive. This suggests that high cost also hinders the expansion of the financial access. More people are seen to be financially excluded in Sub-Saharan Africa compared to that in South Asia because of the high costs.

Table 4: **Cost of Microfinance**

(Total of interest rate, fees and charges, percent per annum)

S.N.	Country	Average Rate	Minimum	Maximum
South Asia				
1.	Afghanistan	25.00 +		
2.	Bangladesh			27.00 +
3.	India	30.58	22.00	41.00
4.	Nepal			18.00 +
5.	Pakistan	39.47	31.00	44.00
6.	Sri Lanka			40.00 +
Sub-Saharan Africa				
1.	Ethiopia	28.70	11.00	42.00
2.	Ghana	87.49	33.00	193.00
3.	Kenya	46.40	17.00	80.00
4.	Malawi	86.34	25.00	225.00
5.	Mozambique	81.20	37.00	118.00
6.	Rwanda	18.58	19.00	19.00

7.	South Africa		19.00 +	34.00 +
8.	Tanzania	58.60	59.00	59.00
9.	Uganda	41.04	31.00	65.00
10.	Zambia	75.12	75.00	76.00

Data Source: MFTransparency Database 2014; other sources for data with +.
+ Indicates that fees and charges are not included in this rate.

Table 5: **Reasons for Not Having Account**

(Percent of population aged 15+, 2017)

S.N.	Country	Financial Institutions are too far away	Lack of necessary documents	Financial services are too expensive
South Asia				
1.	Afghanistan	30	21	21
2.	Bangladesh	9	9	10
3.	India	5	5	6
4.	Nepal	20	10	17
5.	Pakistan	16	15	19
6.	Sri Lanka	6	4	10
Sub-Saharan Africa				
1.	Ethiopia	13	7	3
2.	Kenya	16	14	19
3.	Malawi	13	30	23
4.	Mozambique	24	19	19
5.	Rwanda	4	6	8
6.	Ghana	13	14	10
7.	South Africa	12	9	16
8.	Tanzania	29	25	32
9.	Uganda	30	20	38
10.	Zambia	19	25	19

Data source: Global Financial Index Database 2017, World Bank

4. Cost of Microfinance: A Country Case of Nepal

During 1980s, the policy focus in Nepal was on advancing financial development. Financial development was achieved to some extent but financial access could not increase due to concentration of banks and financial institutions in the urban areas. To address this problem, financial sector policies started to emphasize on financial access in 1990s. As a result, the number of banks and financial institutions and their branches increased significantly. However, such increase was again concentrated in the urban areas. With this development, people in most of the urban areas started to get full range of financial services from various banks and financial institutions and also from non-bank financial institutions. Fees and charges on financial services declined to a reasonable level due to increased competition.

Financial efficiency and access increased gradually in Nepal but such access could not become inclusive. Hence, as in other developing countries, various measures have been implemented to increase the level of financial inclusion in Nepal. Financial inclusion indicators show that only 45 percent of adults in Nepal have an account at a formal financial institution. Use of various financial service products is very low. Number of adults taking loan from a formal financial institutions is about 13 percent, while number of adults taking loan from family and friends is almost four times high (53 percent).

Because of the high operating costs, banks and financial institutions working in rural areas charge high fee and charges for their services. Limited payments and remittance services have expanded but mostly the microcredit has been the main financial service provided under the inclusive finance initiatives. However, microfinance institutions do not provide payments, transfer, deposit and saving services. Limited savings service provided by microfinance institutions are for borrower members only. Under the current modality, all types of institutions such as commercial banks, development banks, finance companies and insurance companies should be present in each and every place in order to provide full range of financial services.

The rate of interest on microcredit is very high in Nepal compared to that on the credit extended by banks and financial institutions. The weighted average interest rate of commercial banks on lending declined from 12.09 percent in July 2012 to 8.86 percent in July 2016 in tandem with the decline in weighted average deposit interest rates. It was due to the increasing level of excess liquidity in the banking system. However, the lending rate of microfinance development banks did not change accordingly although the cost of fund decreased due to the declining interest rate on their borrowing from commercial banks. In January 2017, Nepal Rastra Bank (the central bank of Nepal) capped the interest rate on microcredit at 18 percent.

Table 6: **Structure of Interest Rates in Nepal**

(Percent)

Year	*Weighted Average Interest Rate on Deposit of Commercial Banks*	*Weighted Average Interest Rate on Lending of Commercial Bank*	*Interest Rate on Lending of Microfinance Development Banks**
2013 July	5.25	12.09	20 - 24
2014 July	4.09	10.55	20 - 24
2015 July	3.94	9.62	18 - 24
2016 July	3.28	8.86	16 - 24

** Data on weighted average interest rate on lending of Microfinance Development Banks is unavailable*
Source: Nepal Rastra Bank

As discussed above, the interest rate on microcredit is high mainly because of the high operating costs as microfinance institutions cater to people in rural areas and deal with small size retail credits. Some microcredit advocates argue that if travel expenses and time taken to reach the commercial bank branch in a city are accounted for, the interest rate of 20 to 24 percent per annum charged on microcredit which is available at the door step in a rural area is still cheaper than interest charged by commercial banks on their lending. This argument cannot justify the unreasonable and disproportionately high interest rates.

The interest rates charged by commercial banks in Nepal on some of their loan products are presented in Table 7. It can be seen from the table that comparatively capable or well to do people could borrow money from a commercial bank to buy a private car at an interest rate as low as 3 percent per annum in 2015. In the case of microcredit, borrowers had to pay an interest rate which was 7-8 fold high compared to that for the car loan. On the other hand, micro credit borrowing is in small amount. Borrowers need to earn 30 to 40 percent return on their investment. Return below that is not sufficient to pay interest on credit and to cover their labor charges and land and building rent. This has led several microcredit borrowers to a debt trap.

Table 7: **Interest Rate of Commercial Banks on Loans in Nepal**

(Percent per annum)

S.N.	*Type of Loan*	*2015*	*2017*
1.	Working capital loan	7.0 – 11.0	9.50 – 17.00
2.	Export loan	6.0 – 10.0	7.00 – 15.50
3.	SME loan	8.0 – 13.0	10.00 – 17.00
4.	Home loan	7.0 – 12.0	9.00 – 17.00
5.	Auto loan	3.0 – 12.0	9.00 – 17.00
6.	Education loan	8.0 – 13.0	9.00 – 17.00
7.	Agriculture loan*	5.0 – 14.0	8.75 – 17.50
8.	Microfinance wholesale loan provided to institutions	3.0 – 7.0	7.00 – 15.00

* *Interest subsidy of 5 percent is provided by the Government for credit to commercial agriculture. Farmers pay interest rate less 5 percent subsidy.*

Source: Websites of commercial banks

Table 8: **Financial Indicators of Banks and Financial Institutions in Nepal (2015)**

(NPR billion)

Indicator	*Commercial Banks*	*Development Banks*	*Finance Companies*	*Microfinance Development Banks*
Capital Fund	122.17	30.30	10.53	6.20
Deposits	1462.90	237.10	71.95	16.06
Borrowings	18.42	2.45	0.48	38.50
Loans and advances	1103.15	193.46	64.72	55.33
Profit and loss account	27.66	6.30	2.80	2.60
Profit (as return on capital fund, percent)	***22.6***	***20.8***	***26.6***	***41.9***

Data Source: Nepal Rastra Bank

Table 8 compares the capital fund and profitability of different types of banks and financial institutions. The profit as the return on capital fund in 2015 is 22.6 percent for commercial banks, 20.8 percent for development banks and 26.6 percent for finance companies, whereas it is 41.9 percent for microfinance development banks. Commercial banks, development banks and finance companies are required to maintain cash reserve ratio (CRR), which makes their cost of fund high. However, microfinance institutions are not required to maintain such ratio. Similarly, banks and financial institutions are required to extend certain portion of their total credit to deprived sector. Instead of extending such loans by themselves, banks and financial institutions provide wholesale loan to microcredit institutions at a lower interest rate to meet the deprived sector credit obligation. Rate of interest on such loans are much lower than that on other loan products (Table 7). There are some reported cases that some microfinance institutions receiving wholesale loans at lower interest rates are depositing such funds in fixed deposits and earning higher interest instead of extending such funds as loan to deprived sector. All these tell the story that why the return on capital funds of microfinance institutions is so high compared to other mainstream banks and financial institutions in Nepal.

5. Possible Ways to Reduce the Cost of Inclusive Finance

It is obvious that mainstream banks and financial institutions are not willing to expand their services to rural areas and engage in retail banking as economic activities are low and operating costs are high in these areas. Hence, specialized institutions such as microfinance have been the main vehicles for increasing financial inclusion. However, high fees and exorbitant interest rates charged by them are an issue of serious concern.

In most of the developing economies, the interest rate charged on microcredit is almost double than that charged by the commercial banks. Some of the microfinance institutions deduct first or first few installments of interest payment from the loan amount itself, which makes actual interest rate almost same as that charged by the private money lenders. Because of this, critiques of microfinance argue that still exploitation is there, only the exploiters have been changed. The place of private money lenders has been taken by licensed exploiters. This argument is supported by the profit made by microfinance institutions. This clearly shows that high costs have reduced the net benefits of financial inclusion.

There are several cases that microcredit borrowers take loan from another institution to pay loan of previous lender and ultimately turn to private money lender to pay to the last lending institution. This is evidenced by reported service duplication and triplication situation in the areas served by multiple microfinance institutions. Microcredit borrowers fall into a debt trap as they cannot find a business which produces regular return which is enough to pay interest and charges on loans and to remunerate their own labor.

It is clear that cost issues must be addressed to increase financial inclusion and to make it really beneficial to service recipients. Following are some of the potential measures which can help in reducing the cost of financial services:

(i) ***Design new inclusive finance measures making the cost equitable as far as possible and implement them effectively:*** One way for this is to develop such a model in which each institution or unit of the institution can provide full range of financial services such as payments and transfer/remittance, cash deposit and withdrawal, credit, insurance/guarantee and investment instruments, among others under one roof. This may be possible with the innovative use of modern information and communication technologies. Extending multiple financial services under one roof may help service providing institution to achieve economies of scale.

(ii) ***Introduce initiatives to reduce the cost of inclusive financial services extended under the existing modality:*** Initially, availability of financial service was the focus of the financial access and inclusion policies. Now, it has been demonstrated that if cost is high then inclusive finance will not do any good. Instead, it may lead to legalized exploitation. To reduce the cost, some support should be provided until they migrate to the new modalities mentioned above in (i). Reducing the price of debt by restricting the interest rate is in the same category as reducing the price of food grains, ensuring a basic minimum of labor opportunities and enhancing the cash inflow of the poor (ADB, 2006).

(iii) ***Design targeted programs such that excluded section of population get financial services at below average costs:*** To be a financial service inclusive in its true sense, the cost of finance should be affordable. It is obvious that degree of affordability of each and every section of population cannot be the same. Hence, policies and programs should exercise positive discrimination. For this purpose, government subsidies or other form of support should be extended for infrastructural and technological investment in targeted areas.

6. Concluding remarks

Global efforts toward increasing financial inclusion have produced some results. However, the progress has been slow due to various constraints such as difficulty in physical access, low population density, high transaction costs, high interest and charges, documentation requirements, collateral-based lending, mistrust in financial institution and low level of financial literacy, among others. On the other hand, progress achieved so far has been uneven due to country or region specific challenges. As credit has been the major focus, access to other financial services such as payments, transfer of funds, deposits and insurance is limited. Given this situation, more effective measures should be implemented to speed up the progress toward achieving greater financial inclusion.

Financial inclusion policies and programs have emphasized on increasing the availability of financial services by urging mainstream banks and financial institution to expand their branch networks and by establishing new focused institutions. Due to the high operating costs and small transactions, mainstream banks and financial institutions are unwilling to expand their services in less attractive areas while fees and interest rates charged by the focused institutions such as microfinance on their services are very high. Several people have reported that they are unable to use available financial services due to high costs. Hence, high costs associated with financial services have been one of the major constraints toward increasing their use. On the other hand, whoever used financial services is not benefitting much due to high costs but low return on their investment.

It is obvious that until the cost issues are addressed, financial inclusion cannot progress satisfactorily as cost barrier is one of the frequently referred constraints to inclusive finance. On the other hand, service recipients cannot benefit in real terms from such expensive finance. Hence, policies and programs aimed at increasing financial inclusion should rethink about ways to reduce the cost and make it equitable. This can be possible through developing such a new model in which each institution or unit of the institution can provide full range of financial services under one roof. This may help in reducing the operating cost through economies of scale. In this regard, innovative use of modern information and communication technologies may be helpful. Furthermore, since inclusive finance policies generally are targeted to deprived sections of the population, efforts should be made to avail financial services to them at below average costs. This type of positive discrimination is necessary for full financial inclusion.

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