

Financial Inclusion and Financial Integrity: Aligned Incentives?

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Summary. — The Financial Action Task Force embraces financial inclusion as complementary to anti-money laundering and counter-terrorist financing, as it enhances transparency. This support is based on the premise that the increased use of formal financial services leads to a reduction of usage of informal services. We present evidence on eight African countries that both are not negatively associated. Moreover, informal employment and cash preference reduce the inclination to use mobile financial services. If an increase in transparency acts as disincentive to use formal services, the alignment of financial inclusion and integrity will fail.

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Key words — sub-Saharan Africa, financial inclusion, anti-money laundering, transparency, privacy, mobile money

1. INTRODUCTION

A large portion of the population in developing countries operates in the cash-based informal economy. They save, remit money, and access credit via nonregulated and nonsupervised financial services. Financial inclusion initiatives of multilateral agencies are aimed at extending formal financial services to those who are currently not using such services (CGAP, 2009). Inclusion into formal financial services, it is argued, contributes to economic growth as well as to poverty reduction. To aid higher levels of inclusion, entry thresholds that have excluded socially vulnerable customers such as affordability, eligibility, and geographical barriers are being addressed.

In June 2011 the Financial Action Task Force (FATF), the international standard-setting body for Anti-Money Laundering and Combating Financing of Terrorism (AML/CFT), expressed support for financial inclusion and stated that financial exclusion is a risk to financial integrity. A key underlying motivation for their support is the view that an expansion of formal financial services will improve law enforcement by increasing the number of transactions that become subject to AML/CFT controls and monitoring. In terms of this approach financial inclusion and financial integrity are complementary policy objectives. In 2012 this support was further strengthened when the FATF adopted new, revised Recommendations that were also broadened to combat tax crimes.

The hypothesis that underpins the FATF support is that the expansion of formal financial services translates into a reduction of informal financial services, thereby increasing the reach and effectiveness of AML/CFT controls, as financial transparency is increased.

In this paper we question this hypothesis in relation to developing countries. Our primary research question is whether such a reduction of informal service usage takes place in countries where it is observable that a significant share of the population uses formal and informal financial services in parallel. We present preliminary evidence drawn from different

household surveys conducted by FinScope as well as [Research ICT Africa \(RIA\)](#) in eight African countries (Botswana, Kenya, Namibia, Nigeria, South Africa, Tanzania, Uganda, and Zambia) on the use of formal and informal finance as well as the inclination of individuals to use more formal channels for financial transactions. The evidence shows that in many of these countries, holding a bank account is *positively* associated with the probability to use informal financial services. Therefore, use of formal financial services is not shown to translate into a lowering of the usage of informal financial services.

We also discuss the continued usage of informal financial services from the perspective of the cost–benefit trade-offs that customers make when choosing between formal and informal services. This paper highlights aspects of identification and related transparency of personal financial transactions to government and private sector players and the potential impact that it may have on the trade-offs customers make. Our second research question therefore is whether there are drivers (such as informal employment and preference for cash) that reduce the inclination to use more formal services for financial transactions.

* The authors acknowledge the assistance of FinMark Trust who kindly allowed usage of the FinScope data. The Centre for Financial Regulation and Inclusion (Cenfri) kindly facilitated access to the data and we are especially indebted to Cenfri's Mia de Vos for her research assistance. Moreover, the authors are indebted to the Central Bank of Kenya as well as Enhancing Financial Innovation & Access (EFInA), especially EFInA's Olamidun Laniyan, in Nigeria for access to databases. Neither Finmark Trust nor the Central Bank of Kenya or EFInA however bears responsibility for the analysis of the data or the findings in this paper. We also acknowledge the helpful feedback received from Dionysios Demetis, David Porteous, participants of the Shadow 2011 conference at the University of Münster, 28–31 July 2011 and three anonymous reviewers of this paper. The authors are, however, fully responsible for the views expressed herein. Final revision accepted: November 6, 2012.

We present preliminary evidence derived from the aforementioned RIA surveys on the inclination to obtain income or salary payments on mobile banking accounts. Such payments, especially when earned in the informal sector, may be taxable and clients would be concerned about theft or loss. We therefore expect some individuals to shun greater transparency in terms of considering the use of mobile banking—a more formal channel for financial transactions. The evidence shows that informal employment and a preference for cash reduce the inclination to obtain payments on a mobile banking account. This could be linked in part to some people's concern about their data, but there are no indicators to estimate that relationship at this stage.

For both types of estimations (informal financial service use and inclination to use a more formal channel to obtain salary payments) we used logistic regression in order to control for a number of potentially intervening factors such as gender, age, income, ownership of a Subscriber Identity Module (SIM) card, and place of living (urban/rural) as well as technology aversion. Independent of their influence, we find statistically and economically significant results in at least half of the countries analyzed. In the other cases, the results show the expected sign, but are not statistically significant.

Our second research question is whether there are drivers (such as informal employment and preference for cash) that reduce the inclination to use more formal services for financial transactions. This enables us to draw conclusions on whether financial inclusion will enhance financial transparency and advance AML/CFT controls in specific countries.

A note of caution is due. We regard our analysis as preliminary, because future research might define better proxies for inclinations of clients to use formal channels in order to conduct financial transactions. For this study, after evaluating the different household surveys conducted in our selected countries, we chose those proxies that appeared most closely related to our research question. Moreover, greater effort might be invested in future in finding a broader indicator for formal usage of financial services. However, our analysis is a first step into more in-depth exploration of motives to use formal and informal financial services. Based upon the evidence we have, we can state that in many countries analyzed herein, increased financial inclusion will under current conditions not reduce the use of informal financial services. Hence, the increased transparency that is pursued by the AML/CFT system will not necessarily follow greater financial inclusion.

The paper is organized as follows. Section 2 provides the literature review. Section 3 considers some theoretical considerations on incentives and trade-offs. Section 4 consolidates descriptive empirical results as well as analytical results while Section 5 concludes the article.

2. LITERATURE REVIEW

Our paper is at the intersection of different strands of the literature, addressing respectively financial inclusion, financial integrity, the shadow economy, and drivers and barriers to using formal financial services. The role of transparency in the choice between usage of formal and informal financial services, is relevant to the policy agendas of governments that are pursuing financial inclusion as well compliance with international AML/CFT standards.

"Financial inclusion" can be defined in general as ensuring access to formal financial services at an affordable cost in a fair and transparent manner (FATF, 2011a, p. 12). In the past decade the multilateral agencies have promoted financial sector

deepening as a means to improve economic growth, to reduce poverty, and promote social inclusion. Perceived benefits of financial inclusion, preliminary data, and strong anecdotal evidence (Demirgüç-Kunt, Beck, & Honohan, 2008; The All-Party Parliamentary Group on Microfinance, 2011, pp. 16–19) allowed financial inclusion to progress from a narrow focus on access to micro-credit to a broader concept that incorporates remittances, savings, and insurance products (Dittus & Klein, 2011).

Many researchers have probed the reasons why persons may not use formal financial services. Among those not using formal financial services are persons who elect not to use such services (the voluntarily self-excluded) because they have no need of such services, decline to use them for religious or cultural reasons (Beck, Demirgüç-Kunt, & Honohan, 2009, p. 122) or lack trust in formal financial institutions, for example where they experienced bank failure or fear fraud (Dittus & Klein, 2011, p. 4). Those who wish to access formal financial services may face barriers such as affordability (as formal services are often too costly for low income persons), inappropriate product design (resulting in products that do not meet the needs of excluded customers) and inability to meet eligibility criteria (for example not having sufficient assets to meet conditions for the extension of a loan or being unable to provide documentation evidencing identity) (Bester *et al.*, 2008, pp. 5–7; European Commission, 2008, pp. 40–47). Customers who scaled access barriers may, however, also withdraw from formal financial services. Previously banked customers may withdraw from formal financial services for a variety of reasons including costs, lack of trust, bad credit records, difficulties managing spending, and inappropriate product design (Ellison, Whyley, & Forster, 2010, pp. 15–16). For purposes of this article, the literature regarding usage of accounts by newly-included clients is also relevant. Many formerly excluded clients may be persuaded to open an account that is designed to meet their requirements, but experience has shown many of these accounts may become dormant (Bankable Frontier Associates, 2009). Take-up therefore does not necessarily translate into active usage of an account for day-to-day transactions (Bankable Frontier Associates, 2010; Platt, Singh, Bansal, Giri, & Tiwari, 2011).

In recent years initiatives to increase financial inclusion in developing countries has focused increasingly on the use of technology. Mobile banking is particularly prominent in this regard and an increasing number of financial inclusion studies are focused on mobile money. Mobile banking models leverage off the enormous success of mobile phone uptake in developing countries by using the phone as a key channel to reach new and underserved customers (Pickens, Porteous, & Rotman, 2009). It was estimated in 2009 that more than 1 billion persons without bank accounts had mobile phones (Pickens, 2009). Mobile banking models rely generally on a large range of nontraditional agents such as retailers to provide cash-in and cash-out functions. This enables service providers to extend their reach while keeping service costs low (Chatain, Hernández-Coss, Borowik, & Zerzan, 2008).

Financial inclusion initiatives, including mobile banking developments, in a number of countries were hampered by, among others, regulatory concerns regarding the compliance of proposed new regulatory models with international financial integrity standards (Chatain, Zerzan, Noor, Dannaoui, & de Koker, 2011, pp. xxix–xxx; FATF, 2010). Financial integrity is a broad term that has lately been used to refer to measures that protect financial services against abuse for money laundering and terrorist financing purposes.

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