Financial access and financial stability

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Introduction

The provision of wider access to formal financial services is increasingly becoming a focus of governments and monetary authorities. An issue that must be considered is whether or not such increased access jeopardises financial stability. This paper takes the view that the promotion of access will enhance financial stability in both the long and the short run. The paper also identifies those areas where central bank involvement can promote such a mutually reinforcing process.

Access to services in banking as a development challenge

Countries are faced with the challenge of increasing provision of banking facilities to firms and households alike. A well functioning banking sector can play an important role in channelling resources to the best firms and investment projects. While large companies tend to be well catered for, small enterprises often have to rely on their own funds. The access to finance and the quality and cost of the service that small businesses receive from banks are key to their profitability and prosperity (and that of the economy). For a household, the implication of a lack of access to banking services is severe. The issue of access affects the ability of a household to receive government transfers, or to make payments or to accumulate cash surpluses for planned expenses or emergencies. Individuals who have no option but to carry cash are exposed to security risks. The lack of a vehicle for saving may result in low-income households resorting to expensive short-term debt.

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Table 1

Branch and ATM penetration across countries

	Geographical branch provision	Demographic branch provision	No of ATMs (year)	Geographical ATM provision	Demographic ATM provision
Botswana	0.11	3.77	84 (2003)	0.27	9.00
Kenya	0.77	1.38	242 (2005)	0.56	0.99
Mauritius	71.92	11.92	261 (2003)	133.0	22.04
Namibia	0.11	4.47	235 (2003)	0.30	12.11
Nigeria	2.41	1.62	>352 (2005)	-	370
South Africa	2.22	5.99	14,024 (2005)	6.49	17.5
Tanzania	0.23	0.57	67 (2005)	0.07	0.17
Uganda	0.67	0.53	>150 (2005)	0.90	0.70
Zambia	0.21	1.52	-	0.09	0.65
Zimbabwe	1.11	3.27	288 (2003)	1.15	3.38
Median of 99 countries	**4.80**	**8.42**		**10.07**	**16.83**

Note: Geographical branch or ATM provision refers to the number of branches or ATMs per 1,000 square km. Demographic branch or ATM provision refers to the number of branches or ATMs per 100,000 people.

Source: Beck et al (2005).

The data in Table 1 are those for the geographical and demographic provision of bank branches and ATMs for a selection of African countries. The data provide an indication of the potential access to financial services for firms and households. The median data for some 99 developed and developing countries are shown in bold.

The data suggest that only Mauritius exceeds the median values for both branches and ATMs. South Africa exceeds the median values for ATM provision only.

It is widely agreed that access to financial services can help to distribute opportunities more evenly, especially for poorer households and small businesses.[2] Discussions about access inevitably revolve around changing supply conditions so that the needs of the consumers can be met and usage encouraged. Policy to encourage access must, however, take the objectives of financial stability into consideration.

Financial stability in developing markets

Financial stability requires an effective regulatory infrastructure, effective financial markets and effective and sound financial institutions.[3] It should be noted, however, that while financial stability is associated with efficiency, efficiency on its own does not guarantee that the land is flowing with milk and honey. While efficiency is a necessary condition for net economic welfare, it is not a sufficient condition.

The financial system comprises a number of interrelated components – infrastructure (including legal, payment, settlement and accountancy systems), markets (stock, bond, money and derivatives) and institutions (banks, securities firms and institutional investors). A disturbance in any one of these areas can affect the stability of the system, and risks may arise in any one of these areas. For example, an inefficient payment or settlement system can undermine the speed and accuracy of transactions. The reputational risk of one set of participants can undermine public confidence in the banking institutions.

An independent and non-corrupt judiciary and effective laws to protect property are essential to promoting access to financial services. If loan

[2] Claessens (2005).
[3] South African Reserve Bank (2004).

contracts are not easily enforceable, then banks will not be willing to lend – a problem that may help explain the excess liquidity of banks in a number of African countries. An example is the case of Cameroon, where the legal system allowed the fraudulent attachment of bank deposits as the payment for alleged debts (the "saisie-attributions"). Subsequent legal reforms have helped to contain this problem, which discouraged the use of financial intermediaries.

Over and above these elements, there are potential exogenous risks, which stem from problems outside the financial system and include natural disasters, political disruptions or even the failure of a non-financial company.

Most of the central bank policy instruments designed to promote financial stability directly also affect it indirectly. Prudential instruments protect depositors, monetary policy fosters price stability, and payment and settlement systems promote the swift settlement of financial transactions.[4] While analysis of financial stability overlaps to a large extent with macroprudential analysis of the economy and microprudential analysis of systemic firms and markets, the analysis is incomplete without taking into account the ability of the system to absorb disturbances. In addition, more than one set of risks may manifest simultaneously. Emerging markets may be less resilient in the face of financial instability because their ability to absorb disturbances may be undermined by lack of industrial diversification and weak macroeconomic management.[5]

The issue of financial stability requires an explicit central bank focus – over and above the pillars of prudential soundness, stable monetary policy and an efficient payment and settlement system. The issue of enhanced access also requires explicit regulatory attention. A stable monetary policy on its own does not directly improve the access of small firms to bank credit.[6]

The discussion below identifies regulatory interventions that can both encourage access and reinforce these pillars of central bank policy.

[4] Shinasi (2005).
[5] BIS (1997).
[6] IMF (2005).

The role of the central bank

Each of the subsections below discusses the role of the central bank in enhancing both access and financial stability.

(a) Tiered banking

For the public sector it would be of great benefit if every citizen had a bank account, for which there are both private and social benefits. The private (individual) benefits of access to banking services include the ability to save and to build financial buffers against adversity. Such access also reduces the cost of making payments. Social benefits (ie benefits for society as a whole) include reduction of theft, improved mechanisms for social transfers and other remittances (including tax and benefit remittances) and improved economic linkages to rural and deprived communities.

Central banks can allow for different tiers of banking, with different permissible activities, so as to facilitate new banking entrance and harness these benefits – without exacerbating risk in the system.

Second-tier banks may be "narrow" or "core" banks: in the case of a so-called "narrow" (or savings) bank, all deposit liabilities are invested in approved highly liquid money market instruments and no other credit business is allowed, while so-called "core" (or savings and loan) banks can engage in lending to the private sector provided such loans are funded from their second-tier capital (in essence the core banks' subordinated debt).[7]

Third-tier banks, like first-tier banks, can use deposit liabilities for lending to the private sector, but only if their depositors and lenders are from the same community. Third-tier banks are smallish operations such as village banks, community banks and cooperative banks. The key issue here is that the possible bankruptcy of a third-tier bank should pose no systemic risk whatsoever for the financial sector at large.[8]

The minimisation of risk from the central bank's point of view is a consequence of limited credit risk exposures of second- and third-tier banks. The tiered banking mechanism does not compromise regulatory

[7] For more detail, see Bossone (2001).
[8] Falkena (2004).

Table 2

International comparison of selected banking and institutional indicators (2002)

	Number of banks in market for deposits	Net interest margin	Bank concentration (top three banks)
Botswana[1]	5	5.7	88
Ghana	17	11.5	55
Kenya	53	5	61.6
Lesotho[1]	3	11.96	99
Mauritius[1]	10	11.1	79
Mozambique	10	5.9	76.6
Nigeria	51	3.8	86.5
South Africa	59	5	77
Tanzania	29	6.5	45.8
Uganda	15	11.6	70
Zambia	16	11.4	81.9

[1] Hawkins (2003).
Source: Buchs and Mathisen (2003).

standards, but recognises that not all banks provide the full range of first-tier commercial banking services and that regulations and supervisory practices should be appropriate to the activities of banks.

Tiered banking potentially provides a mechanism for regularising informal financial service providers and extends the benefits of supervision. It provides a development mechanism for existing institutions such as microfinance institutions (MFIs). If, for example, we have a situation where large MFIs on a sound financial footing seek to grow (Senegal)[9] or if we have a situation where deposit-taking is restricted to banks (South Africa), the provision of a second-tier bank licence may encourage regularisation.

Through tiered banking, central banks can facilitate new bank entry to supplement the services offered by first-tier commercial banks, extend access and enhance financial stability through the extension of regulatory and supervisory reach.

(b) Competition in banking

Barriers to greater use of banking services include not only physical accessibility, but also inappropriate products and pricing. Competition can address this: because of the central role of the banking system in the economy, the role of competition is particularly important in banking.

The conventional analysis of competition in the banking industry usually focuses on factors such as the number of suppliers in an industry, the market share of the dominant players, etc. While the number of banks varies, the concentration levels for the top three banks are high in Africa (with Tanzania and Ghana the outliers); see Table 2.

However, the ease of entry and exit – in other words the contestability of the market – may be at least as important as the number of suppliers. Where contestability is high, incumbent firms are restrained from exercising monopoly power (such as through high costs, prices and profits) because if they were to exploit market power this would immediately induce new firms to enter the market. It is the credible *threat* of entry that deters anti-competitive behaviour by incumbents. While the number of actual competitors is largely irrelevant in

[9] IMF (2005).

determining competitive conditions in a contested market, it becomes a matter of greater concern where there are high barriers to entry or restricted access to essential infrastructure. In Table 2, the net interest margin varies widely, even where concentration levels are similar. While concentration levels are slightly lower in Zambia than Botswana, the interest margin is substantially higher in the former.

A market can be competitive (as measured in traditional ways) but competition may nevertheless not be *effective*. Even though there may be many competitors in a market, competition is only effective in practice if the consumer is able to (i) make a rational choice between competitors, and (ii) exercise choice at low transaction costs. Both may be impeded by obscure pricing and bundling of services.

Central banks can play a role in ensuring that there is sufficient contestability so that incumbents' market power is kept in check. This involves ensuring that licensing does not become too great a barrier. Allowing for tiered banks and foreign bank entry can also contribute to the contestability of certain market segments. Privatisation of state-owned banks can foster both competition and access if it is managed well. Ironically, state ownership of banks has not led to wide access to appropriate services, nor does it appear to contribute to economic development.[10] The central bank can assist the process of privatisation by encouraging sound supervision of state-owned banks through improved accounting standards and the like while they continue to operate as such.

Regional integration initiatives can also enhance effective competition and contestability. In both the CEMAC and the WAEMU (the two CFA franc zone groupings), banks need only a single banking licence to operate in the region. The central bank and bank supervisory authorities have roles to play in establishing a level playing field, facilitating payments within the region, and establishing an effective region-wide money market. Cooperation among central banks can provide the groundwork for more effective competition, even in the absence of a common currency, for instance through the harmonisation of payment systems (as in SADC).

In addition, the central banks can play a supervisory role in ensuring that banks disclose prices to consumers in a consumer-friendly way.

[10] Ingves and Berengaut (2004).

(c) The national payment system

For an economic system to function properly, a payment system is required so that settlement between buyers and sellers can be arranged efficiently. Payment inefficiencies, such as manual procedures and numerous paper-based controls, can impose major costs on financial intermediaries and thus on the economy. At the same time, the payment system must be well designed from a risk management point of view if it is not to be a potential source of systemic risk.[11]

The central bank can play a role in balancing the interests of larger and smaller banks and encouraging appropriate innovation. This may not only involve the central bank in providing a strategic leadership role in the payment system, but may also include establishing the principles of transparency of payment rules and procedures and access standards – for banks and non-banks alike.[12]

Outreach to rural and outlying areas (through facilitation of payment services) can be greatly enhanced by new technologies, but consumers may take some time to trust new instruments. Clearly access (supply) is not the same as use (demand), but the central bank can play a role in ensuring public confidence in new instruments.[13]

(d) Deposit insurance

The objective of a deposit insurance scheme is to promote confidence and stability in the financial system and to provide protection for unsophisticated and small depositors. The benefit of a compulsory deposit insurance scheme is that it cover all banks and depositors, and not only some banks or only the weaker banks. Some aver that without deposit insurance, small depositors will never migrate their support from the dominant banks in an economy. Hence deposit insurance may encourage confidence in small and second-tier banks and underpin their sustainability. But deposit insurance should not be introduced with the main objective of solving problems associated with emerging banks, and a financial system should be sound before deposit insurance is introduced.

Deposit insurance can be implicit or explicit. Implicit deposit insurance exists where there are no stated rules but depositors have assurances

[11] Committee on Payment and Settlement Systems (CPSS) (2001).
[12] CPSS (2005 and 2006).
[13] CPSS (1999), (2000), (2003) and forthcoming.

Table 3

Types of deposit protection systems in selected countries

	Implicit	Explicit	Date enacted/revised	Coverage limit ($)	Funded by
Cameroon	▪				
Ghana	▪				
Kenya		▪	1985, compulsory	1,750	Banks and govt
Nigeria		▪	1988, compulsory	2,435	Banks and govt
South Africa	▪				
Tanzania		▪	1994, compulsory	376	Banks and govt
Uganda		▪	1994, compulsory	2,310	Banks and govt
Zambia	▪				
Zimbabwe	▪				

Source: JDI Online Library (2006); Kane (2004).

implied by governments' action, through either precedence or stated intention. In Table 3, Cameroon, Ghana, South Africa, Zambia and Zimbabwe may be seen to have implicit deposit insurance. Explicit deposit protection, where the terms and conditions of the scheme are explicitly stated in a statute, exists in Kenya, Nigeria, Tanzania and Uganda. The scheme provides a legally enforceable guarantee on all, or a portion, of the principal, and in some cases the interest, of certain deposits. The table shows the date of the existing statute, the coverage limit and the source of funding in each country. Both the banking sector and the government typically bear the burden of deposit insurance in African countries.

Central banks can help identify the appropriate base for the funding of deposit insurance (as, say, a percentage of bank deposits and non-performing loans) and the appropriate coverage limits. In addition, their role in encouraging the soundness of each insured institution is crucial.

(e) Foreign-owned banks

The entry of foreign banks usually helps to improve financial sector efficiency and risk management, including capital allocation based on risk-adjusted profitability and corporate governance based on widely dispersed ownership. It can enhance competitiveness and may encourage innovation. In certain circumstances, it may lead to rapid extension of credit.[14] Foreign banks may also prove to be more resilient than local banks at times of crisis.[15]

However, foreign ownership poses challenges for host countries. This is primarily due to the different organisational structures of foreign-owned banks and the lack of harmony between foreign and local legal and regulatory systems.[16] The issue of foreign-owned banks in emerging markets was recently reviewed in a special Working Group of the BIS's Committee on the Global Financial System.[17] These issues were extensively reviewed in a series of workshops held to follow up some of the issues raised in the CGFS report.

Central banks need to have adequate information to ensure appropriate supervision of foreign banks and adequate assessment of their activities. Harmonisation of the legal and accounting frameworks and

[14] See also Domanski (2005).
[15] Clarke et al (2001).
[16] The discussions at these workshops are summarised in Committee on the Global Financial System (CGFS) (2005).
[17] See CGFS (2004).

bankruptcy procedures of host countries with international norms may ease this task.[18]

Conclusion

The discussion suggests that the central bank objectives of financial stability and financial service access may be mutually reinforcing. However, a central bank that adopts these strategies would need to be aware of the following practical implications:

– *The prioritisation of policies*. While the policies discussed above are complementary to achieving an accessible, yet stable, banking environment, some priorities may be easier to implement than others. For example, improved disclosure requirements on banking services and the development of enabling legislation for second- and third-tier banks may be easier to facilitate than the privatisation of state-owned banks. Setting up deposit insurance may be a prerequisite for the sustained participation of second-tier banks.

– *The impact on the regulatory and supervisory structures*. The successful implementation of these policies will require enhanced supervisory capacity and skills. Central banks must meet the challenge of assigning resources accordingly.

– *The communication of the objectives of such policy*. The central bank and government need to speak with one voice to the public and the financial sector, so that the objectives are clear and publicly supported.

[18] Song (2004).

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