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Finance for All

# The Paradox of Financial Inclusion and Exclusion

Is it possible for people who have been financially included in the formal financial sector to become financially excluded again after a while? Is this a paradox? Can this really happen? If this happens, why does it happen? These are some real questions that the financial inclusion practitioners may face while working towards promoting financial inclusion.

In reality, certain conditions such as favourable policies and regulations encourage greater formal account ownership and attract households and poor individuals to own a formal account which gives them access to formal savings, formal credit and other basic financial services. In contrast, other conditions such as discriminatory and unfriendly institutional profiling, high account maintenance fees, multiple taxation, excessive bank charges and unfriendly attitude can discourage formal account ownership and formal account usage. These conditions make people abandon formal financial services, leading to greater patronage of informal financial services such as peer-to-peer lending and increased usage of the services of informal moneylenders.

Undoubtedly, formal account ownership can give unbanked adults access to formal financial services. Owning a formal account improves the access to credit, deposit and saving products from the formal financial institutions in the absence of any constraints. When constraints are non-existent, the marginal benefit of using formal financial services is positive.

A paradox arises when agents of financial inclusion incorporate economic and social constraints in offering formal financial services. These constraints limit the ability of poor customers to use financial services to the fullest extent. The constraints affect agents of financial inclusion positively and affect customers negatively up to a point where the marginal benefit of being financially included is negative for some customers.

When the marginal benefit of using formal financial services becomes negative, the affected customers (or banked adults) will

evaluate the cost of each constraint they face, and make a decision on whether to discontinue using their formal accounts or to exit the formal financial sector when they can no longer bear the negative effect of certain constraints. These constraints can compel poorer customers to exit the formal financial sector while other customers may abandon their formal accounts, making it inactive and dormant for a long time, and after a while, the formal accounts are closed by the financial institutions which lead to financial exclusion.

A simple illustration of the financial inclusion-exclusion paradox can be provided as follows. In the context of the financial inclusion drive in a country, extensive policy efforts, new and innovative financial products/services development and marketing, and advocacy and persuasion are used to bring the unbanked adults into the formal financial sector. These new entrants become the customers of financial institutions and service providers such as the banks, MFIs and Fintech agents. The new entrants are offered formal accounts which can give them access to credit, deposit, savings and other financial products and services. Further, the expectation is that the excitement of the new-entrants about their new opportunities will also induce them to invite other family members and friends to join the formal financial sector, leading to higher demand for formal financial services.

This, then creates an opportunity for the banks and fintech businesses to profit from the growing market by introducing fees and charges such as account maintenance fees, charges for using Fintech platforms, fees for using certain financial products, etc. These fees usually have no effect on high-income users and users who receive frequent account inflows because their frequent account inflows (or infrequent large account inflows) helps to dampen the effect of the cost of financial services.

On the other hand, fees imposed for using financial services can become burdensome to low-income customers, poor customers, and customers who receive little or no account inflows – this group of people may have been jobless or heavily indebted prior to joining the formal financial sector – and the fees imposed for using financial products and services can wipe away the margin that low-income and poor customers hope to gain by joining the formal financial sector. This can lead to dissatisfaction and frustration among the low-income and poor customers; they can become hesitant to use the formal financial services again until their accounts are closed while other dissatisfied customers may prefer to exit the formal financial sector. This describes how previously banked adults may become unbanked again which we may term as the financial inclusion-exclusion paradox.

The relevant issue is: How to resolve the paradox? This requires significant policy efforts to eliminate all constraints using relevant policy instruments including partnership with the private sector as well as cooperation and advocacy. Social constraints, such as informal norms, cultural barriers and unfriendly profiling should be eliminated through community orientation and re-orientation programmes. Economic

constraints, such as high interest rates, undue cost of financial services, and high tax rates, can be eliminated through more productive and remunerative employment generation policies, public works programmes, lower taxes, introducing regulation that lower the cost of financial services for low-end customers, and similar measures.

Another potential policy is to introduce an income-based costing approach for financial products and services. Many agents of financial inclusion such as banks and Fintech players adopt a fixed cost approach to pricing financial products and services. They charge the same fee to poor users, low-income users, middle-income users and high-income users who use these financial products and services. Such fixed costing approach affects low-income and poor customers more than it affects the middle-income and high-income users.

The alternative costing approach would be the income-based approach. This approach allows the low-income customers to pay a lower fee and poor customers pay a much lower fee, when they use these financial products and services, than the fees paid by high-income customers. This approach will reduce the cost burden on the banked poor adults and encourage them to remain in the formal financial sector, thereby preventing a situation where poor customers exit the formal financial sector due to high cost of financial services. To adopt the approach, agents of financial inclusion should develop a model that categorise customers into income groups, and then allocate a price to each income group so that the customers are charged the fee associated with the income category to which they belong.

Although the above illustration may appear simplistic, the fact is that many deeper social and economic constraints exist in the formal financial system and these constraints can make banked adults become unbanked again. The outcome provides a paradox because banked adults can become financially excluded (or unbanked) when economic and social constraints make it difficult for them to remain in the formal financial sector. They may feel better off when they are outside the formal financial sector.

For resolving the paradox, policy makers should identify these constraints and understand how they affect access and use of basic financial products and services especially how it affects the low-income and poor individuals. Once the real reasons are identified, policy instruments can be used to eliminate some of these constraints. In addition, public-private partnership and collaboration can also help to eliminate some of these constraints.

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