Financial Inclusion and Stability: Linkages Among Financial Development and Economic Growth

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Abstract

Purpose. More than half of the world’s adult population lacks access to credit, insurance, savings accounts, and other forms of formal financial services. Therefore, providing access to financial services for all has become a priority for national policymakers, multilateral institutions and other players in the development and innovation field. The aim of this paper is to answer the following questions: What are the key processes that lead to an inclusive financial system and what are the wider (longer term) impacts of improved financial inclusion on the lives of disadvantaged people, their quality of life and life chances.

Approach. The questions are answered by adopting a multi-stage approach. The first stage involves ‘talking’ to ‘knowledgeable’ individuals of agencies/projects that deliver financial inclusion services and aims at getting a sense of the types of agencies that deliver financial inclusion, their experiences with promoting financial inclusion, and the (perceived) wider impact on service users. The second and third stages are central to this paper since they aim at capturing how people make use of financial inclusion services and the longer term impacts of improved financial inclusion on their life chances and quality of life.

Findings. As economy is moving towards virtual currencies and digital innovations in finance, a bank account has become an essential tool in shaping an inclusive financial system, given its promise to reduce or eliminate the inefficiencies surrounding the conduct of specific types of financial transactions, and to increase financial inclusion. Moreover, access to banking is considered a basic necessity in most developed countries. Financial services and instruments play an important role in the process of domestic economic development. While some scholars have focused on the interaction of large or small enterprises, the most important consumers of financial products are the households due to their influence the scale and asset mix of finance.

Value. The paper takes into consideration digital innovations in finance (or FinTech), which have, in recent years, attracted considerable attention from public authorities, financial sector stakeholders and academia, given their promise to reduce or eliminate the inefficiencies surrounding the conduct of specific types of financial transactions, and to increase financial inclusion.

Keywords: Financial inclusion, Financial innovation, FinTech, Crowdfunding, P2P, Microfinance, Poverty, Remittances, Financial development, MFI, IFI
1. INTRODUCTION

It is generally accepted that reducing poverty\(^1\) and social exclusion should lie at the heart of government policy. The term social exclusion is, at times, used as a synonym for poverty. However, as Burden has aptly observed, poverty focuses more on the distribution of resources, while social exclusion represents a wider concept, which is set against the background of globalisation, and the structural changes that it brings (Burden, 2000). Social exclusion has been defined as “a short-hand label for what can happen when individuals or areas suffer from a combination of linked problems such as unemployment, poor skills, low income, poor housing, high crime environments, bad health and family breakdown” (Sinclair, 2001). Social exclusion raises broader issues than poverty that cannot be solved by income transfers. Besides, even if the concept of social exclusion shares a similar cluster of ideological and political implications with the concept of poverty (Atkinson, 1998), policies designed to relieve poverty are only one aspect of an inclusive policy designed to reduce or eliminate social exclusion.

One of the facets of social inclusion, the antithesis of social exclusion, is financial inclusion, which has been viewed as an “important condition for sustaining growth” (Subbarao, 2009). By creating opportunities to save and invest, and by enhancing access to credit, an inclusive financial system can generate substantial benefits for the less socially advantaged. Promoting financial inclusion\(^2\) has received an increasing share of attention in the recent years, as demonstrated by the number of countries that committed to the Maya Declaration\(^3\) and the G-20 Financial Inclusion Action Plan, as well as by the strategies and targets set by central governments. Despite its various dimensions, and the ensuing challenges in defining the concept, the Alliance for Financial Inclusion (AFI, 2010) states that a clear definition of financial inclusion is needed to “track progress in achieving more inclusive financial systems and gauge their impact.” Definitions as well as measurements of financial inclusion have evolved over time, from classifying individuals and enterprises as either included or not, to viewing financial inclusion as multi-dimensional. In a bid to define the concept, the Financial Inclusion Data Working Group of the Alliance for Financial Inclusion (AFI FIDWG)\(^4\) agreed on three main dimensions of financial inclusion,

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1 As stated in the European Anti-Poverty Network’s Note, Poverty and Inequality in the European Union, “poverty is generally divided into two types, absolute or extreme poverty and relative poverty. Absolute or extreme poverty is when people lack the basic necessities for survival. For instance, they may be starving, lack clean water, proper housing, sufficient clothing or medicines and be struggling to stay alive. This is most common in developing countries but some people in the European Union (EU), for instance homeless people or the Roma in some settlements, still experience this type of extreme poverty. Relative poverty is where some people’s way of life and income is so much worse than the general standard of living in the country or region in which they live that they struggle to live a normal life and to participate in ordinary economic, social and cultural activities. What this means will vary from country to country, depending on the standard of living enjoyed by the majority”. For a more detailed read, please see Poverty and Inequality in the EU section of The Poverty Site. Available at http://www.poverty.org.uk/summary/eapn.shtml, accessed on 22 April, 2017.
3 The Maya Declaration is the set of commitments to financial inclusion made by AFI members. More information is available at http://www.afi-global.org/gpf/maya-declaration (accessed 10 July 2017).
4 Formed in 2009, the AFI FIDWG aims to develop and promote a framework for measuring financial inclusion to be used by all AFI members, and to create opportunities for members to share lessons learned on financial inclusion data collection and policymaking.
providing the underpinning for data collection: access, usage and quality. The World Bank’s 2008 report (World Bank, 2008) had a different focus, stating that “financial inclusion, or broad access to financial services, is defined as an absence of price or non-price barriers in the use of financial services.”

Promoting access to financial services has become a major concern for policymakers in developing countries. Broad access to financial products is interconnected with social and economic development (World Bank, 2008). In this regard, a developed financial system is important in achieving economic development and poverty alleviation (Beck et al., 2000; Beck et al., 2004; Honohan, 2004a; OECD, 2012). In this respect, Sarma (2008) and Aghion (2008) argue that through finances, growth is achieved because it fuels ‘creative destruction’ by allocating resources more efficiently. This means that through broader access to financial services, newcomers are “empowered and freed from the disadvantages that would otherwise arise from their lack of inherited wealth and absence of connections to the network of well-off incumbents” (Rajan et al., 2003).

The Copenhagen World Summit on Social Development of 1995 defined poverty as “a condition characterised by severe deprivation of basic human needs, including food, safe drinking water, sanitation facilities, health, shelter, education and information. It depends not only on income but also on access to services” (UN, 1995). Irrespective of the particular wording that one might choose, what the various definitions of this concept have in common is that they all attempt to define the minimum standards of living that everyone ought to have, regardless of their country of residence. The emphasis is, thus, on the inadequacy of living standards of those in need, as stated by the United Nations (Lister, 2004).

At the political level, there are tendencies towards a harmonised definition of poverty across countries. International treaties and agreements (EEC, 1981; EEC, 1985) at the European level defined poverty in terms of having insufficient resources to participate in a “minimum acceptable way of life” even though the EU has reverted on occasions to the relative income standard – that is, the number and percentage of population with less than half, or a smaller or larger fraction of, average household income. In recent years, the European Commission has become a significant protagonist in the debate about poverty. The Commission (CEC, 1993) supports a definition which sets the poverty line at 50 per cent of average

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5 In 1975, the Council of Europe adopted a relative definition of poverty as: “individuals or families whose resources are so small as to exclude them from the minimum acceptable way of life of the Member State in which they live” (EEC, 1981). The concept of ‘resources’ was defined as: “goods, cash income, plus services from public and private resources” (EEC, 1981). On 19 December 1984, the European Commission extended the definition: “the poor shall be taken to mean persons, families and groups of persons whose resources (material, cultural and social) are so limited as to exclude them from the minimum acceptable way of life in the Member State in which they live” (EEC, 1985). According to UNICEF, this definition “is today the most commonly used definition in the industrialised world” though “for practical purposes” it is usually interpreted as “those whose incomes fall below half of average income” (UNICEF, 2000).
Digital innovations in finance (or FinTech) have in recent years attracted considerable attention from public authorities, financial sector stakeholders and academia, given their promise to reduce or eliminate the inefficiencies surrounding the conduct of specific types of financial transactions, and to increase financial inclusion. Pursuant to a Draft Report of the European Parliament on FinTech, “new technologies are rapidly changing the nature of the financial infrastructure around the globe” (European Parliament, 2017). Significantly, the European Parliament is only one of a number of stakeholders that have expressed an interest in the transformational potential of digital innovation. Whether financial market actors will reap the benefits of digital innovation, and what the latter’s contribution will be to fighting poverty and increasing financial inclusion, will largely depend on the extent to which policymakers can ensure the creation of the appropriate legal, regulatory and institutional environment.

The extant literature documents the existence of a strong link between a well-functioning financial system and inclusive growth. What follows is a concise review of the literature, to illustrate the point.

2. LITERATURE REVIEW

Whilst several scholars have expressed the view that there is a clear connection between economic and financial development, there is still uncertainty as to whether financial development also implies financial inclusion. Hannig and Jansen found that, at the heart of financial inclusion, is the need to bring the segment of the population that is outside of the financial system (the so-called ‘unbanked’) within the fold of the formal financial system, giving them the opportunity to access financial services whether in the form of savings, payments, transfers, credit or insurance. Similarly, Sarma and Pais define financial inclusion as the process that ensures the ease of access, availability and usage of the formal financial system for all members of an economy.

Kendall, Mylenko and Ponce define financial inclusion as the process of providing financial services to the poor. For its part, the Indian Committee on Financial Inclusion, and Rangarajan have opined that financial inclusion may be defined as the process of ensuring access to and use of financial services and timely and adequate credit where needed by vulnerable groups, such as weaker sections and low income groups, at an affordable cost in a fair and transparent manner by mainstream institutional players.

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6 Income is undoubtedly a good proxy of living standards, and income deprivation has been very effective in guiding policy action and raising public concern for poverty. Yet, it is not without shortcomings. First, income fails to represent the full amount of available resources, as individuals can also rely on real and financial assets to cope with the needs of everyday life and to face unexpected events. The omission of wealth may appear somewhat surprising in light of the standard economic theory of consumption behaviour, where the budget constraint embodies current net worth together with the discounted value of current and future income flows. In empirical applications, the omission is often forced by the lack of a database with both income and wealth information, but it may also reflect the slow development of analytical tools accounting for the role of assets in the poverty definition.
Despite the constant evolution of the process of financial globalisation, and the fact that digital financial innovations are gaining ground, bank accounts remain essential tools for financial inclusion. However, at times of limited liquidity, new forms of raising capital, such as crowdfunding, are asserting themselves on the back of digital financial innovation. Lambert and Schwienbacher, Schwienbacher and Larralde, and Valanciene and Jegeleviciute were amongst the first scholars to define and explain the concept of crowdfunding. In their view, the concept is defined as a way of financing a project, or a company, through the internet. The financial resources come from a large number of individuals, who may provide money either in the form of donation or in exchange for financial or nonfinancial rewards; this view is adopted by De Buysere et al. as well. In their definition of crowdfunding, Kleeman et al. have emphasised the importance of this phenomenon in the financial system by stating that “it is clear that crowdfunding is a particular form of crowdsourcing whereby the crowd is asked to provide a solution to a financial problem, namely, the lack of financial resources for a business idea to be initiated”; this view is also adopted by Hagedorn and Pinkwart. According to Cumming et al. the fundraising process starts when the company/individual seeking finance sets a funding goal. If the target goal is not reached in an all-or-nothing campaign, then backers will have their money returned. In the keep-it-all model, the fund seeker will keep all the funds that were raised, even when the funding goal is not reached. The funding may be provided by way of donation or by way of return (in this regard, see the reflections of Lambert and Schwienbacher, and the European Commission). In the same vein, Kirby and Worner, Esposti, and the EU are of the opinion that crowdfunding can be classified based on the nature of the return the crowd expects; hence, the focus on P2P lending (backers become investors and seek a yield).

2.1 Understanding financial inclusion

Since the 1980s there has been a substantial increase in the number of people, both nationally and internationally, using a wide range of financial services and products. This increase is mainly due to structural changes in the financial services sector, the payment of wages by automatic credit transfer and the spread of home ownership (Kempson et al., 1999; Sinclair, 2001). Banking services have become progressively more important due to the ‘financialisation’ of social relationships (Gloukovitzoff, 2006). Consequently, most consumers in developed countries now have a bank account. A proportion of the population, however, remains excluded from banking and other financial services, which means, in practical terms, that they are financially excluded.

Why is exclusion from financial services regarded as a prominent issue? One way of answering this question is by looking at the increasingly ‘financialisation’ of everyday life. Access to a bank account,

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7 Financial services refer to those used for personal financing, including bank accounts, current accounts, savings, credit, insurance and bill payments services. In Europe these are mainly provided by banks, building societies, credit unions, post offices and insurance companies.
credit and insurance is now widely regarded as “essential supports for personal financial management and for undertaking transactions” in modern societies (Speak et al., 1999). Speak and Graham describe several indispensable private services (Fisher et al., 1999) which “can now be considered essential to sustaining any meaningful degree of real economic and social participation in modern societies.” Groups in society that are unable to access financial services are frequently unable to obtain other key social benefits and financial exclusion can often exacerbate other kinds of social exclusion. Financial exclusion is invariably experienced by poorer members of society; significant numbers of low income people are excluded from financial services spanning a range of basic products that include credit, insurance, bill-payment services and deposit account facilities.

At times, it appears easier to explain a phenomenon (such as financial inclusion) by analysing its antithesis, that is by defining financial exclusion. Prima facie, financial exclusion refers broadly to the inability (however occasioned) of some societal groups to access the financial system. The concept of being ‘financially excluded’ can thus be defined as not having access to formal financial services such as banking accounts, credit cards, insurance, payment services, etc. Early literature on financial exclusion concentrated on issues of geographical access to services, particularly banking outlets. Therefore, financial exclusion was narrowly viewed in terms of ‘access’, and was first described by Leyshon and Thrift as “the process that prevents poor and disadvantaged social groups from gaining access to the financial system” (Leyshon et al., 1995). Kempson’s was the first attempt to offer a wider definition of financial exclusion, acknowledging that financial exclusion is complex and multi-dimensional and a consequence of a range of problems with access, conditions, price, marketing or self-exclusion (Kempson et al., 2000). Gloukoviezoff also finds that ‘access’ is only part of the problem, and in his view the greatest challenge is the difficulty that the financially excluded face in ‘using’ financial services (Gloukoviezoff, 2004). Consequently, Gloukoviezoff defines financial exclusion as “the process by which a person encounters such difficulties in accessing and/or using its banking practices that he/she is no longer able to have a normal life in society” (Gloukoviezoff, 2004).

In light of the foregoing, financial inclusion can be regarded as the “ability to access and effectively use appropriate financial products and services” (emphasis added) and it has multiple facets (Clark et al., 2005). Financial inclusion “is not just about access to products but also the quality of engagement with those products and the need for individuals to develop skills and confidence to make informed decisions” (Regan et al., 2003). Therefore, to be able to access and use financial products, it is not enough for the

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8 These can be classified into three broad forms: (1) Transmission services: basic transaction facilities, such as deposit and withdrawals, bill payments, etc.; (2) Protective services: measures which offer some safety against the risks and vagaries of life, such as insurance and savings; and (3) Promotional services: resources required to facilitate autonomy and to develop enterprises, such as loans and credit.
individual to have certain skills, information and confidence, but rather a wider range of financial products in the financial mainstream. This means that bringing financial inclusion forward is shared amongst a range of actors: individuals themselves, but also the state and financial institutions as providers of financial products (Lederle, 2009). In addition, “opening a bank account, whilst a positive step, does not move someone from being excluded to being included. There is a spectrum of financial inclusion” (Regan et al., 2003).

As stated by Regan and Paxton (Anderloni et al., 2007), it is not sufficient to have access to certain financial products if the customer cannot choose what kind of operations can be done using those financial instruments – for example, owning a bank account is not enough to promote financial inclusion since an account may be inaccessible due to being overdrawn or may be only used for the receipt of money, thus constituting a case of “exclusion within inclusion” (Clark et al., 2005). Moreover, mere access to financial services is of little meaning if people cannot or do not wish to make use of them. There are certain indicators that make it possible to assess whether financial products are suitable for a specific individual. Speak and Graham suggest that the appropriate financial product is the one that reflects the individuals’ financial needs and circumstances (Speak et al., 1999). The appropriate financial product offers fair conditions in terms of costs, provision and structure although individuals may not be aware of unjust terms and conditions.

The Global Partnership for Financial Inclusion regards financial inclusion as “an inclusive financial system that provides access to financial services for all in a reliable, convenient, affordable, continuous and flexible manner by focusing on financially underserved as well as financially excluded” (GPFI, 2011). This definition not only embodies the access and quality lenses but it also specifies the targeted population of financial inclusion efforts, and addresses the different facets and diversity of financial inclusion. An inclusive financial system allows for more effective and efficient social policy interventions.

Financial sector reforms that promote financial inclusion are at the heart of the international development for policymakers and development institutions (Ardic et al., 2011). Despite the fact that modern societies and economies are moving towards virtual money and digital innovations in finance, access to the financial system, mainly through bank accounts, remains essential for the management of our daily lives.

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9 The Office of Fair Trading (OFT) in the United Kingdom, for example, set guidelines for the non-status lending market, including that lenders should “not engage in unfair business practices”, including charging very high rates of interest, and that “there should be responsible lending, with (…) a proper assessment of the borrower’s ability to repay.” (Office of Fair Trading, 1997).

10 Global Partnership for Financial Inclusion is an inclusive platform for all G20 countries, interested non-G20 countries and relevant stakeholders to carry forward work on financial inclusion, including implementation of the Financial Inclusion Action Plan, endorsed at the G20 Summit in South Korea.
Inversely, lack of access to financial products and services, or the inability to make use of them, can be serious obstacles to economic and social integration (European Social Watch Report, 2010).

### 2.2 Financial Inclusion through Microfinance

Microfinance is defined by Ledgerwood as “the availability of financial services to unbanked or poor or lower income clients or lesser privileged sector of the society” (Ledgerwood, 1998). Microfinance represents the “provision of credit without collateral, usually in relatively small amounts and for short periods of time” (Ghosh, 2013). A hype has developed around the potential of microfinance to allow formal financial institutions to enter into forms of lending that are dominated by informal arrangements. This phenomenon was qualified as a ‘fundamental innovation’ that allows microfinance institutions to offer access to and use of financial instruments without collateral to consumers who would otherwise be excluded “not only because of the risk of default in general but because of the difficulties and high transaction costs involved in sorting more and less reliable individuals” (Stiglitz, 1990).

Priyadarshee and Ghalib argue that microfinance is “a poster child of exploitation of the vulnerable” (Priyadarshee et al., 2011) and that is because, as stated by Ghosh, “microfinance has gone from being a hero to zero in the development discourse”, and thus “from being lauded as the silver bullet to solve problems of development and poverty reduction, to being derided as the progenitor of financial instability and enhanced vulnerability among the poorest people who can ill afford to take this additional burden” (Ghosh, 2013). Modern microfinance is said to be ‘born’ in Bangladesh, when Mohammad Yunus reinterpreted the small-scale lending by creating a network of lending; in this sense, Bateman states that this system created a “small elite of microfinance providers who entered into unsustainable patterns of lending that ensured short-term profitability but increased the vulnerability of the poor” (Bateman, 2010).

Duvenback et al. came to the conclusion that “the widespread policy enthusiasm for microfinance in the global development community had no empirical basis”; rather it was built on ‘foundations of sand’ (Duvenback et al., 2011). Similarly, according to the Centre for the Study of Financial Innovation, “too many clients of too many microfinance institutions have taken on too much debt” and thus “the sector displayed problems that are not unknown in other parts of the financial sector, such as wrong incentives, poor corporate governance and lax of inadequate risk management” (Centre for the Study of Financial Innovation, 2012).

Moreover, beyond the foregoing considerations, which suggest that microfinance does not alleviate

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11 This not-for-profit form of microfinance focused on development and poverty reduction was formalised in Grameen Bank in 1983, but was gradually phased out during the 1990s and replaced by a model that focused on ‘full-cost-recovery’, thus making its way into a more market-oriented approach that would accommodate and encourage for-profit microfinance.
poverty, it is argued that “microfinance actually constitutes a powerful institutional and political barrier to sustainable economic and social development, and so also to poverty reduction” (Bateman et al., 2012). The argument goes as follows: microfinance ignores the “crucial role of scale economies and thereby denies the importance of large investments for development” (Amsden, 2012), and “the widespread adoption of this model and its international acceptability are emphasised by the fact that it is a model for poverty alleviation that is politically acceptable to the neo-liberal establishment and not because of its inherently positive qualities” (Bateman et al., 2012).

A factor that is less discussed when striving to achieve financial inclusion through microfinance is that by using it, a great deal of costs is imposed on borrowers, which means that, “they are forced directly or indirectly to undertake the supervisory, monitoring and penalising activities that are usually seen as the responsibility of the lenders” (Ghosh, 2013). On the same note, Hulme points out that individuals tend to borrow for different purposes than the lenders might think, for example school fees, medical emergencies, food, because they do not have access to the financial services that fit their needs (Hulme, 2000). Phillip Mader’s (2013) insightful review supports the above conclusion: “this industry consists of two types of actors – microfinance institutions and funders – whose interest is usually to lend or invest money at the highest possible rate of return (…). The losers in this scheme, according to Sinclair (2012), are the poor people who pay excessive interest rates – with all the imaginable effects, from business failure to over-indebtedness and worsened poverty – as well as the original investors and donors, who are duped.” This highlights the problem associated with treating microfinance as either a significant poverty alleviation strategy or even a means of incorporating otherwise excluded potential borrowers into the institutional finance system. Microfinance is ‘a double-edged sword’, in the sense that it can either reduce the financial vulnerability of households or push them further into debt (Guerin et al., 2009).

Copestake contends that: “(a)n excessive focus on the potential of microfinance can simultaneously serve as populist modality for benevolent paternalism, convenient smokescreen for the messy finance of crony capitalism and fodder for an ideology of equality of opportunity over economic justice. By emphasising the importance of individual access to financial services, a narrow definition of microfinance also risks contributing to the neglect of a wider development finance agenda that includes improving financial allocations to the collective services needed by poor people such as physical infrastructure, security, health and education services” (Copestake, 2010).

We can conclude that, whilst microfinance is no panacea for the problems caused by poverty, it can help [re]direct resources and power into the hands of poor people and thus letting them chart their own path out of poverty. It can therefore be argued that, if we reject the idea of microfinance being the way to
poverty reduction or economic diversification, it would become difficult for policymakers to address the exclusion of the poor people from the formal financial services and avoid a higher level of exploitation. How can the need for the development of an inclusive financial system be addressed?

2.3 The ‘New Wave’ Microfinance – the commercialisation approach

As microfinance is constantly growing into a more ‘mainstream’ financial services phenomenon, the financial markets have witnessed a wide range of new forms of financing and investment opportunities becoming available to microfinance institutions. At the moment, there are more than 150 million poor people being served by microfinance institutions (Karnani, 2011). The Consultative Group for the Assistance of the Poor (CGAP) is of the opinion that “the worldwide number of poor people that have access to credit is nowhere near the market potential” (Farrar, 2008).

Cull et al. (2009), and Rhyne and Otero (2007) contend that the financial market place has been dominated so far by micro-financial institutions (MFIs), which are concentrated mostly in Asia, Africa, Eastern Europe and Latin America, with the ultimate purpose of reaching the poorer customers (Drake et al., 2002). In their view, “the MFIs are paving the way towards the commercialization of microfinance, which also allowed the entrance of local, regional, and international banks, as well as consumer lenders, into the arena.” However, market structure might be affected; these new players might only seek quick profits rather than actual delivery of long-term value for customers and shareholders. That is why this ‘commercialization’ brought about changes in areas such as ownership structure, regulation and supervision of micro-financial institutions (Roy, 2010), which led to a strong debate as to whether the focus on MFIs shifted from poverty alleviation to ‘profit maximization’ only (Armendariz, 2010).

Dieckmann (2007), Krauss and Walter’s (2008) angle in this respect is that while some of the new players might be committed to microfinance for social development reasons, more and more private investors have been attracted by profits in microfinance, the attractive risk profile, its social value, and by a low correlation to other mainstream investment classes. One clear example in this sense is the case of the initial public offers (IPOs). The huge profits produced by the IPOs has become a source of concern in the microfinance community. Now, there is nothing wrong with the fact that shareholders make profits out of IPOs. As stated in CGAP’s Focus Note (CGAP, 2007), “development agencies and private donors have always subsidized some activities that are expected eventually to produce private profits, because they think that a broader social objective will be served at the same time. Building a road or a dam, or funding an export promotion project to generate employment, will all enrich private individuals who are able to

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12 The MFIs range from the developmentally oriented non-profit organizations that have been leading the way in Bangladesh, to public sector banks that dominate the microfinance market in Indonesia, to specialized microfinance banks rising to prominence in Latin America.
build or expand businesses if the project is successful”.

The development of equity investment received recognition with the success of the first initial public offering by Banco Compartamos, the largest MFI in Latin America. On April 20, 2007, Compartamos went public by holding an IPO on the Mexican stock exchange; “about one third of the shares were floated in the market, and the IPO was well received by the investors as the sale was over-subscribed by 13 times” (Rosenberg, 2007). While advocates of the commercialization of microfinance point to the IPO as a milestone event that will open up new avenues and opportunities for microfinance, others, including Mohammad Yunus, have expressed scepticism that the goals of profit-seeking capital market investors can be compatible with the interest of poor rural women. Yunus reacted to the news of the Compartamos’ IPO with shock, fearing a “public backlash against microfinance” as quoted in Cull et al. (2009). To him, Compartamos revealed itself as one of the greedy money lenders he had set out to abolish. Where the profit motive is seen to be taking precedence over the social mission of financially including the poor – be this towards the end of poverty alleviation or as an end in itself – the borders of the financial inclusion assemblage are revealed. This boundary is the line separating financial improvement of the poor from profit for outside investors.

One side of commercialization is the access to financial services by the households and not cheap credit, thus making the credit demand inelastic (Morduch, 2000). While this approach focuses on institution building through profitability to serve as many clients as possible, the social approach has a quite different understanding of effective poverty alleviation; for them, the wide outreach is not the only aim: deep outreach also has to be taken into account. This can be illustrated by two slightly different objective functions: both want to maximize the total number of clients served, but the ‘welfarist’ gives an additional, conditional weight on the difference between the clients’ income and the poverty line. In this sense, Morduch argues that, “if the distribution of income below poverty line is considered, well-targeted programs can often do more for poverty reduction than much larger programs reaching mainly better-off households” (Morduch, 2000). That is because high interest could maintain access to credit for the very poor as well as absorbing large parts of the gains from their investments, leaving them not necessarily better off. Also, there is a moral dilemma included when asking “one set of very poor individuals to generously agree to help out another set of very poor individuals” (Bateman, 2010).

The implications of commercialisation are not invariably positive for clients, nor is it clear that they are to the benefit of the MFIs themselves. The solution could be this: the combination of a socio-commercial

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13 There are different understandings of human welfare. The term ‘welfarism’ is usually associated with the economic conception of welfare. Economists usually think of individual welfare in term of utility functions, a perspective in which social welfare can be conceived as an aggregation of individual utilities or utility function.
approach with a client focus. As Lützenkirchen (2012) aptly states: “First and foremost, this has to include a culture of responsibility among MFI managers, staff, and investors, in which client needs are understood, suitable products are designed, and the social impact is constantly evaluated. In practice, MFIs will have to increase their spending on personnel to strengthen the basis of Microfinance operations, namely, the client-lender relationship. Also, interest rates should be lowered if possible to reduce moral hazard and to increase impact. This will naturally diminish returns compared to the levels attained some years ago. But on the positive side, volatility will decrease and social performance will increase, so that Microfinance will become more attractive for social investors”, with its ultimate goal of poverty alleviation in an efficient manner (Rhyne, 1998; Woller et al., 1999).

The financial sector is different from other sectors due to its potential for instability and the need to protect the small and relatively uninformed investors/customers (Dewatripont et al., 1993; Goodhart et al., 1998). Therefore, developing innovative ways of payment means that transactions costs will be reduced, therefore the exchange of goods and services will be facilitated, resulting in a better allocation of resources.14

2.4 Financial technology and financial inclusion: definition and overall market significance

In the absence of a universally accepted definition of ‘FinTech’,15 this can be defined as the sum of innovations in digital and information technology, with an application (actual or potential) on the provision of financial services. The term covers Distributed Ledger Technologies (DLTs), ‘Blockchain’, virtual currencies, mobile-telephony and other communication technologies accessible to payment service users, new digital advisory and trading systems, digital innovation-powered P2P lending and equity crowdfunding platforms.16 It follows that, as an alternative approach towards the facilitation and provision of financial services, FinTech covers a very wide range of digital innovations and technology-enabled business model innovations in the financial sector. Such innovations have the potential to “disrupt existing industry structures and blur industry boundaries, facilitate strategic disintermediation, revolutionise how existing firms create and deliver products and services, provide new gateways for

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16 “FinTech may be understood as finance enabled by new technologies, covering the whole range of financial services, products and infrastructure” as defined in European Parliament’s Draft Report on FinTech.
entrepreneurship, democratise access to financial services, but also create significant privacy, regulatory and law-enforcement challenges” (Philippon, 2016).

FinTech represents a revolutionary phenomenon, in the context of which some of the most important players are non-bank financial institutions, as well as a number of more loosely regulated non-financial firms such as tech companies and network operators (European Parliament, 2017; PricewaterhouseCoopers, 2016; Accenture, 2016; BBVA Innovation Center, 2016).17 The eventual involvement, on a large scale, of non-financial firms in the provision of innovative financial services calls, on the one hand, for regulatory cooperation between the authorities responsible for the supervision and oversight of the more traditional areas of finance, in order to achieve synergies, where appropriate, to fill-in the regulatory gaps and to balance conflicting interests, and, on the other, for a greater measure of engagement and dialogue with the private sector and innovators (GPFI, Private Sector Engagement Strategy, 2015).

In defining an analytical framework against the background of which to assess the possible impact of FinTech, both on financial markets at large and, more narrowly, in respect of financial inclusion, one should not lose sight of FinTech’s potential to represent a central building block in the European Union’s strategy to promote the creation of a modern digital society. FinTech is of direct relevance to the Commission’s Capital Markets Union and Digital Single Market strategy, and it is bound to have an impact on existing financial markets regulation, including the CSDR, the MiFID, and the Payment Services Directive. The interaction between FinTech and the existing body of financial markets regulation will be instrumental, going forward, in calibrating the legal and regulatory response to the emergence of the FinTech phenomenon.

A final point to keep in mind is that, for all its promises, FinTech also raises a number of novel practical and legal concerns, including concerns with retail investor protection, FinTech’s potential to facilitate the extension of funding to unworthy borrowers, but also systemic risks following from the partly unregulated and opaque nature of some of the players active in the FinTech space. These concerns are bound to represent barriers that would need to be overcome before the wide-spread adoption of FinTech in a financial sector context. However, these concerns do not invalidate the prospect of FinTech as a facilitator for P2P lending and for more affordable remittances, in a bid to overcome financial exclusion. It is to these prospects that I now turn in the remainder of this article.

17 Mike Laven, CEO at ‘The Currency Cloud’, has aptly observed that, “although banks have been responsible for the innovations of payments, for example credit cards, online banking has become unsuitable for the evolution of smart phones, social media and cloud computing. The financial services industry is evolving in more ways than one and financial technology is altering the landscape in more ways than one.”
2.5 FinTech and crowdfunding

Crowdfunding could be amongst the most promising areas of application for FinTech, and it is already having an impact on marketplace lending, which includes both P2P lending and social lending, by providing borrowers with lower rates on loans and investors with a higher source of fixed income. While its share of the total funding of European businesses is still relatively small, it has been growing fast, especially in some Member States, helping to mobilise capital, and channel it to SMEs and individual borrowers.

Following the start of the financial crisis in 2008, borrowers began looking for ways to secure lower rates on their borrowings while, in turn, lenders sought higher rates of return on their investments. On their side, banks were constrained in their lending activities by the higher levels of regulation introduced in the wake of the financial crisis, as well as by market uncertainty, both of which paved the way for alternative lending models, including P2P lending. Following the outbreak of the financial crisis in 2008, bank credit almost came to a standstill, primarily in Europe (Dapp, 2013), making it harder for small and medium enterprises (SMEs)\textsuperscript{18} (Stein et al., 2010; ACCA, 2010), and also individuals, to have access to bank financing, and, simultaneously, create an opportunity for crowdfunding as an alternative method for raising money (Hagerdon et al., 2013; Hagedorn et al., 2016). Even if bank credit were to rebound, reaching its pre-crisis levels, there would still be room for crowdfunding, as a complementary source of capital for SMEs and individuals (rather than as an alternative to bank credit) (Hornuf et al., 2014b).\textsuperscript{19} It follows that the financial crisis, in conjunction with advances in digital technology, have served as core drivers for market demand for the development of alternatives or complements to the banking system as a source of lending for SMEs and individuals alike.

FinTech has facilitated the P2P lending process by powering distributed, online lending platforms offering borrowers easy and efficient access to lenders (Bekker, 2015). FinTech-powered lending platforms create a marketplace where investors who wish to lend funds can find potential borrowers and provide credit through P2P Agreements.\textsuperscript{20} These platforms rely on online technology to facilitate the interaction between the borrower and the investor, which would otherwise be far costlier and cumbersome. Apart from matching borrowers with investors, and putting the loan contract in place, P2Ps platforms entail the following set of operational functions:

- verifying the ‘bankability’ of the borrower;

\textsuperscript{18} SMEs represent a major driver of the world economy. However, SMEs often have a major problem in dealing with their finances and ensuring appropriate funding as detailed in International Finance Corporation – IFC (2015). Enterprise Finance Gap Database.

\textsuperscript{19} This would also be true of equity crowdfunding, which was expected to become a complementary source of funding to all forms of ‘angel investing’, including venture capital and private equity fund lending.

• assessment of the credit quality;\textsuperscript{21}
• payment processing;
• implementing anti-fraud and anti-money laundry checks, and ‘know-your-customer’ assessments; and
• legal compliance and reporting.

Another means through which FinTech could facilitate crowdfunding platforms is through the creation and administration of so-called Decentralised Autonomous Organisations (DAOs). DAOs can be defined as innovative, software-based unincorporated associations, similar to partnerships or joint ventures (but without legal personality), the aim of which is to pool their investor-members’ financial resources towards the achievement of a common business objective. Rules encoded as DLT-embedded ‘smart contracts’ (automated, software-based contractual-type arrangements) and executed upon fulfilment of pre-defined trigger conditions – hence, free of human intervention – can be instrumental in facilitating the running of these organizations, for instance by enforcing the collective decisions of the community of members of a DAO, without the intervention of fund managers.\textsuperscript{22} At the time of writing, there was no settled legal view in terms of the precise company law status of DAOs, the law or laws subject to which they may operate, or whether their investor-members could be liable, as shareholders, for any debts incurred, or any damages caused, by a DAO.\textsuperscript{23}

In terms of the transformational potential of FinTech, as an enabler for P2P lending, it has aptly been observed that “we are at a point where we have an opportunity to reposition financial services. With the technology available, we can change the way transactions are done, reducing costs from dollars to pennies. Through collaboration, we have the opportunity not only to revive businesses that have died, but also to create new ones that haven’t even been thought of” (EY, 2016).

2.6 Impact of Crowdfunding on economic growth

On a global level, whether one is talking about emerging or mature markets, the growth and prosperity of economies is highly dependent on entrepreneurial activity. Young entrepreneurs are “the lifeblood of economic growth” (EY, 2016). Broadening access to finance for innovative companies, start-ups or other

\textsuperscript{21} Such as providing a score for credit quality that investors can then base their judgement on, or estimating default risk in order to inform the risk-adjusted interest rate offered.

\textsuperscript{22} Capital allocation decisions are made by the anonymous stakeholders themselves who can vote directly on any major decision to allocate the DAO’s funds. Companies or individuals who want to tap the crowd funding-raised funds are to submit a proposal; proposals are published online, with stakeholders voting which proposals to adopt, and what funds to allocate to each of them.

\textsuperscript{23} For instance, it has been argued that “if ‘management’ of an organisation is conducted automatically by code, legal systems will have to determine who to hold accountable if laws are broken and disputes arise. The legal frameworks around corporations and other business associations would have to adapt to the concept of distributed management” (Mills et al., Distributed ledger technology in payments, clearing, and settlement, Finance and Economics Discussion Series 2016-095. Washington: Board of Governors of the Federal Reserve System. Available at https://www.federalreserve.gov/econresdata/feds/2016/files/2016095pap.pdf, accessed 25 April 2017).
unlisted firms - including SMEs - is part of the Capital Markets Union Action Plan (Communication from the Commission, 2015)\(^2\) with the success of these firms being crucial for job-creation and economic growth in Europe.

In today's economic environment securing investment finance is challenging for these firms, particularly when they move from start-up into the expansion phase. Access to finance for young, innovative firms appears to be an issue even in countries where access to bank finance has remained stable throughout the crisis. Thanks to their strong local networks and relationships, banks will continue to provide the majority of funding to SMEs. However, only 41% of all SMEs in the EU perceive no limitations in their access to future financing (European Commission, 2015). This helps to explain the shift towards alternative forms of finance, including crowdfunding.

The European Commission is of the opinion that “crowdfunding can offer other benefits to firms: (i) it can give a proof of concept and idea validation to the project seeker; (ii) it can help attract other sources of funding, such as venture capital and business angels, (iii) it can give access to a large number of people providing the entrepreneur with insights and information, and (iv) it can be a marketing tool if a campaign is successful.” Moreover, “by providing an online marketplace to match investors and investees or lenders and borrowers, investment-based and lending-based crowdfunding can bring more competition into retail and capital markets. Crowdfunding can be seen as one part of the broader universe of the technological innovations with potentially transformative implications for the financial system, its intermediaries and users” (Communication from the Commission, 2016).

As already mentioned, the European Parliament has already shown a great deal of interest in crowdfunding. Its resolution dated 9 July 2015 on Building a Capital Markets Union (European Parliament resolution, 2015) states that “the CMU should create an appropriate regulatory environment that enhances cross-border access to information on the companies looking for credit, quasi-equity and equity structures, in order to promote growth of non-bank financing models, including crowdfunding and P2P lending.” Furthermore, the European Parliament’s resolution of 19 January 2016 on stocktaking and challenges of the EU Financial Services Regulation (European Parliament resolution, 2016) emphasises the potential of innovative market-based funding, stressing the constant need to create an appropriate regulatory regime to accommodate it.

2.7 Remittances, FinTech and Financial Inclusion

\(^2\) On average, around 60% of start-ups survive the first three years of activity, and those that do contribute disproportionately to job creation as stated in OECD, 2015. Young firms account for an average of only 17% of employment, but they create 42% of new jobs as found in Calvino et al., 2016.
Labour migrants’ remittances\(^{25}\) are growing rapidly in the post-Soviet countries, and as such, it became an important aspect for researchers and policymakers (Kakhkharov et al., 2016). The increased interest in the flow of remittances has raised questions about the role of remittances in economic activities because it represents a lifeline for millions of individuals in helping them raise their living standards (Kakhkharov et al., 2016). Remittances are seen as “a first experience of a financial service for recipients. Moreover, people-to-people payments are often the starting point and trigger further financial inclusion” (Report by the International Fund for Agricultural Development and the World Bank Group to the G20 Global Partnership for Financial Inclusion, 2015).

A ‘healthy’ banking system is usually considered to be “a driver of economic growth” (Monnin et al., 2010), as it can “facilitate[s] the performance of an economy and of dissipating financial imbalances that arise endogenously or as a result of significant adverse and unanticipated events” (Schinasi, 2004). Traditionally, the banking sector has been both the main provider of funding for the economy and the main source of innovation in banking matters. That being said, it is estimated that there are approximately two billion unbanked people around the globe that banks and the global financial system do not, currently serve. It has aptly been observed that “without access to financial services, savings cannot accrue interest in deposit accounts, they cannot be lent out to be reinvested in the local economy, and no credit history can be built to judge a person’s creditworthiness. In many communities, this exclusion means that people are only able to save informally (through the purchase of land or durable goods, or money saved ‘under the mattress’); and they must rely on relatives or local lenders for borrowing, typically with severe limitations in terms of amounts, availability and costs” (Report by the International Fund for Agricultural Development and the World Bank Group to the G20 Global Partnership for Financial Inclusion, 2015).

The confluence of the 2008 global financial crisis, the rise of FinTech, and the review of the regulatory regime governing the operation of the banking sector, was to signal a catalytic shift in the role of the banking sector as the core provider of funds and as the key source of financial innovation, and to accelerate the transition towards a more pluralistic financial system, where the relative weight of established banking intermediaries has decreased, while that of alternative sources of funding has, inversely, increased. One of the areas where the relative importance of non-bank financial intermediaries has been significant, and where FinTech might play an increasing role in supporting financial inclusion and in promoting economic growth, is that of the market for remittances.\(^{26}\) There is a large body of

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\(^{25}\) Remittances are defined as cross-border, person-to-person payments of relatively low value.

literature to support the proposition that remittances can be a catalyst for financial inclusion and economic development (Report by the International Fund for Agricultural Development and the World Bank Group to the G20 Global Partnership for Financial Inclusion, 2015; Anzoategui et al., 2014; Acosta et al., 2007); what the evidence seems to suggest is that remittances increase both the senders’ and the recipients’ use of financial services, such as the opening of savings accounts, the making of deposits and the accessing of credits and loans (BBVA Research, 2014).

The impact of remittances depends greatly on their use. While the evidence suggests that these are spent mostly for consumption purposes, their targeted investment would increase the sustainability of their beneficial effect for the national economy in the countries of their beneficiaries (Molodikova, 2008). Yet, from very few examples that there are of remittance-fund investments, it becomes clear that such investment can be a driver for economic development.

2.8 Impact of Remittances on Poverty

By increasing the household income, remittances are apt to not only promote economic growth and development but also to reduce poverty in developing countries. The literature suggests that households that receive remittances are financially better off at multiple levels compared to those that do not receive remittances (Adams, 1991; Lachaud, 1999; Fajnzylber et al., 2007; Adams, 2006; Gupta et al., 2007; Anyanwu et al., 2010; Ajayi et al., 2009). Moreover, remittance-receiving households have higher incomes and, thus, a higher level of consumer spending and lower incidences of extreme poverty (Adams, 1991; Lachaud, 1999; Fajnzylber et al., 2007; Adams, 2006; Gupta et al., 2007; Anyanwu et al., 2010; Ajayi et al., 2009). Adams and Page have demonstrated that a 10% increase per capita would decrease the number of people living in poverty by 3.5% (Adams et al., 2005). That said, research suggests that international remittances may have more of an impact in reducing the severity of poverty rather than its scale (Adams et al., 2010; Adams et al., 2010).

Remittances represent countercyclical financial flows, in the sense that the flow of money increases when financial markets decline. Remittances have tended to rise in times of economic downturns, political and civil crises because migrants living abroad send more money in response to the family’s needs, thus representing a large and stable source of foreign currency (World Bank, 2005; Yang, 2006; Yang et al., 2007; Mohapatra et al., 2009). Moreover, a remittance is often seen as an ‘insurance policy’ against loss of income and other financial challenges, which means that remittance-receivers have higher savings level and, consequently, a stronger ability to cope with economic shocks (World Bank, 2006b; Yang, 2006; Yang et al., 2007; Mohapatra et al., 2009).
The important linkages between remittances and development have the potential to transform the material well-being of migrants, their families, and their societies, especially when good policies are in place. Remittances improve the living standards of the receiving households, by increasing the level of their disposable income to be channelled to expenditures such as nutrition, housing, healthcare and education. As aggregate flows, remittances influence national reserves, foreign currency and saving and credit ratios. From a policy perspective, remittance flows have an unparalleled effect on poverty reduction and, especially when properly leveraged, on economic development (Manuel, 2012).

The point of departure in remittances and development is their effect on income. Remittances are typically pooled with other sources of income (salaries, rents, social support). Out of all income earned, remittances included, savings are set aside and built. Because remittances have the effect of increasing disposable income, they also increase the household’s capacity to save. Thus, at the level of the remittance-receiving household, remittances fulfil the function of contributing to building liquid and fixed assets (Manuel, 2012). Therefore, it is of importance to differentiate between formal and informal savings. Remittance recipient households can and do save, but without access to financial institutions and services, much of their savings are kept informally.

Overall, it should be noted that the relationship between the inflow of remittances and financial inclusion has a positive impact on economic growth. Furthermore, remittances represent a person-to-person flow of money because of its direct connection with the specific (lower-income) segment of that country which means that there is no intervention from government. In this sense, remittances are considered to be a form of development stimulation because there are no additional administrative costs. This means that, through remittances, financial inclusion is improved by way of providing affordable financial services which are within the formal financial system to those who would otherwise have had no access to formal financial services. It follows that remittances play an important role facilitating access to the financial system, an issue touched on earlier in this paper.

2.9 Link between remittances and FinTech

FinTech holds the promise of facilitating the creation of an inclusive digital economy, by playing a critical role in strengthening economic resilience while, at the same time, ensuring that the global digital economy benefits the rich and the poor alike. Blockchains, in particular, have the potential to replace

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27 In some cases, remittance recipients face geographical, social, or legal barriers that make it very difficult for them to have access to a financial institution. Even those who have access may not use financial institutions and services because they do not realise that they have access, or because they do not understand the benefits of using them. For example, many remittance recipients enter financial institutions on a monthly basis to receive their remittance, but do not hold a savings or checking account with that institution. In light of this, financial access and financial education can help to mobilise informal savings through remittances into the formal financial sector.
single points of failure within the financial system, through decentralised market structures, such as distributed ledgers, which, on account of their decentralised nature, can render the provision of financial services (including the sending of remittances) less costly hence, more easily accessible to the unbanked or the underbanked (Hyland, 2016).

In the same way that the World Wide Web has rendered possible the direct and cost-efficient exchange of information on a global scale, FinTech and Blockchain technologies can empower individuals around the world to transact their financial business on a P2P basis – hence, without use of intermediaries - so as to more swiftly and more efficiently exchange value across borders, without recourse to banks, brokers or exchanges. It follows that the potential of FinTech resonates with the concerns expressed by G20 in respect of the need to attain financial inclusion and, in particular, with the commitment of the G20 to further “inclusive and sustainable financial systems that offer all households and companies appropriate access to financial services.”

3. Final remarks

Financial inclusion has grown in importance given that poverty is still one the greatest social problems challenging Europe. A person could be considered financially excluded when the access to or the use of financial services and products offered by formal financial institutions is hindered. The report on Financial services provision and prevention of financial exclusion (Réseau Financement Alternatif, 2008) of the European Commission, Directorate-General for Employment, Social Affairs and Equal Opportunities sets up a list of basic financial services which are considered essential to daily life. These are the following:

- a bank account to receive income;
- a transaction account to make payments from;
- a savings account to store money; and
- access to unsecured credit to manage temporary cash shortages and unexpected expenses.

Today, over 3 billion poor people (EC - Joint Report on Social Inclusion, 2004)28 have no access to basic financial services, essential for the management of their lives, hence the constant need to build an inclusive financial system that can reach out to those people, and empower them to work their way out of poverty through access to loans and deposit services. As economy is moving towards virtual currencies

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28 “People are said to be living in poverty if their income and resources are so inadequate as to preclude them from having a standard of living considered acceptable in the society in which they live. Because of their poverty they may experience multiple disadvantages through unemployment, low income, poor housing, inadequate health care and barriers to lifelong learning, culture, sport and recreation. They are often excluded and marginalised from participating in activities (economic, social and cultural) that are the norm for other people and their access to fundamental rights may be restricted.”
and digital innovations in finance, a bank account has become an essential tool in shaping an inclusive financial system, given its promise to reduce or eliminate the inefficiencies surrounding the conduct of specific types of financial transactions, and to increase financial inclusion. Moreover, access to banking is considered a basic necessity in most developed countries. Financial services and instruments play an important role in the process of domestic economic development. While some scholars have focused on the interaction of large or small enterprises, the most important consumers of financial products are the households due to their influence to the “scale and asset mix of finance” (Honohan, 2008). An inclusive financial system “bolsters both access to resources and the ability to transform resources into opportunities” (Honohan, 2008). In addition, “even though microfinance institutions have strong local knowledge, product development acumen, and the ability to manage small transactions, most lack the stable core banking systems and specialised technical skills to implement branchless banking models or tap into existing systems” (Guatum et al., 2008). Therefore, providing access to and use of formal financial services has gained a major prominence in the past few years as a policy objective for national policymakers (CGAP, 2009). As broad access to financial services and products is interconnected with social and economic development (PRR on Access to Finance, 2006), a developed financial system is important in achieving economic development and poverty alleviation (Beck et al., 2000; Beck et al., 2004a), and to increase financial inclusion. **Acknowledgments**: I gratefully acknowledge the support and generosity of Phoebus Athanassiou, without whom the present paper could not have been completed.
References


