

New Frontiers in Banking Services

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(Editors)

New Frontiers in Banking Services

Emerging Needs and Tailored
Products for Untapped Markets

With 20 Figures and 42 Tables

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Preface

This book is devoted to an issue that is the subject of growing interest amongst policy makers, financial providers and academics. That issue is the problem of unbanking or underbanking in developed countries. The issue has arisen because, faced with an ever more sophisticated and efficient financial system, an increasing number of people have found themselves in danger of being excluded from it.

The goal of the papers that follow is to draw attention, both through a theoretical framework and through field study, to the need for banks, financial institutions, public authorities and non profit associations to increase their efforts to understand the process of financial exclusion, so that they can develop approaches to help people on low to moderate incomes to gain access to the whole range of financial services, from payment to savings, and from loans to investment. Some farsighted banks and financial institutions have already developed strategies, and introduced new products and services, to promote financial inclusion in these untapped markets.

The research group is international and multi-disciplinary. The authors are grateful to the Italian Ministry for University Research (MIUR) for financial assistance provided under the “PRIN 2003” programme.

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We would like to record our most sincere thanks to all those who have participated in the research project, and to all the bodies and institutes that have contributed to it.

Luisa Anderloni
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Aosta, September 2006

List of Contributions

<i>Introduction</i>	
Benoît Jolivet.....	1

Part I

<i>Access to Bank Accounts and Payment Services</i>	
Luisa Anderloni and Emanuele Maria Carluccio.....	5
<i>Access to Credit: the Difficulties of Households</i>	
Laura Nieri.....	107
<i>Access to Investments and Asset Building for Low Income People</i>	
Maria Debora Braga.....	141
Appendix to Part I	
<i>Methodological Notes to the Field Research in France, Italy and Spain</i>	183

Part II

<i>What Are the Specific Economic Gains from Improved Financial Inclusion? A Tentative Methodology for Estimating These Gains</i>	
Philip Molyneux	191
<i>From Financial Exclusion to Overindebtedness: the Paradox of Difficulties of People on Low Incomes?</i>	
Georges Gloukoviezoff	213
<i>The Role of German Savings Banks in Preventing Financial Exclusion</i>	
Natalia Bresler, Ingrid Gröbl and Anke Turner	247

<i>Economic Growth and Financial Inclusion: the Case of Poland</i> Ewa Miklaszewska	271
<i>Italian Banks' Credit Approach Towards Low-Income Consumers and Microenterprises: Is There a Bias Against Some Segments of Customers?</i> Eliana Angelini.....	299
<i>Banking the Poor: Policies to Bring Low- and Moderate-Income Households in the United States into the Financial Mainstream</i> Michael S. Barr	323
<i>Migrants and Remittances</i> Luisa Anderloni	353
<i>Conclusions</i> Benoît Jolivet.....	373

Contents

Preface	V
List of Contributions	VII
Introduction	1
Part I	
1 Access to Bank Accounts and Payment Services	5
1.1 Introduction: Financial Exclusion	5
1.2 Interests, Concerns and Possible Solutions	11
1.2.1 General Trends	11
1.2.2 Underbanked Individuals and Fringe Banks	15
1.2.3 Over-Indebtedness	16
1.2.4 Financial Literacy	21
1.2.5 The Service of General Interest Mission and the Community- Based Approach	22
1.2.6 Concerns and Possible Solutions	29
1.3 The Issue of Measurement and Comparative Analysis	30
1.4 Types of Response	35
1.5 Case Studies.....	43
1.5.1 Europe	43
1.5.2 The Situation Overseas	69
1.6 Result from a Survey in France, Italy and Spain	84
1.7 Conclusions and Future Perspectives	95
1.8 References	99
2 Access to Credit: the Difficulties of Households	107
2.1 Introduction	107
2.2 The Use of Credit by Households	108
2.2.1 The Questionnaire Survey	112
2.3 A Theoretical Framework for Credit Exclusion	117
2.3.1 The Role of Credit to Overcome Social Exclusion	117
2.3.2 Economic Rationales for Credit Exclusion	118
2.4 Beating Credit Exclusion	123
2.4.1 Lending to Households: a Profitable Business Area	124
2.4.2 Reducing the Costs and Risks Associated with Households Loans.....	128

2.4.3 A Wider Scope for Not-For-Profit Intermediaries and Organizations	132
2.5 Conclusions and Policy Implications	134
2.6 References	137
3 Access to Investments and Asset Building for Low Income People	141
3.1 Saving and Asset Accumulation for LMIs: Theoretic Framework.....	141
3.2 The USA Experience with the Individual Development Accounts (IDAs)	145
3.2.1 Features of the IDA Accounts/Programs	145
3.2.2 Stakeholders of the IDA Accounts/Programs	154
3.2.3 Funding of the IDA Accounts/Programs	159
3.3 Saving and Asset Accumulation with Tax Refunds	162
3.4 The British Experience with the Child Trust Fund and the Savings Gateway	165
3.5 Conclusions	172
3.6 References and Bibliography	173
3.7 Appendix - Comment on Data About the “Access to Investment Services”	178
<i>Appendix to Part I - Methodological Notes to the Field Research in France, Italy and Spain</i>	<i>183</i>

Part II

4 What Are the Specific Economic Gains from Improved Financial Inclusion? A Tentative Methodology for Estimating These Gains	191
4.1 Introduction	191
4.2 Defining Financial Exclusion	192
4.3 European Evidence on Exclusion	193
4.4 Market Context and European Policy Responses	195
4.5 From Exclusion to Inclusion – Identifying the Costs and Benefits	199
4.6 Measuring the Economic Gains from Improved Financial Inclusion ...	207
4.7 Conclusion	209
4.8 References and Bibliography.....	210
5 From Financial Exclusion to Overindebtedness: the Paradox of Difficulties for People on Low Incomes ?	213
5.1 Introduction	213
5.2 A Definition of Financial Exclusion as a Social Phenomenon	215
5.2.1 Return to the Definitions of Financial Exclusion	215
5.2.2 Use Difficulties	217
5.2.3 Financial Exclusion and Social Exclusion: Moving Towards an Overall Definition	219
5.3 Access and Use of Credit: the Importance of Social Constraints	221
5.3.1 The Financialisation of Social Relations	222
5.3.2 Use of Credit as a Forced Response to Life Risks	224
5.4 The Mechanisms Underlying Access and Use Difficulties.....	227

5.4.1	The Reasons for the Banking Relationship	228
5.4.2	The Need for Suitable Advice to Customers on Limited Incomes	231
5.4.3	Banking Imperatives Versus Customisation of the Service	233
5.4.4	Standardisation of the Service that Is the Source of Access and Use Difficulties, and Therefore of Overindebtedness	236
5.5	Conclusion	241
5.6	References	243
6	The Role of German Savings Banks in Preventing Financial Exclusion	247
6.1	Introduction	247
6.2	Savings Banks as a Part of the German Banking System	249
6.2.1	The Three-Pillar Structure of the German Banking System	249
6.2.2	Key Facts of the Sparkassen-Finanzgruppe	251
6.2.3	Relationships Between Municipalities and the Sparkassen- Finanzgruppe	252
6.2.4	Recent Developments Affecting the Sparkassen-Finanzgruppe	253
6.3	Is the Public Mandate of the Savings Banks Obsolete or a Successful Strategy to Prevent Financial Exclusion?	254
6.3.1	Stipulations of the Public Mandate of German Savings Banks	254
6.3.2	Provision of Basic Banking Services	256
6.3.3	Nationwide Provision of Financial Services	257
6.4	Financing of Small and Medium-Sized Enterprises	259
6.5	Encouraging the Accumulation of Wealth and Financial Education	261
6.6	Future Outlook on the Sparkassen-Finanzgruppe	262
6.7	References	265
7	Economic Growth and Financial Inclusion: the Case of Poland	271
7.1	Introduction	271
7.2	Transformation of the Polish Banking Sector and Provision of Banking Services	273
7.3	Provision of Banking Services to Households and Corporations	282
7.4	Models of Bank Services to SME	287
7.5	Barriers to Providing Banking Services to SME: Results of Bank Surveys	290
7.6	Conclusions	294
7.7	References	297
8	Italian Banks' Credit Approach Towards Low-Income Consumers and Microenterprises: Is There a Bias Against Some Segments of Customers?	299
8.1	Introduction	299
8.2	Methodologies of Credit Risk Measurement: Credit Scoring Models	302
8.2.1	The Choice of Highly Explanatory Variables	305
8.3	Strengths and Weaknesses of Credit Scoring	307
8.4	The Effects of the Adoption of Credit Scoring on a Marginal Borrower's Credit Process	310

8.5	The Experiences of Some Italian Banks	313
8.6	Conclusions	318
8.7	References	319
9	Banking the Poor: Policies to Bring Low- and Moderate-Income Households in the United States into the Financial Mainstream	323
9.1	The “Unbanked” and the “Underbanked”	323
9.1.1	The Alternative Financial Sector	324
9.1.2	The Costs of Being Unbanked	326
9.2	The Banking Sector	327
9.2.1	Barriers to Banking the Poor	327
9.2.2	Governmental Policy and Private Sector Innovation	329
9.3	Payments Systems and Distribution Networks	333
9.3.1	Checks and Debit Cards	333
9.3.2	ATMs	335
9.3.3	Direct Deposit and Bill Payment	337
9.4	Transforming Financial Services for the Poor	339
9.4.1	A New First Accounts Tax Credit	339
9.4.2	The Community Reinvestment Act	344
9.4.3	State Policies and Welfare Reform	345
9.4.4	Financial Education	345
9.4.5	Reforming the Alternative Financial Sector	346
9.5	Conclusion	349
9.6	References	350
10	Migrants and Remittances	353
10.1	Migration Phenomena: Modern-Day Elements of an Ancient Phenomenon	353
10.2	The Risk of Financial Exclusion Within a Broader Perspective	355
10.3	Migration Phases and Personal Variables as Key Elements of Financial Needs	356
10.3.1	Demand for Financial Services Aimed at Immigrants	357
10.4	Migrant Remittance Behaviour	365
10.5	Conclusions	368
10.6	References	370
11	Conclusions	373
	Editors and Contributing Authors	377

Introduction

Benoît Jolivet

The world of banking services is a fascinating but complex one. It is much more than simply an ideal place from which to observe the interplay of supply and demand for specific services.

It is also a mixture of pure markets and of intermediaries, of banks regulated by both central banks in charge of monetary policies and by financial supervision authorities. Money remains something special, always including an element of public trust, and the high degree of information asymmetry calls for public intervention on the side of consumers and their protection.

This new book attempts to shed some light on this world, which has rules of its own yet permanently interconnected economic, social, institutional and sociological aspects. New major concepts such as financial exclusion and inclusion, are clearly defined and show the interconnection with other aspects such as, for example, poverty. In this world of finance, so often seen in terms of technique and marketing, it is very helpful and positive to take into account the independent views of people with different academic perspectives. The first part of the book is dedicated to the issue of access to different types of financial services; and includes an analysis based on a wide ranging literature review and desk study of the most interesting examples of practice worldwide, as well as on specific research conducted in France, Italy and Spain.

Access to banking accounts and to payment services is a most important issue today, because they are seen increasingly as a right and as a key to full citizenship. This is also why this right is increasingly enshrined in law or regulation despite the fact that the question of its status as a basic need or as a service of general interest is still a matter for debate in many countries. Without reasonable and affordable access to these two basic areas of services, however, the chances of participating in normal social life are reduced, leading to a greater risk of social as well as financial exclusion.

Access to credit is important to develop the potential offered by employment. The issue is complicated by the fact that it is the responsibility of financial institutions to supply and price credit according to risk, which means denying credit to those who are at risk of not being able to pay it back. While there clearly may be no right to credit per se, turning down somebody who is solvent does present difficulties.

In the banking world, solutions are linked with principles of segmentation, scoring methods and the awareness of the sub-prime market. This book gives an account of a whole range of new and interesting examples of work currently being developed in different countries that could lead to the adoption of new types of good practice.

One of these types of practice is in facilitating access to investments and asset building for low-income people. Some examples that could lead to new ideas are presented here. The most advanced experiences and interesting solutions in this area come from the USA and the UK.

The second part of the book presents different studies, all related to specific aspects or projects, showing that, from a theoretical as well as a pragmatic point of view, there is scope for products to meet new and emerging needs. This association of new elements of demand and supply, arising from untapped markets, should be to the benefit of all.

The development of financial activities as an important part of the key services sector, should bring more activity and employment and therefore more economic growth.

Focussed on encouraging financial inclusion, instead of simply fighting against financial exclusion, this development could also lead to improved social cohesion and specific economic gains.

All the aspects developed here could herald new frontiers, new behaviours and new synergies between economy and finance that are of interest to all - citizens, bankers and decision-makers. For example, the ideas of «banking the poor», without necessarily having recourse to special institutions, or of bringing solutions to migrants wishing to make remittances, could open the door to new approaches, especially for those with an interest in sustainable development and corporate social responsibility.

Some specific perspectives are also of considerable interest, for example on the prevention of over-indebtedness, financial exclusion, and the merits of micro-enterprises.

The overall message conveyed by each of the authors of this book, the message that we are only at the very beginning of new developments and innovations in the world of financial services, especially ones that take into account new social needs, is an extremely encouraging and refreshing one.

Part I

1 Access to Bank Accounts and Payment Services

Luisa Anderloni and Emanuele Maria Carluccio

1.1 Introduction: Financial Exclusion

The link between finance and growth has been thoroughly studied by several analysts from a macroeconomic perspective, with theoretical approaches, methodological issues and empirical analyses that are still being debated¹. In relation to developing countries, the study of access to financial services by families and individuals is fairly recent. In this context, both private and social benefits have been shown to accrue from improving access to financial services, such as promoting economic growth and improving income distribution. In addition, it can play a key role in reducing risk and vulnerability².

In contrast, it is access to bank relations that has been more recently studied within developed countries³. Since the 80s, special attention has

¹ For a wide overview of this debate, see Goodhart C.A. (2004), Levine R. (1997) and Levine R. (2005), in which the main focus is on aggregate growth. They consider the impact on real economy, namely on the development of the country's economic activities in terms of several GNP configurations. The essential functions recognised by Levine for the financial system are described from a macroeconomic perspective and focus primarily on business activity. However, the most recent analysis and studies highlight new research perspectives on the relationship between finance, income distribution and poverty. Furthermore, recent studies on the link between finance and growth in the developed countries have tended to address the question of whether bank-based systems are superior to the market-based ones.

² For all of them, see Beck T., A. Demirguc-Kunt and R. Levine (2004) as well as Honohan P. (2004).

³ A certain attention was given to all this in Europe in the sixties at the time of institutional reforms and/or interventions on territorial articulation and bank institutional structures. For example, in France, a set of measures paved the way

been devoted to the issue of financial exclusion, seen as part of the wider issue of social exclusion. This has been particularly true of the US, as well as some European countries – the UK and France in particular. The issues have proved to be multifaceted with a range of different solutions proposed. The experience of several countries in addressing these issues is described later in this chapter.

Both theoretical and practical studies have been undertaken. At a theoretical level, studies have looked at the economic, sociological, institutional and behavioural reasons why some market segments have difficulty to accessing the financial system. They have also addressed the question of appropriate policy responses.

From a practical point of view, the studies have looked closely at who exactly are having access difficulties, the reasons for these difficulties, possible solutions to meet at least the most basic needs, the types of institution most able to play a role in financial inclusion.

Several trends in the banking system and, more generally, in the wider institutional framework have tended to exclude people with low-moderate incomes, who have tended to be increasingly lumped together with the poorest elements of the population.

The analysis that follows looks at the debate about financial exclusion in several countries. Many stakeholders are involved: government, the financial services industry, related authorities and voluntary groups, consumer organisations and different academic interests. They have focussed on a number of aspects:

- from the social point of view, the importance of everybody being able to participate in financial processes and to benefit from the basic mechanisms that provide opportunities for economic independence⁴;
- from the point of view of society's economic interest, individuals excluded from financial transactions and payment systems cause inefficiencies within the financial system that results in social costs⁵;

for a households' higher level of access to bank services, which went up from 18% in 1966 to 99% nowadays. See Gloukoviezoff G. (2004c).

⁴ In this respect, Sinclair S.P. (2001), p. 14 states that people facing difficulties accessing banking services can be prevented from being able "*to make an economic contribution to the community*".

⁵ So, as it was underlined, following the renewed interest for the access of retired people or the ones that receive subsidies of different kinds, in the US as well as in UK, the debate on financial inclusion and the offer of basic banking accounts to meet the life-line banking has been also stimulated by the need to reduce the administrative costs related to social subsidies management. In this respect, it is the electronic forms of payment that have been promoted.

- those who are financially excluded also risk being socially excluded and are not able to take part fully in the production of value, and to make a positive contribution to the system as a result;
- from a legal point of view – but with major social and economic implications as well – the debate is around the right to an account, a service that is an essential part of normal economic and social life, to be provided at a reasonable cost and quality⁶.

If the concept of financial exclusion is a multidimensional one⁷, what are its main elements?

At least two possible definitions of financial exclusion are described in the literature.

A wider definition focuses on financial needs. It refers to the difficulties experienced by low-income and socially disadvantaged people in accessing the financial system in all its forms in order to meet those needs. These needs include opening a bank account, to have the option of non-cash payment services and to have access to affordable credit. The needs also include the opportunity to build up modest assets through appropriate savings and investment vehicles offering flexible terms and easy access to funds, and also take account of social security allowances and unstable work patterns.

A rather more restrictive definition puts the emphasis on specific services and their absence. These services are sometimes described as “essential” and refer more to a certain notion of universal services, “*services that do not have an impact on the households’ budget, but (they) represent at the same time essential elements for the individual’s life, subsistence, security and participation to the economic and social life*”⁸. This definition is

⁶ On this debate in Europe, see following § 1.2.5.

⁷ See Kempson E. and C. Whyley (1999) and several other authors that have further studied and confirmed this.

⁸ See Anderloni L. (2003a), Pesaresi N. and O. Pilley (2003) with a specific reference to State aids in this context. See also Pilley O. (2004) : “*L’accès de tous aux comptes courants et aux moyens de paiement autres que l’argent en espèces, ne figure pas parmi les services essentiels (électricité, eau, chauffage, santé, éducation, justice et services publics et privés tels que la culture, le sport et les loisirs) auxquels doivent pouvoir accéder tous les citoyens européens en dépit de l’importance de cet accès pour un exercice plein de la citoyenneté dans une société de l’information. Par contre, le surendettement y figure. Il est explicitement reconnu que le surendettement peut conduire à une fracture sociale et, à ce titre, doit faire l’objet d’une prévention. Enfin la responsabilité sociale des entreprises est évoquée spécifiquement comme un moyen essentiel de mobilisation*”.

usually used in the context of legislative measures to impose an obligation in terms of a universal service of essential or basic bank services.

An additional dimension to financial exclusion also includes “underbanked” individuals who, while they do in fact have a bank account (they are not “unbanked”), use their account very little as they have a pattern of living in which they mostly use cash or prefer to use other channels outwith the mainstream financial system⁹. This dimension will also be discussed in later sections.

In the light of these features, it seems appropriate to adopt a wider definition of financial exclusion, such as the following: *“The inability to access necessary financial services in an appropriate form. Exclusion can come about as a result of problems with access, conditions, prices, marketing or self-exclusion in response to negative experiences or perceptions”*¹⁰.

The advantage of this definition is that it effectively encompasses both objective circumstances, “lack of access to financial services”, as well as specific assessments: whether, as a matter of fact, the services offered are appropriate to the needs. Furthermore, it also links the objective situation to various circumstances that, whether individually or jointly, lead to exclusion. These include both obstacles from the supply side as well as barriers from the demand side, such as lack of knowledge or awareness.

In general, this concept of financial exclusion can be applied both to individuals and to communities, namely homogenous groups of individuals that live in the same context and share access difficulties. In general terms, financial exclusion amongst individuals and/or communities is due to

⁹ In this respect, Barr M. (2004) uses the term “unbanked” to refer to “individuals that do not have an account (savings, checking, or otherwise) at a depository institution” and refers to the “underbanked” people as those with an account at a depository institute but who rely for their financial services providers (such as check cashers, payday lenders, auto title lenders, refund anticipation lenders, and rent-to-own companies) that largely serve low and moderate income neighborhoods”. Barr observes that the problems faced by the “unbanked” and “underbanked” overlap significantly but diverge in important aspects, which he further develops.

¹⁰ See Sinclair S.P. (2001). This notion is further accepted by Carbó S., E.P.M Gardener and P. Molyneux (2004). On the other hand, according to Gloukoviezzoff G. (2004c), financial exclusion is the process whereby people encounter such access and/or use difficulties in their financial practices that they can no longer lead a normal social life in the society in which they belong. In other terms, he links the notion with the social implications these difficulties imply and clearly underlines that the social consequences that constitute it vary depending on the society under consideration as well as the status of the person concerned.

geographical location, low income, general conditions of poverty, age or disabilities, living in depressed urban areas or belonging to specific, often ethnic, groups. While earlier studies often focused on the geographical aspects of exclusion¹¹, later studies have taken a broader perspective and have sought to explain wider underlying processes behind financial exclusion.

Following a study supported by the Financial Services Authority in Britain in 2000, the following categories of causes/forms of financial exclusion have been identified and are widely accepted¹²:

- “*geographical access*”, referring to the existence of bank and counter services in particular geographical areas;
- “*access exclusion*”, referring to restricted access as a result of banks’ risk assessment processes;
- “*condition exclusion*”, the conditions relating to financial products offered mean that they fail to meet the needs of some groups of clients;
- “*price exclusion*”, charges associated with products or services that are too high for some individuals;
- “*marketing exclusion*”, some market segments are specifically excluded by the way marketing and sales are targeted;
- “*self-exclusion*”, referring the fact that some parts of the population refuse to approach banks, believing that any request for products or services would be turned down.

These main elements of financial exclusion have been further analysed and, depending on the perspective applied, grouped differently in particular cases¹³.

¹¹ See the experiences made in the UK and in the US in § 1.5.

¹² The classification Kempson E. and C. Whyley propose has been further addressed by Anderloni L. (2003a), Carbó S., E.P.M Gardener and P. Molyneux (2004). It is an importance reference for all the following studies. In fact, also G. Gloukoviezoff, while studying the issue of over-indebtedness, underlines that “*the deprivation of all or part of financial services (from a bank loans and savings products) and over-indebtedness are two side of the same coin*” and analyses financialisation of social relationship within modern societies. See his contribution (Chapter 5) to a more precise discussion of the aspects the various authors underline.

¹³ Beck T. and A. de la Torre (2006) distinguish 3 types: *i)* “geographic limitations”, referring, as example, to “the absence of bank branches or delivery points in remote and scarcely populated rural areas that are costlier to service”, *ii)* “socio-economic limitations when financial services appear inaccessible to specific income, social or ethnic group either because of high costs, rationing,

Another useful distinction, focussing on the causes of financial exclusion, explores concepts such as affordability and access, with an emphasis on economic variables, on the one hand and, on the other, on behavioural variables¹⁴.

A further relevant distinction can be made between: *i*) access and the opportunity to use financial services and *ii*) the actual use of financial services¹⁵.

In many cases, “alternative financial services providers” play an increasingly important role, especially payment services (exchange, cheques and transfer of remittances to the original country for migrants, and loans for immediate cash needs). In addition, there are also bank accounts that are opened but that are basically not used. So, within the category of self-excluded people, there are also those that refuse any form of bank service¹⁶. This is linked sometimes to a certain resentment towards the system but, more often it is linked to the fact that the services offered are not financially accessible, fall short of what is needed, or because the potential user believes they would be rejected by the bank and see little point in making an approach in the first place.

Difficulties of access and difficulties in using these services are closely linked to the behaviour of both providers and their customers. The above approach provides a useful tool to analyse the issues and to identify a wider range of interventions with the potential to facilitate financial inclusion.

financial illiteracy, or discrimination” and *iii*) “limitations of opportunity” when “talented new comers with profitable projects are denied finance because they lack fixed collateral or are not well connected. As a variant to the main above-mentioned classification, Honohan P. (2005) explicitly proposes the following categories: *i*) “price barrier”, when service is available but too expensive, *ii*) “information barrier”, when poor household’s creditworthiness cannot easily be established, and *iii*) “product and service design”, when banks fail to offer the kind of services that would be most useful for poor households. The reason for these barriers, Honohan points out, may be technological, regulatory or market factors.

¹⁴ See Connolly C. and K. Hajaj (2001).

¹⁵ This position is shared by Gloukoviezzoff G. (2005a) too. About this aspect, see also World Bank (2005), further developed in § 1.3 and the above-mentioned distinction between “unbanked” and underbanked,” proposed by Barr M. (2004).

¹⁶ These responses include the ideological position of refusing to interact with any banks. In this respect, see in §1.6 the results of the survey that has been carried out in France, Italy and Spain.

Table 1.1 Summary of different types of financial exclusion

Difficulty of access		
Supply side practices	Direct screening	Banking policies: refusal to serve customers on account of profile.
	Indirect screening	Counters localisation policies in areas with no socio-economic degradation Marketing: adverts to profitable/ market segments only (marketing exclusion)
Demand side practices	Self-exclusion	Refuse to use some services
Difficulty of use		
Supply side practices	Customer profile scored “too costly to serve”	To force a deeper usage of services (policy of packaging, link some services to others, etc.) Higher fees and charges for those services that are more frequently used by undesired customers
	Customer profile scored “too risky to serve”	To use penalty clauses and charge fees and commissions for non payment to improve profitability or to weed out customers that do not pay To take advantage of lack of knowledge of their rights from weak customers (undue foreclosure, dishonour of plans in cases of over-indebtedness)
Demand side practices	Eschew banking relationship	Do not keep the bank informed about the difficulties being experienced To look for solutions from outside the banking relationship (revolving credit, undeclared work, etc.)

Source: adaptation from Gloukoviezoff G. (2005).

1.2 Interests, Concerns and Possible Solutions

1.2.1 General Trends

There are several reasons why growing sectors of the population are interested in having accessing financial services and why increasing attention is being given to the problem of financial exclusion. These include:

- an increased focus on all types of social exclusion and discrimination. In Europe, this interest has been encouraged by a number of leading countries (France, Great Britain and some Nordic countries) and has also been strongly supported by the European Union¹⁷. A major emphasis has been then put on measures to promote the social and economic potential of all to the full;
- the spread of social and economic organisational models over the past two or three decades that, on one hand, have made it more difficult to survive without contact with banks and other financial services providers and that, on the other, have increased socio-economic instability¹⁸. This instability has also made stable relationships with banks and other financial services providers more difficult and expensive and has widened the gap between the provision of necessities, on one side, and the accessibility of what is offered on the other;
- providers own policies may result in the neglect of clients considered marginal. In particular, cost based pricing and risk-based policies, with their corresponding techniques of measuring profitability and capital allocation can contribute to this. Growing pressures on banks for a higher manufacturing and distribution efficiency call for a stringent reduction in costs in search of greater profitability. This results in market segmentation policies with a preference for customers with greater financial resources, whereas those with more modest resources no longer benefit from cross-subsidies from other market segments. In fact, until recently, many basic banking services

¹⁷ In particular, the Lisbon European Council in March 2003 underlined the positive interaction between economic, social and employment policies, which aim to promote a model of sustainable development for the Union to raise all the European citizens' lifestyle. This would be possible by linking economic growth, social cohesion and safeguard of the environment. This objective is pursued also by modernising the European social model, investing in people and fighting against social exclusion.

¹⁸ Some phenomena are mentioned, in particular: *i*) the employment market has become more flexible with more and more flexible working contracts, compared to the full-time open-ended jobs, *ii*) the traditional families have disappeared; see also the implications of ageing population, rising number of separations and divorces, diminution of marriages and, as a consequence of that, the rising number of cohabitations and children born to unmarried couples or raised by only one parent on the social integration solidity, *iii*) the development has geographically polarised, with major gaps between urban and suburban areas, economic and social wellbeing and degraded areas, *iv*) the speed gaps in the development of a knowledge society.

were effectively cross subsidised by more profitable activities. Increasing competition and the emphasis on efficiency and profitability have conspired to eliminate these models. Automation and the spread of self-service banking, with low levels of interaction with bank staff, have also had a negative impact on access. More traditional users with lower technological and financial literacy and unwilling to use self-service banking, are penalised and do not benefit from the lower bank charges for self-service transactions;

- the transformation of the banking system. Many types of bank (such as mutual, co-operatives, previously public or, more rarely, private banks), have been privatised or taken over by commercial banks. The primary task of many of these banks in the past was to develop the local context and to support the poorest parts of the population, as well to encourage involvement in the local community;
- the rationalisation of the network of bank retail outlets as a consequence of the two above-mentioned factors¹⁹. Outlets are increasingly located in the most profitable areas and increasingly tend to avoid degraded urban areas and poorly populated rural ones²⁰;
- measures both to combat money laundering and to combat the financing of terrorism bring a greater bureaucratisation of financial transactions in their wake and increase the importance of management and counter staff knowing more about their customers;
- finally, the increasing withdrawal of the state from the provision of social security means that there is a growing need for personal savings and more use of private sector provision to meet future needs, including the needs of those with the least financial resources.

People running the greatest risk of financial exclusion as a result of these trends share important common features even if their context is different. Evidence from different countries suggests that financial exclusion is concentrated among people with the lowest incomes and that unemployed people, those unable to work due to sickness or disability, and

¹⁹ It should be mentioned that the above-mentioned transformation process has often come along with concentration and revision processes, within a group perspective, with localisation of counters, closure of the ones that were overlapping in some areas and the ones whose profitability was considered not sufficient according to new profitability requirements and the new business' mission.

²⁰ This contributes to the concentration of multiple disadvantages in certain urban and rural communities and among some groups.

lone parents are especially affected²¹. Indeed, many people either stop using, or close down a bank account and cancel insurance policies when they leave the labour market.

Furthermore, it is the youngest and oldest parts of the society that have the most limited access to the bank services, though for different reasons. Young people on low incomes tend to have poor knowledge of financial services and, in addition, are more likely to have experienced financial difficulties because of a failure to respect their financial (and non-financial) commitments. Members of the oldest age groups on low incomes tend to have lived on a low income all their lives, never to have used financial services and to have only used cash. They tend to be highly resistant to change and prefer to continue the practice of carrying out their transactions solely in cash²².

Recent immigrants and refugees face particular problems, partly through low income and partly through lack of appropriate documentation²³. Cultural and religious factors can also have an impact²⁴. In addition to this, migrants from some specific areas often have either a poor or even no knowledge of the banking system or have little trust in it. For this reason, they are reluctant to engage with banks. Together, ethnicity and low income can lead to geographical concentrations of serious financial exclusion.

In drawing up a picture of factors that contribute to difficulty of access to the banking and financial services industries, there are three further issues that increase the risk of financial exclusion in the broad sense of the term:

- underbanked people and the use of fringe banks;
- over-indebtedness and payment incidents;
- financial illiteracy and other forms of misuse of the financial system.

²¹ See Anderloni L. (2003a), Bayot B. (2005), Kempson E., A. Atkinson and O. Pilley (2004), Gloukoviezzoff G. (2005), Kempson E. and C. Whyley (1999), and § 1.6 in this chapter.

²² See Anderloni L. (2003a) pp. 58-96, GES (2000) and Kempson E., C. Whyley, J. Caskey and S. Collard (2000).

²³ Permit to stay or identity documents. About the issue of migrant population's access to financial services, see: Atkinson A. (2006), Anderloni L. (2003b), Anderloni L., E. Aro and P. Righetti (2005) and chapter 10 in this book.

²⁴ In particular low-income Muslims living in a predominantly Christian often find that there are no Shariah-compliant financial services they can use. About Islamic finance, see Llewellyn D. and M. Iqbal (eds) (2002).

1.2.2 Underbanked Individuals and Fringe Banks

Though underbanked individuals formally have access to a bank account, for various reasons their needs are not satisfactorily met through their relationship with the bank and they remain then partially excluded from the banking system (for example they have no fiduciary instruments at their disposal, such as cheques or credit cards). Because of this they use alternative channels. To meet a need for immediate cash, for example cashing a cheque or other payment instrument, or a short-term loan, they address themselves to providers operating in areas of “grey regulation” often out-with the remit of consumer protection legislation. The underbanked individuals’ position can take different forms in different contexts. For example, in France where, for historical reasons, cheques still represent an important payment instrument, not having a chequebook puts one at a severe disadvantage; moreover, the widespread use of credit cards means that the failure to own one can reflect negatively on a person’s trustworthiness. In Sweden, internet banking is widespread and bank transactions at the counter are financially penalised and those without access to a computer and to the internet suffer.

In some contexts, the fact that the unbanked or underbanked individuals use fringe banking services is a matter of some considerable concern since they tend to be associated with exorbitant costs and unfair conditions. The sector comprises both providers with a long tradition of meeting the needs of marginal customers (in particular the pawnshops that provide credit upon pledge, that experienced an exponential development in the 80s)²⁵, as well as newcomers to the market (cheque cashing firms, pay-day loan firms, rent-to-owns and, more generally, finance and loan companies), who provide, immediate cash to this market segment. This case is forthcoming at the expense of very high charges, since they associate a high premium to the risk involved.

This phenomenon is particularly widespread in the US²⁶, in Canada²⁷ and in the UK²⁸. In these countries, increasing attention has come to be paid to these services and their impact on their customers – most of whom are economically fragile. In some other countries (for example in Italy and

²⁵ Caskey J.P. (1994).

²⁶ See Caskey J.P. (1994), Fox C.J.A. (1998), Rhine S.L.W. et al. (2001), Arthi Varma (2004).

²⁷ See Buckland J., M. Thibault et alia (2003) and (2005).

²⁸ See Carbó S., E.P.M. Gardener and P. Molyneux (2004) and several articles on the daily press in 2004.

Ireland²⁹) there are signs that seem to indicate that these financial services have established themselves and are growing in importance. However, since the phenomenon has not been studied in detail, it is not really possible to get an accurate picture of its size, its ways of working and the dangers involved. The above-mentioned studies clearly show, however, the risks associated with the fringe banking sector, particularly for low-income, socially and economically fragile customers. In fact, the sector encourages a vicious cycle where indebtedness grows, the costs of servicing debt increases, and the repayment arrangements become ever more demanding, with the result that the financial situation of those dependent on the sector becomes more and more difficult with an increased risk of poverty as a result.

1.2.3 Over-Indebtedness

Over-indebtedness appears, at first sight, to be a paradoxical phenomenon. In fact, in addition to being associated with financial exclusion on account of difficulties in accessing the financial services market, modern economies also see financial exclusion resulting from exclusion from the market as a result of over-indebtedness, and when the situation has been faced in a way that is damaging³⁰. At the same time there is another growing form of indebtedness. This is household indebtedness (to support consumption, to purchase the house, as a result of unforeseeable events, and so on) and it is a characteristic trend in modern economies: the over-indebtedness risk³¹ –

²⁹ In particular, usury is mentioned, that is to say funding at so high rates that the loan will be ever redeemed, but it grows so massively to force the debtor to sell all his/her available goods, ask for the family's help, and includes in some cases slavery and prostitution. These are of course illegal operations that remain out of the legal credit market and for which even the rules on threshold usury rates are ineffective.

³⁰ On how the two phenomena are compatible, seen as two sides of the same coin, see G. Gloukoviezoff in this volume.

³¹ To underline the social implications of the phenomenon, the following definition is adopted: "*over-indebtedness conditions are present when a private subject (a household) is incapable of facing the payment obligations in due time according to its current revenue. If it did it, its survival conditions would disappear*". See Anderloni L. (1997), p. 77. On the notion of over-indebtedness and, even more, on the modalities to measure this phenomenon, the literature's debate is still open and there is no general agreement about how this is to be defined or measured.

and, in particular, so-called “passive over-indebtedness”³² – is higher for the socially and economically fragile individuals. It should be remembered at this point that over-indebtedness can result not only from the need to keep up loan payments, but may also result from other commitments including rent, utilities, insurances, taxes and duties or cash advances within family structures.

In fact, while over-indebtedness can affect all sections of the population, researches have shown that it is primarily related to low income. Besides lower incomes, separations and divorces are also often major factors.

Over-indebtedness has, then, important and complex links with social and financial exclusion. While over-indebtedness is often a consequence of social exclusion it can also be a direct cause of exclusion, leading to exclusion not only from financial services, but also from other spheres of economic life such as telecommunications, housing or even employment.

Problems of over-indebtedness mostly arise through changes in circumstances that give rise to an unexpected decline in income, making existing commitments unaffordable. This can include job loss, divorce and the onset of long-term sickness and disability. Some of these tend to be concentrated among young families. At the same time, it is important to note that people who are already socially excluded, and living on low income for long periods of time, also have a high risk of over-indebtedness, particularly taking into account all their household commitments rather than simply consumer borrowing.

³² This is distinguished, from a logical point of view, from active over-indebtedness. “Active” over-indebtedness indicates the condition caused by the individual’s high tendency to spend (for consumption and/or investments) because he/she highly trusts his/her current and future revenue capacity. In other words, the individual’s economic and financial behaviour makes him/her underestimate his/her engagements’ size (entity and deadlines). Alternatively, he/she implicitly overestimates his/her income flows over time. “Passive” over-indebtedness indicates the condition that has been generated after indebtedness decisions, by unforeseeable factors that are generally independent from the individual’s will, job loss as an instance. In this context, there is no revenue (or parts of it) and the income flows has been interrupted or reduced; at the same time, some unplanned liabilities have emerged (diseases, disability, rising rent costs). These elements are more likely to occur within the economically and socially weakest and most vulnerable parts of the population and within the economic cycle’s phases that go towards recession. The distinction on the practical point of view is not always evident. It is clear that the lowest the individual’s current revenue is, the most frequently the “active over-indebtedness” will occur, for cultural and economic needs.

The links between over-indebtedness and financial exclusion can thus be summarised as follows:

- some studies have shown clearly that the people who are mostly subject to passive over-indebtedness (see definition above), have much in common with people who find it difficult to access the financial system and gain appropriate and mindful use of financial products and services³³;
- payment and debt repayment difficulties resulting from over-indebtedness often causes financial exclusion. For example, modern credit ratings techniques, allow personal information to be distributed through centralised credit reporting systems, so that someone with negative credit information such as a default can find themselves excluded in future from access to finance and, as mentioned above, also telecommunication or even employment;
- the means of preventing the risk of over-indebtedness occurring³⁴ and the ways of dealing with it, once the difficulties have reached a climax³⁵, are often the same as the ones that can be used to prevent the risk of financial exclusion and to help economically and culturally fragile people develop a relationship with the financial system.

Besides its links with financial exclusion in general, the issue of the financial exclusion of households has given rise to two particular concerns at EU level.

³³ On the extreme, it is the population with the highest revenues that most frequently face active “over-indebtedness”. In the countries where consumer credit is very widespread, people are becoming over-indebted simply through over-borrowing. These people are not necessarily living on low incomes: indeed to obtain the levels of credit they have, they need to be in fairly secure jobs on middle incomes. They are people who are active consumers, who frequently aspire to a life style that they cannot afford on their income – consequently they live beyond their means by borrowing heavily. They also tend to be relatively young, since this is the time when household budgets are most limited and the need to borrow arises.

³⁴ The most common initiatives to deal with problems of over-indebtedness are, on the demand side, programs for promoting financial literacy and to raise levels of financial capability, on the offer side, initiatives for promoting responsible lending by creditors, and on the institutional side, appropriate arrears recovery practices by creditors.

³⁵ *Ex post* initiatives to deal with serious problems of over-indebtedness are both procedure for bankruptcy or “personal recovery” to deal with the most difficult, i.e. irreparable, situations, and provision of free debt advice for helping to draw a plan of reimbursement and provision of mediation services with the creditors in order to come to an agreement on a rescheduled plan of reimbursement.

The first is the impact on consumers of the enlargement of the credit market, and increased competition and innovation. This is in the context of European Union moves towards a single harmonised market for financial services, progress with the Financial Service Action Plan³⁶ and the proposal for modifying the Directive on consumer credit³⁷. The priority is to find a balance between the goals of maintaining accessible and affordable credit together with the promotion of the internal market, while ensuring at the same time, a high degree of protection for consumers throughout the European Union.

This debate highlights a discrepancy between the objective of offering financial service providers legislation to allow them to operate in the same way in all the Member States, through full harmonisation of key legislation and, at the same time, the goal of not reducing levels of consumer protection, leaving space for regional problems and combating the increase in over-indebtedness. A major concern is that, in some contexts, aggressive policies to promote the use of credit via revolving cards could lead to an intolerable increase in indebtedness, including over-indebtedness amongst those who are most economically and culturally fragile and who would be most exposed to the risk of taking on too big commitments too quickly. The increase in card-based payments undeniably presents a number of policy problems, the most serious of which is the likelihood that the use of cards will contribute to an unjustifiable level of consumer credit and that borrowing on the cards will contribute to an increase in the level of consumer bankruptcy³⁸.

Secondly, preventing and dealing with different forms of over-indebtedness represents, in some countries, an important part of the common objective to fight against poverty and social exclusion. The Lisbon European Council has established a political framework, including the fight against exclusion in the Union's overall strategy³⁹. This is to be achieved through an open method of co-ordination combining national action plans and a Commission's initiative for co-operation in that field. In accordance with its mandate, the Treaty of Nice endorsed the fight against

³⁶ See http://ec.europa.eu/internal_market/finances/policy/index_en.htm

³⁷ See Modified proposal for a Directive of the European Parliament and the council on credit agreements for consumers amending Council Directive 93/13/EC COM (2005) 483 final and the following Council of the European Union, DS258/06 of April 4th 2006. The importance to amend the Directive is reaffirmed in White Paper, Financial Services Policy 2005-2010.

³⁸ Because increasing financial distress imposes externalities on the economies in which it occurs, the global rise of the credit card poses serious policy questions.

³⁹ See Lisbon European Council, Presidency Conclusion, March 23rd and 24th, issue "*Promoting social inclusion*".

social exclusion and all forms of discrimination, within its European social agenda⁴⁰. Furthermore, it has included the fight against exclusion within art. 137 of the Treaty establishing the European Community. Based on this, the Council has invited the Member States to elaborate a common approach by preparing two-year National Action Plans on Social Inclusion⁴¹. In this context it should be pointed out that, amongst initiatives aimed at preventing the risk of exclusion, several national plans have included specific initiatives to confront over-indebtedness and financial exclusion. In particular, as over-indebtedness has increased it has had unfavourable implications for poverty and exclusion amongst individuals and households (for example, they were discouraged from looking for or accepting a job)⁴². Initiatives taken to combat the rise in over-indebtedness include the promotion of information and the development of educational activities⁴³. In addition, some countries⁴⁴ have also adopted measures to improve access to banking services and to provide free financial advice services. On top of this, the reports presented by United Kingdom⁴⁵, Netherlands, France, Finland, Belgium and Germany highlight the measures taken to combat financial exclusion, such as easier access to bank accounts, simplified soft

⁴⁰ See Nice European Council Meeting, December 7th, 8th and 9th 2000, Presidency conclusions, Annex I, European Social Agenda, III Fighting Poverty and all forms of exclusion and discrimination in order to promote social integration.

⁴¹ See NAPS/Inclusion 2003-2005 and updated reports on 2004-2006 NAPS/Inclusion.

⁴² The situation and level of attention is different in the various countries, since there is no official or academic shared definition, it is difficult to compare the available data. This phenomenon seems to be relevant in Austria, Belgium, Germany, France, Ireland, Netherlands, the UK, Portugal where the NAP on Social Inclusion point out that the phenomenon has reached worrying levels and in Spain where a report of the Bank of Spain underlined the problem that 34.5% of the poorest families had debts which were three times more than their annual income. See Commission of the European Communities, Commission Staff Working Document, Implementation and update reports on 2003-2005 NAPS/Inclusion and update reports on 2004-2006 NAPS/Inclusion, COM (2006) 62 final.

⁴³ Examples of that are Austria, Belgium, France, Luxembourg, Portugal that include these initiatives within the 2003-2005 NAPS on Social Inclusion.

⁴⁴ France and Belgium in the first case, the UK in the second case.

⁴⁵ The experience is particularly articulated in UK: generally, also afterwards, the government sets out the goal to reduce by 50% the number of people that do not have any bank account; to this purpose, it has created a special fund for financial inclusion. Some regions (Northern Ireland, Wales and Scotland) have taken specific initiatives.

loans and face-to-face counselling to cater for the needs of people on low incomes. In these cases, financial exclusion is seen as part and parcel of social policies to fight poverty and promote social inclusion.

Other initiatives taken to prevent and manage over-indebtedness include services that offer advice and guidance for people with debts⁴⁶ and legislation on the regulation of debt⁴⁷.

1.2.4 Financial Literacy

The lack of financial understanding amongst consumers is a second major issue and surveys in a number of developed countries⁴⁸ suggest that financial literacy levels are particularly low amongst the less educated, minorities and those on the lowest incomes. Financial literacy is increasingly important today for a number of reasons:

- the wide range of financial products and services designed to meet a range of often sophisticated needs that are not easily understandable by the inexperienced user;
- the increasing complexity of financial products, with a very sophisticated range of options; combined with a time gap between the purchase of a financial product and its use to do what it is supposedly designed to do. Therefore, it is only at a later stage that it becomes apparent whether the original choice made was appropriate or not;
- the reduction in public pension provision and the need for the integration of public and private provision or the substitution of the latter for the former. The choices involved are complex ones, in which the risk tends to be transferred from the provider to the worker;
- the general growth in standards of living and therefore the increasing number of individual investors who have money saved that needs to be invested. At the same time, the increasing level of job insecurity in a more flexible labour market often make this saving essential to provide a buffer in the face of sudden changes of income;
- the trend towards the liberalisation of markets with a proliferation of providers and distribution channels, together with increasing product innovation, increases the risk of mis-selling and of consumers being actually “ripped off”.

⁴⁶ See the experiences of Austria, Belgium, Germany, Finland, France, Hungary, Netherlands, Ireland and the UK.

⁴⁷ With reforms introduced in Germany, France and presently under discussion in Belgium, Finland and Netherlands.

⁴⁸ See US, the UK and Australia.