

NO. 55

**Banking the Poor:  
Key Prospects and Constraints**

by

**Robert Hinson**

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# WORKING PAPER SERIES

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## **Banking the Poor: Key Prospects and Constraints**

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### **Abstract**

**Purpose:** This paper seeks to conceptually analyse the key constraints to providing financial services to the poor faced by banks and other financial institutions; especially to economically disadvantaged regions of the world like the West African sub-region. **Methodology:** We adopt a literature survey approach and draw on theoretical concepts like finance, financial services, micro-finance and mobile technologies to reach our study conclusions. **Findings:** High transactions costs due to asymmetric information, inability to securitize loans with collateral are some of the key constraints to extending credit or banking services to the poor. Many financial institutions that offer credit to the poor usually adopt group-based lending approach capitalizing on peer monitoring and guarantee mechanism. Technology could however be developed and deployed to process loan payments, savings deposits, withdrawals and transfers to the poor, Mobile technology also holds some promise for alleviating extreme poverty and providing channels for the poor to enjoy banking services. **Originality/Value:** This paper examines in a multi-theoretical fashion key issues attendant to banking the poor.

**Key Words:** Banking, Poor, Mobile, Technology, Africa,

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## **Financial Services and the Poor**

About 90 percent of the people in developing countries lack access to financial services from institutions, either for credit or savings, which further fuels the “vicious cycle of poverty” (Robinson, 2002). According to the Human Development Report (2005), the ratio of the incomes of the richest 20 percent of the population to the poorest 20 percent exceeded 17 in 21 countries, but was less than five in 27 others. In some countries, essentially nobody lives on less than \$1 per day, but in 22 countries more than one-third of the people live below this commonly used poverty line. To look more directly at the impact of financial development on absolute poverty, Beck et al. (2007) estimate the change in the share of each country’s population below the international poverty line that results from financial development. Again, they find a robust effect of finance on poverty alleviation. Countries with higher levels of financial development experienced faster reductions in the share of population living on less than \$1 a day over the 1980s and 1990s (Beck et al., 2007).

Studies on poverty and finance have been conducted mostly in developing-economy contexts, especially in Asia and Latin America with most of these studies focusing on the link between microfinance and poverty (Dixon et al., 2006; Sadeq, 1997; Dao, 2004). In developing countries like Africa, very few studies have been conducted on the correlation between poverty and finance (see Odhiambo, 2009). Most people in developing economies like Ghana do not have access to a bank, credit union or similar financial services. Innovations in the financial services sector in Ghana have compelled financial institutions to diversify their portfolio of products and services; and the target population they serve. Most financial institutions have broken new grounds and started reaching out to the marginalized in society by making products and services available to them through a number of technological platforms like ATMs, mobile phones and the Internet.

A review of extant literature on providing financial services to the poor, however reveals that not many studies have been conducted in the African context. Studies relating to providing financial services and the role of such services to the poor have been conducted in Asia (Koveos and Randhawa, 2004; Hassan and Renteira-Guerrero, 1997; Megicks et al., 2006; Kumar and Newport, 2005; Matin et al., 2002; Mahajan and Ramola, 2009; Dusuki, 2008; Gehlich-Shillab, 2008); Europe (Hussain et al., 2001); America (Bouman, 1990; Hawke, 2002; Henson and Wilson, 2002; Germain, 2000); Australia (Ahmad and Ahmad, 2009). Studies conducted in the African context have so far examined how financial services could be accessed by the urban poor in South Africa

(Paulson and McAndrews, 2001); how technology could be deployed to provide financial services to the poor in war-ravaged Uganda (Firpo, 2005). The focus on West Africa and for that matter Ghana in particular in relation to providing financial services to the poor is almost non-existent. Studies available have examined such issues as motivations for bank patronage (Hinson et al., 2009); poverty profile and the correlates of poverty (Adjasi and Osei, 2007); and the Internet and banking (Woldie et al., 2008). Koku (2009) catalogues a number of reasons why research into finance and poverty has been scanty in developing economy context. We attempt in this paper to extend Koku (2009)'s work by conceptually examining some of the key impediments to financial services patronage by the poor.

### **Challenges facing the poor in the bid to patronize Banking services**

There are varying definitions of the poor in several developing country contexts and according to [www.ghanaweb.com](http://www.ghanaweb.com) a poor person in Ghana is supposed to earn below GHC 3.11 (2.15 USD) a day and this wage took effect from February 1<sup>st</sup> 2010. This represented a 17% increase from GHC 2.65 a day. Providing financial services to poor in the society often requires more than traditional style of financial intermediation. According to [Ledgerwood \(1999\)](#), financing the poor takes some form of measures of up-front investment to nurture human capacity (e.g. knowledge, skills, confidence and information) and build local institutions as a bridge to reduce gaps created by poverty, illiteracy, gender and remoteness (Dusuki, 2008). Social intermediation has been defined as “a process in which investments are made in the development of both human resources and institutional capital, with the aim of increasing self-reliance of marginalised groups, preparing them to engage in formal financial intermediation” ([Bennett et al., 1996](#); [Pitt and Khandker, 1996](#)).

Social intermediation is different from other common types of social welfare services because it offers mechanism enabling beneficiaries to become clients who must then be ready to enter into a contract involving reciprocal obligations. This aspect of social intermediation should eventually prepare individuals to enter into solid business relationships with formal financial institutions. By playing the role of social intermediation, banks not only build a self-reliant groups of poor people in rural areas with related skills that could foster long-term business relationship, but also create cost advantage of informal monitoring and enforcement systems in the long-run, which is inevitably important for a more efficient and effective role of financial intermediation (Dusuki, 2008).

Financial institutions and poor clients face high transactions costs due to asymmetric information problems which naturally appear in financial transactions. These are costs related to identifying and screening the loan applicant, processing the loan application, completing the documentation, disbursing the loan, collecting repayments and following up on non payment (Shankar, 2007). Traditionally, most formal financial institutions are structured to handle much larger individual transactions or loans than those required by the poor. Lending to the poor who normally demand small amount of loans is regarded expensive because of high overhead costs (Jacklen, 1988; Zeller and Meyer, 2002; Braverman and Guasch, 1986).

Empirical studies have shown that a substantial number of households, especially the most poor, appear ill-equipped to handle even small scale, localized risks (Alderman and Paxson, 1994; Morduch, 1997). In view of the virtually complete absence of formal insurance and social security systems accessible by the poor (Haddad and Zeller, 1997), they use a multitude of measures to reduce the likelihood or impact of risks either through ex-ante or post measures for smoothing income, consumption or both (Murdoch, 1997; Rutherford and Arora, 1996). Households enter into co-insurance contracts with their neighbours, relatives and market partners who reciprocate help in difficult times.

Demand for financial services from poor households' calls for short and long term credit lines for financing inputs and investments in both physical and human capital, and for provision of savings opportunities with different rewards and maturities. Financing the poor entails some measures of up-front investment to nurture human capacity and build local institutions as a bridge to reduce gaps created by poverty, illiteracy, gender and remoteness (Ledgerwood, 1999). Financial institutions play the role of intermediaries between surplus units that consume less than what they earn and those individuals and firms that need money to generate output. Dusuki (2008) argues that many financial institutions that offer credit to the poor usually adopt group-based lending approach capitalizing on peer monitoring and guarantee mechanism. From a lenders point of view, granting loans is only costly, but also carries high risk for the lending institutions. Credit default is the uncertainty associated with a borrower's loan repayment.

According to Koveos and Randhawa (2004) in a world of rational agents where information is costly and imperfect, information asymmetry between loan applicants and the lenders, primarily

banks, leads to strategic self-maximizing behaviour. It is the responsibility of the uninformed lenders to differentiate among the mass of informed borrowers to identify the most efficient among them. In the absence of information from borrowers that would reveal their true creditworthiness, banks charge higher interest fees to offset the risks caused by this information asymmetry. The poor traditionally do not have the collateral needed by most commercial banks so that credit can be extended to them. It is a common knowledge that conventional banking traditionally provides opportunities to those people who are able to show their ability to pay back the loan, i.e. able to provide some form of collateral; to access banking services. Most traditional formal lenders like commercial banks regard low-income households as too poor to save, thus accentuating the risk of supplying credit to them (Adams and Vogel, 1986; Sinclair, 1998). Wilson (2001) also argues that collateral will be a barrier in financing as it will deter the lower income class to take credit as they simply do not have enough collateral, afraid to pledge their collateral being unsure of their ability to repay.

Credit markets are generally characterized with high asymmetric information, notably, the existence of moral hazard and adverse selection problems, which leads to severe distortion and sometimes complete collapse of the formal credit market (Akerlof, 1970; Daripa, 2000). According to Dusuki (2008) financial contracts will not be written under this condition. The contracts between borrower and lender will only be honoured if the element of trust exists in such transactions. Diamond (1991) and Holmstrom and Tirole (1993) argue that the basis of trust depends on two critical elements: first is the applicant's reputation as a person on honour; and second is the availability of enough capital or collateral against which claims can be made in case of default. The problem caused by adverse selection and moral hazard cannot be overlooked. The poor are usually perceived by profit-oriented banks as high-risk borrowers due to inherent difficulties in assessing their credit worthiness at the same time their inability to provide collateral to pledge against any potential default risk. Field and Torero (2004), posit that a critical barrier to access credit by small and informal borrowers is their frequent inability to securitize loans with collateral, often a necessary condition for participation in formal credit markets.

### **How can Microfinance help?**

The microfinance movement over the last two decades has provided new hope to the poor for increased financial independence. A number of studies have examined the impact of financial

services for the poor. Woller and Parsons (2002) examined the direct and indirect economic impact of MFIs on their community. Gertler et al. (2003) test whether access to MFIs helps Indonesian families smooth consumption after health shocks. Kumar and Newport (2005) also examined the role of microfinance in disaster mitigation in India.

Ledgerwood (1999) and Kumar et al. (2006) refer to microfinance as the provision of financial services to low income clients including self-employed, low income entrepreneurs in both urban and rural areas. Microfinance also means providing financial services (savings, credit, and payment transfers, insurance) for the poor and low income people. Robinson (2002) argues that microfinance institutions offer the platform for the provision of loans in advance of the demand for credit, for the purpose of inducing investment and consequently economic growth. Micro financial institutions have evolved to encompass the provision of a wide range of financial services such as deposits, loans, payments services, and insurance to low-income households and their micro-enterprises.

Matin et al. (2002) argue that the micro-finance sector is commonly viewed as unregistered sources of credit that encompasses money lenders, pawnbrokers and traders, rotating savings and credit associations, accumulating savings and credit associations and deposit takers. Formal providers are those who are subject to the banking laws of the country of operation; provide conventional retail services to customers and engage in financial intermediation. Semi-formal providers are microfinance institutions that are usually registered as NGOs or cooperatives and occasionally as banks with a special charter. Microfinance institutions can be categorized into two: formal and informal providers. The informal providers of financial services are a heterogeneous group that rarely operate out of offices and maintain few records (Rutherford, 1999; Seibel and Parhusip, 1999) and these could be the more potent alternative in helping the poor enjoy financial services.

### **The role of mobile and allied technologies in delivering services to the Poor**

Most of the poor particularly those in marginal areas have remained outside the fold of formal financial system. Opportunities for depositing their small savings and access to loans for emergencies and micro investments have been identified among their most urgent needs (Seibel and Parhusip, 1999). Drawing lessons from a pilot survey conducted in Uganda Firpo (2005) notes that technology could be developed and deployed to process loan payments, savings deposits, withdrawals and transfers to the poor.

Mobile phone usage within the broader context of information and communication technology (ICT) application is widely perceived to play a significant role in promoting social and economic development. This includes the improvement of livelihoods of the poor and the achievement of national development goals in developing countries. Mobile phone usage has the potential of improving productive efficiency by facilitating the exchange of information and ideas at a distance, thus reducing the time and resources that would have been spent on travel and information gathering. Mobile phones are relatively accessible compared to other information and communication technologies in developing countries, and since they differ in sophistication, the poor can find phones made to suit their preferences. Thus mobile phones are user friendly as the owner does not need any form of training to be able to use the device. In addition the proliferation of mobile phones has led to the decline in its prices, making the device relatively affordable compared to other forms of ICT. For these reasons, mobile phones are more accessible to the poor than other kinds of ICT. Heeks (2008) actually notes that “if you had to choose three words to sum up the future of information and communication for development (ICT4D), they might be ‘mobiles, mobiles, mobiles’”. It is in this regard, that the United Nations views the effective use of information and communication technology (ICT) by developing countries as a key catalyst in achieving the Millennium Development Goals.

The International Telecommunication Union (ITU) estimated that by the end of 2008, mobile phone penetration would have reached the 61 percent mark compared with 12 percent in 2000. Subscriptions to mobile phones have grown at an annual average rate of 24 percent since the turn of the century. The ITU further estimated that Africa has the highest mobile phone penetration rate in the world, contributing no less than 65 million new subscribers during 2007. Although Africa lags behind other continents in the use of mobile phones, the penetration rate has increased dramatically from just one in 50 people at the beginning of this century to almost one third of the continent’s population today. As at May 2008, there were 300 million users of mobile phones in Africa, accounting for about 7.5 percent of the total number of mobile phones in use across the globe.

The rapid adoption of mobile phone use in Africa, in both urban and rural areas, is a source of renewed hope for attainment of economic growth and development. The success of mobile phone technology, driven largely by competition, has led to the proliferation of low-priced mobile phones

and lower costs of network connections thus making mobile phones easily accessible. Mobile phones in particular appear to be a driving force for affordable and accessible technology in developing countries and Africa in particular. Thus, mobile phone usage has the potential of closing the technological divide that exists between the advanced and developing economies.

In a developing economy like Ghana for example, the total number of mobile phone users in the country, increased from 383, 000 in 2002 to about 10, 500, 000 users by the end of 2008 (Government of Ghana Budget Statement, 2009). Not only has there been an increase in usage but also an expansion in coverage. Whereas mobile phone coverage in Ghana was initially limited to a few urban areas, it has spread rapidly into rural areas, an indication that the demand for such services is high. In Ghana, though the country has made significant strides in the fight against poverty in the last decade according to the Ghana Living Standard Survey (GLSS, 2007) V, more than 28 percent of the population are estimated to be poor, with 18.5 percent estimated to be extremely poor. Anecdotal evidence indicates that in spite of the level of poverty, a section of the Ghanaian population in both urban and rural areas struggle and saves so as to either acquire or maintain a mobile phone. The Ghana Poverty reduction strategy I and II acknowledges the important role of ICT in the successful promotion of development and reduction of poverty.

The escalating growth of mobile phone usage in developing countries has resulted in several studies attempting to determine the individual's decision to acquire and use a mobile phone (Sridhar & Sridhar, 2007; de Silva & Zainudeen, 2007; van Biljon and Kotzé, 2007; Meso et al. 2005; Chakraborty, 2005; and Donner, 2005) and the impact of its acquisition and usage (Thompson and Garbacz, 2007; Abraham, 2006) on the individual. Thompson and Garbacz (2007) using a stochastic model identify a positive effect of telecommunications (particularly mobile phones) on productive efficiency in developing nations. For example, Chakraborty (2005) found that mobile phone usage has the capability of improving economic growth and reducing poverty levels in developing countries.

According to Saunders et al. (2007) advances in information technology have changed the delivery of banking services. Banking institutions have historically delivered banking services through face-to-face interaction with the customer at a particular branch. More recently, however, the face-to-face interaction has been channeled into electronic delivery mechanisms, the so-called "self-service

technology'' (Bitner et al., 2000; Lee, 2002a). This according to Firpo (2005) would help alleviate some of the barriers to accessing financial services by providing a secure, low cost, and reliable means of capturing transaction data and then transferring that data in a consistent, standardized manner. Such a system could improve operational efficiencies, decrease transaction costs and enable sustainable outreach to underserved populations.

Other studies, however, caution that mobile phone usage may not necessarily have a positive impact on growth and development. de Silva & Zainudeen (2007) assert that the perceived social and economic benefits from the acquisition and usage of mobile phones may not be wholly right, especially among the bottom poor. They found out that about 25 percent of the poorest people in Sri Lanka reported that direct access to mobile phones has worsened their ability to earn or save. They thus stipulated that the use of mobile phones does not necessarily lead to an increase in the owner's income and earnings, as many of the poorest people do not use the phones for productive purposes. They therefore argue that mobile phone usage can only be instrumental in the fight against poverty if it addresses specific social and economic development challenges and if the device is used in the right way and for the right purposes.

Lower-cost information and communication technology, such as mobile phones, the Internet, and e-mail provides the basis for provision of financial services to the poor. As the use of new technologies especially the mobile phone expands, banks have the opportunity to bring the unbanked closer to the formal banking system (Booz and Allen, 2003). With the right design, technology can also provide a lower-cost means of monitoring and controlling operational risks across large distances (Krishnan et al., 1999). Cainey and Hagens (2008) noted that combining increasingly inexpensive and mobile computing power with Internet allows some micro lenders in India to consolidate loan portfolio data from individual branches across the country every few hours. Paulson and McAndrews (2001) argue that the provision of electronic financial services will address most of the problems generated by asymmetric information by developing a valuable package banking products, including new services and greater convenience for the user, while keeping the transaction costs to the financial institution of providing services under control.

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