Amando M Tetangco, Jr: Mainstreaming financial inclusion as a strategic objective

Speech by Mr Amando M Tetangco, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at the BSP-BIS Research Conference of Financial Inclusion and Central Banks, Cebu, 3 June 2016.

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Good morning everyone. On behalf of the Bangko Sentral ng Pilipinas, I welcome all of you to Cebu.

This conference, which the BSP is privileged to co-host with the BIS, is actually the result of a discussion in the Asian Consultative Council (ACC) of the BIS. It was early 2014 in Sydney, if I am not mistaken, when BSP suggested to the ACC governors, that a possible area of research for the BIS Hongkong Office (under the ACC process) could be the relationship between financial inclusion and financial stability. In particular, we suggested that the BIS Hongkong Office investigate whether increased financial inclusion contributes to or detracts from financial stability. Necessarily, Dr. Remolona and his team would also have to determine the possible transmission mechanism for this linkage.

That suggestion came at a time when revisions to the G20 Financial Inclusion Action Plan (FIAP) were being undertaken during the Australian G20 Presidency. By that time also, the United Nations had already underpinned the importance of financial inclusion as an imperative in the attainment of a wide range of targets under the Sustainable Development Goals. The UNSGSA, Her Majesty Queen Maxima of the Netherlands, had also by then already conducted intensive meetings on financial inclusion with the Standard Setting Bodies that included the BCBS, CPMI, FATF, IADI and IAIS.

Clearly, the once-peripheral issue was then becoming mainstreamed in the global discourse.

The BSP Experience

At that time, we were also trying to better understand this issue for our own policy work in the BSP. You see, by 2014, the BSP already had over a decade of experience with microfinance as a flagship program for poverty alleviation.

Our efforts started as an advocacy, with the belief that creating an enabling policy and regulatory environment could catalyze market players to see microfinance as a sound and viable undertaking. We endeavored to create a supervisory and regulatory framework that recognized the peculiarities of microfinance while striving to maintain alignment with international standards. Such balance allowed the entry of banks into the microfinance market by reducing barriers and providing incentives, while at the same time, ensuring that players act, and their operations conducted, in a safe and prudent manner. In particular, we put in place the needed measures that cover the full credit cycle of microfinance from loan application to full repayment.

Following the principle of proportionality, we allowed less documentary requirements and enabled the use of group support or liability arrangements, cash flow based and character lending, and high frequency amortizations. We balanced that with demanding and timely loan review and loss provisioning. We also provided a mechanism for unregulated microfinance institutions to formalize themselves into banks.

Regulations were likewise established to leverage off technology to more efficiently and cost-effectively reach out to more microenterprises across our archipelago of 7,107 islands. And in 2007, we created a full-time unit in the BSP to look into financial inclusion issues.

This approach enabled over 170 banks – mostly our rural banks – to deliver microfinance services to nearly 1.5 million microentrepreneurs. The outstanding loans to these microentrepreneurs are at PhP 11.3 Billion, a 333% increase from the 2002 levels of PhP 2.6 Billion. The banks have also enabled these clients to save for the first time in their lives. At present, these microentrepreneurs have accumulated savings of around PhP 4.5 Billion. Moreover, the generation of related new business opportunities that cater to the low income and the unbanked, e.g., micro-insurance, micro-housing loans and remittances, has enabled them to expand their markets and client base without compromising, in fact in some cases, even strengthening their institutional stability.

While these numbers were encouraging, and as we were getting more microenterprises into the formal financial sector, we also knew that we needed to better appreciate how these newly on-boarded enterprises would affect (in the long run) the financial markets they were entering.

Fortunately, the rest of the ACC governors went along with our suggestion in 2014, and so we are here today. But, as you can appreciate from the topics of our conference, the BIS has pushed the envelope further on that research agenda. For the next day and half, we will be covering the full mandate of central banking, not just financial stability but monetary policy and the growth objective as well. This agenda certainly reflects that financial inclusion is multi-faceted.

Implications of Financial Inclusion

Indeed, financial inclusion cuts across multiple macroeconomic goals. Financial inclusion has been seen to contribute to broad-based economic growth and development; as well as complement other policy objectives such as reducing inequality and promoting financial stability and integrity. Financial inclusion also has important implications for monetary and financial stability policy.

These are bold claims, yet the work of many of you in this room have strengthened these convictions through your academic work in collecting and analysing evidence, some of which we will have the opportunity to discuss in this conference. *(e.g., from Professor Beck's early work in looking at financial intermediation and growth (2000) and more recent ones on finance, inequality and the poor (2007) to Dr. Hannig's discussion on financial inclusion and financial stability (2010) and Professor Karlan's numerous work on looking at impact of credit (2007) or other financial services in households.)* In no small measure therefore, you have contributed to what could be likened to an evolution: a gradual – yet almost natural – advancement of financial inclusion as a widely-accepted policy objective.

In this conference, we hope to further enrich the discourse through exchanges among central bankers and our select group of experts and see how we can pursue financial inclusion as a complement to our primary responsibilities as central bankers.

A good way of achieving this is, to keep in mind that while financial inclusion has benefits, it also brings changes to the nature of the risks we face. Two that come top of mind are: 1) changes in the behavior of market participants; and 2) changes in the design and delivery of financial products. Related to these is a third, that is, the potential changes in the reaction function of policy makers.

To illustrate the first kind of change – the change in market behaviour. Newly-included agents may not necessarily behave in the same manner as those who are "already served" and "have been served" for some time now. Because banks are more familiar with the latter, the melding of the two client bases may create new operational challenges for the banks' frontline staff.

Change in agent behavior also affects monetary policy. Mehrotra and Yetman (2014) argue that when more clients are able to smooth consumption, authorities have more monetary policy space to concentrate on fighting inflation. The underlying principle is that smooth consumption patterns help reduce the cost of output volatility. [I will leave this for James to further explain during his presentation tomorrow.]

For the second type of change: on ways to design and deliver products to improve access to financial service. Financial product providers need to be mindful that, while most of the new entrants (generally the poor) have had to be savvy to deal with their unpredictable cashflows to “survive”, they are not (necessarily) as capable in dealing with a whole array of new financial products. Moreover, banks must also be careful to extend certain types of credit to certain clients. This could just expose lenders to higher risks and it can also expose ill-informed borrowers to increased risk of debt distress.

These concerns related to product development highlight the need for proportionate regulation that adequately balances the need for flexibility and openness to innovation, on one hand, with that of mechanisms to ensure that risks are properly managed, on the other. This will allow market contestability and the development of market-based solutions to serve markets that were traditionally unserved or underserved.

We’ve already seen innovative market-based approaches to improve credit access for microfinance borrowers. We’ve witnessed the move from brick-and-mortar offices to alternative Financial Service Providers such a micro banking offices and e-money issuers.

Addressing Technological Innovation: Thru Financial Education, Consumer Protection and Proportionate Regulation

Innovations, particularly through financial technology, can indeed be the catalyst for greater financial inclusion. Technological innovation has the potential to reduce costs and accelerate the on-boarding of currently excluded markets into the formal financial system. In addition, technology solutions promise to enhance regulatory capacity and tools to supervise the market, and facilitate regulatory compliance and reporting of financial institutions. Some examples of these include:

1. Big data analytics and algorithms that can be used to address information assymetry in financial service provision (e.g., analytics of social media behavior can predict financial behavior of target clients);

2. Crowdfunding platforms that may be utilized for generating funds for SMEs, start-ups and innovators. (e.g., peer-to-peer lending or equity crowdfunding)

3. Digital currencies. (When this is safely managed, this may facilitate payments, money transfers and e-commerce.)

4. RegTech or using technology to enhance regulatory capacity and enable regulators to analyze data to ensure timely supervision and intervention.

As traditional players (such as banks) interconnect and engage new players (such as fin tech companies - which are often not within central bank supervision), there is a greater need to look at the entire chain of financial services being offered. The challenge for central banks and regulators here is to stay abreast with emerging business models and innovation, to understand the inherent risks of these new models, and to know how to proportionately manage the risks. This will require capacity to undertake the said functions.

A number of central banks, including the BSP, have turned to the “test and learn” approach, more recently known as the “regulatory sandbox” to address this gap.

The “sandbox” approach presupposes a dialogue and collaborative relationship between the central bank and the industry innovators. It acknowledges that financial inclusion solutions often arise from these innovators because the latter have greater flexibility and technical capacity to create products and generate systems to deliver them.

Essentially, the sandbox provides an opportunity for innovators to connect to banks and other financial system players with clear authority from the regulators. Providing a sandox for these players gives the regulators a “ring side” seat that helps them assess potential risks to guide them in deciding when and how to regulate the new market, if needed. The ultimate objective is to be aware of the risks, employ mitigating actions as needed, but in a manner that also enables financial inclusion.

While we need to allow ample space for the market to create cost-effective solutions that work for financial inclusion, prudence dictates that regulators must also be on the lookout for activities that impact financial integrity and consumer protection negatively. We need to have market conduct and consumer protection regulations that are infused with the philosophy that all financial consumers, including the less sophisticated and often low-income clients must be treated with dignity and respect, their consumer rights upheld and their financial well-being protected. The regulators must act as the “honest broker” between the clients and the financial institutions. In addition, we should also make the deliberate decision to provide financial education to financial inclusion clients with the view of anticipated positive returns over the long-run.

Finally, the changes that increased financial inclusion brings calls for greater coordination among regulators. Coordination could positively help harmonize regulations, address regulatory gaps and level the playing field.

Financial Inclusion as a Policy Priority

Mindful therefore of these risks but also aware of the benefits that financial inclusion offers, can there be too much financial inclusion? Is financial inclusion a worthy policy objective to pursue?

My response here would have to be – that as in all things, there must be balance. (Like in the fairy tale Goldilocks – not too hot, not too cold… not too big, not too small…. but just right!)

To achieve such balance, there should only be financial inclusion, to the extent that there is sufficient quality capacity to supervise. There should only be financial inclusion to the extent that the players can be properly incentivized and are able to process financial information. There should only be financial inclusion to the extent that the regulator is able to provide adequate financial consumer protection. When these conditions are present, we can say we have responsible financial inclusion.

Clearly, this balance would have to be jurisdiction-specific. But a common framework and a set of working principles for implementation could be derived. The framework and principles could then be the bases for closer dialogue among stakeholders, including central banks, other regulators, the standard setting bodies and the private sector.

Much has already been done to bring us closer to that common understanding of these things. But much remains.

In this dynamic and ever evolving pursuit of financial inclusion, we must continue to strengthen our evidence base to inform our policies, stay abreast with developments and ensure that our actions remain relevant, constantly challenge and question our positions if only to ascertain that they are the right ones.

I believe this conference can largely contribute to this important exercise.

The work of pushing forward responsible financial inclusion is huge. And it is important that the pursuit of financial inclusion would not be to the detriment of other policy objectives.

Hopefully, after today, we have more clarity in what we need to do as central bankers. Central banks who believe that a strong and stable economy and financial system is only truly relevant if it benefits the majority of our population.

On that note, I look forward to our discussions in the next day and a half. Thank you for your attention.