Emmanuel Tumusiime-Mutebile: Financial inclusion and the development of the financial system

Speech by Mr Emmanuel Tumusiime-Mutebile, Governor of the Bank of Uganda, at the 3rd Graduation Ceremony of the Uganda Institute of Banking and Financial Services, Muyenga, Kampala, 4 October 2013.

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The Board Chairperson of the Uganda institute of Banking and Financial Services,

Members of the Board of Directors of the institute

Members of the Institute present

The Graduands

Invited Guests in your respective capacities

Ladies and Gentlemen

First I would like to thank the Board Chairperson, Mrs. Balaka, for inviting me to officiate at this function. I would also like to congratulate all those who are graduating today.

Financial inclusion, which is defined as expanding access of low income families to a broad range of formal financial services, has become a priority for financial sector policy makers across the developing world in recent years. The main reasons for prioritizing financial inclusion as a policy objective are threefold.

First, expanding the opportunities of people to trade is almost always welfare enhancing; this applies to financial markets as well as other types of markets. Secondly, access to financial services may help poor people to finance investment in micro-enterprises, for example the purchase of farm inputs, which will enable them to raise their incomes. Thirdly, financial inclusion can help to deepen financial markets, for example by attracting more savings into banks, although it is not the only channel through which financial markets can be deepened. Empirical research has shown that a deepening of the financial system supports higher levels of private investment and economic growth over the long term.

These are sound reasons for supporting efforts to promote financial inclusion, but I also think that the policy challenges pertaining to promoting financial inclusion are more complex than is often realised, in two important respects. The first is that access to financial services may not be the only constraint, or even the most important constraint to achieving a strategic policy objective. For example, it is unlikely that expanding access to financial services in rural areas will enable smallholder farmers to expand their output and raise their incomes unless it is supported by efforts in other areas, such as the provision of agricultural extension services and better rural feeder roads, to help smallholders to modernise their farming practises.

Secondly, although there may be synergies between financial inclusion and other strategic objectives of financial sector policy, such as the deepening of financial markets, there may also be trade-offs with other objectives. It is important to comprehend clearly what these trade-offs and synergies might involve if sound policies for the development of the financial sector are to be designed. This requires an understanding of the economic reasons why so large a share of the population is excluded from access to financial services.

The vast majority of the Ugandan population have virtually no access to formal financial services, other than the use of mobile money. The latest FINSCOPE survey, which will be published shortly, found that only 8 percent of Ugandans save money in a bank account, while another 6 percent save money with a savings and credit cooperative (SACCO). The financially excluded are the poor, especially those living in rural areas.

The main reason why the poor are excluded from access to formal financial services is because serving this segment of the population entails financial institutions incurring much higher transactions costs, relative to the value of the services provided, than is the case for more wealthy customers. These costs may be prohibitive for the bank or for the customer to bear. Furthermore, the costs of operating branches in rural areas are large relative to the rather limited volume of revenues which can be generated from these branches, especially as many of the basic requirements of operating a bank, such as the provision of electric power, are more expensive in rural areas than in urban areas.

Serving the financially excluded may also entail higher risks for financial institutions, because the poor have fewer resources to cushion themselves against adverse shocks and fewer assets which can serve as collateral for loans than wealthier customers have. As such financial exclusion reflects the economic reality of conducting the business of financial services in a poor and largely rural society; it is not just a form of market failure which can be easily rectified through policy intervention. That is why promoting financial inclusion involves potential trade-offs with other policy objectives. I will give one example of such a potential trade-off.

A major concern of the Bank of Uganda (BOU) is the very high interest rate spreads of commercial banks, as I have made clear on several occasions. The average net interest margin of the Ugandan banking system in the last financial year was 12 percentage points. High interest rate spreads lead to high real lending rates, which constrains borrowing by productive enterprises, especially those which operate in competitive markets where profit margins are thin. This is especially the case for small and medium scale enterprises (SMEs) which provide the main source of formal sector employment for Ugandans, and are thus essential in the struggle to eradicate poverty. The respondents of the World Bank's Doing Business Survey reported in the 2013 African Competitiveness Report cited access to finance as the second most problematic factor for doing business in Uganda (after corruption). The main reason why interest rate spreads in Uganda are so wide is the high fixed and operating costs of the banks. Interest costs comprise less than a third of the total expenses of commercial banks in Uganda; the rest of the costs comprise salaries, utilities, the maintenance of buildings and provisions for bad debts.

Reducing bank operating costs is essential if interest rate spreads are to narrow and lending rates for borrowers are to be made more affordable. However, reducing bank operating costs may not be compatible with expanding access to banking services to the poor, if the transactions costs and the risks involved in providing banking services to the poor are higher than those involved in serving existing bank customers. That does not make it undesirable to expand financial services to the vast majority of the population currently unbanked, but it does mean that it must be done in a cost effective manner which does not force up the average cost to asset ratios of banks or increase the risks in their loan portfolios.

How might it be possible to promote financial inclusion in a manner which does not conflict with other strategic goals of financial sector policy? Branchless banking innovations like Mobile Money and Agent Banking offers a solution to some aspects of the problem of financial exclusion, although not all. Over eleven million people, comprising a third of Uganda's population, are registered as mobile money customers. Mobile banking in Uganda currently only offers payment and money transfer services, but it has the potential to provide a platform for other financial services; for example linking customers to savings accounts in banks, as is starting to happen in Kenya through the agent banking model. However mobile banking per se will not alleviate the main constraints facing the poor in accessing credit from formal financial institutions.

Microfinance institutions, which utilise innovative modalities for serving low income households, such as group lending, and provide financial products which are tailored to the needs of this segment of the population, offer another channel for expanding financial inclusion. When microfinance first emerged in Uganda, in the 1990s, it was undertaken by not for profit organisations using concessional finance from abroad and did not involve taking deposits from customers. In 2003, Uganda enacted legislation to allow microfinance institutions to take deposits and for those that do so to be regulated by the BOU, as a third tier of supervised financial institutions (after banks and credit institutions). This reform was motivated by the recognition that access to deposits is often equally as important as access to loans for low income customers and that microfinance institutions would be more sustainable over the long term if they could build a domestic deposit base, rather than having to rely on donor funds, to finance their lending.

The growth of deposit taking microfinance in Uganda over the last 10 years, since the Microfinance Deposit Taking Institutions Act was passed in 2003, has not really met expectations. Only a few microfinance institutions applied for licenses as tier III microfinance deposit taking institutions (MDIs). The total deposits of the MDIs are less than one percent of the deposits of the commercial banks. At the same time a plethora of semi formal and informal financial institutions, which include nearly two thousand SACCOs, have grown up. All of these semi-formal and informal financial institutions, which are not subject to any prudential regulation, are collectively referred to as tier IV financial institutions.

The growth of the unregulated financial sector has prompted the BOU to rethink its strategy towards the tier IV financial institutions. It is not feasible to try and regulate all of the SACCOs and other tier IV institutions, because there are far too many of them to do this effectively. However, we believe that the larger SACCOs, those with hundreds or thousands of members, should be encouraged to graduate to become microfinance deposit taking institutions, licensed and regulated by the BOU. This will enhance their financial stability and therefore help to protect their savings. We are currently in the process of preparing amendments to the MDI Act to make it easier for the larger tier IV institutions to graduate to become licensed MDIs, for example by removing the requirement that MDIs should be limited liability companies, rather than mutual associations. In addition, the amendments to the MDI Act will create an obligation on SACCOs which hold total savings of more than Shs 1.5 billion to convert to tier III status. We anticipate that approximately 13 of the existing tier IV MFIs and SACCOs will graduate to tier III status.

Financial exclusion is not caused only by constraints on the supply side of the financial market. Many people are discouraged from participation in formal sector financial markets because of a lack of knowledge, or misinformation, about financial products and insufficient knowledge about their rights as consumers of these products. To address these problems, the BOU has launched a program to promote financial literacy, through educational activities. The BOU has also prepared consumer protection guidelines for commercial banks and publicized these in the media.

To conclude, I want to emphasize the complex challenges facing policymakers. There are fundamental economic reasons for why large parts of the population are excluded from financial services. We need to promote financial inclusion, but this objective must be balanced against other priorities for financial sector development.

We should, therefore, aim to encourage innovations to promote financial inclusion which can minimise the trade-offs and maximise the synergies with other policy objectives.

Thank you for listening.