CAZENOVE
CAPITAL MANAGEMENT

Financial inclusion

Executive summary

The debate about inclusive finance is gaining momentum throughout the world. An international effort is being led by the G20 and the UN Financial Inclusion programme. In the UK, a Financial Inclusion Commission, comprised of cross-party parliamentarians and experts in the field, was set up in 2014 to investigate the issue and make practical recommendations.

What is financial inclusion?

According to the Financial Action Task Force (FATF), financial inclusion is about "providing access to an adequate range of safe, convenient and affordable financial services to disadvantaged and other vulnerable groups, including low income, rural and undocumented persons, who have been underserved or excluded from the formal financial sector." It is also about ensuring that individuals, to whom only basic financial products are currently available, have access to a variety of financial services[1].

We believe that financial inclusion is one of the important ways in which banks can rebuild customers' trust following the financial crisis and demonstrate that they play a positive role in society. This means serving the real economy, including those customers that may not be particularly profitable (although including them in the financial system may help generate broader economic benefits in the long term).

What are the main issues?

On a global basis there are about 2.5 billion people (about half of the working age population) who are currently excluded from the formal financial system[2]. In the UK, the Financial Inclusion Commission estimates that 3.6% or nearly 2 million adults don't have a bank account and around 2 million people took out a high-cost loan in 2012 as they were unable to access any other form of credit.

This highlights one of the key features of the financial inclusion debate in the UK: the current lack of socially responsible credit providers. Indeed, payday lenders have been in the spotlight recently for providing aggressive and unsustainable lending conditions to the financially needy and new industry rules have been introduced in order to cap interest rates.

Another issue facing the financials sector is the new Universal Credit welfare system. This is a means of providing benefits claimants with a single monthly payment of several benefits, directly into a bank account. This will require greater financial inclusion in the UK banking industry as unbanked claimants will need access to basic bank accounts and some form of financial education in budget management.

Risks and opportunities

Financial inclusion poses a number of risks and opportunities to banks, insurer and consumer finance companies that investors should be cognisant of. Risks include regulatory risks arising from the introduction of new mandatory pricing or payments conditions, credit risk from the extension of financial services to low income or financially uneducated customers and competition risk from alternative lending other sector companies to capture new customers instead of mainstream banks and insurers. Opportunities include the chance to win new business through financial innovation and the use of new technology.

We see Lloyds, L&G and Aviva as the best placed companies in the UK in terms of financial inclusion, mainly because they offer affordable credit and insurance policies.

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1 http://www.fatf-gafi.org/media/fatf/content/images/AML%20CFT%20measures%20and%20financial%20inclusion.pdf
2 Global data G20 Financial Inclusion Action Plan (FIAP) 2014

Introduction: the financial inclusion debate in the uk

Financial exclusion

The financially excluded are those with no access to banking services such as bank accounts, credit or debit cards, non-cash financial payments, insurance or secured credit. On a global basis there are about 2.5 billion people (about half of the working age population) who are currently excluded from the formal financial system[3]. Closely linked to poverty, financial exclusion means it is more expensive for the poor to get funding (on a global scale, it could be 20% more expensive on average[4]). 26% of the newly banked are 'net losers', meaning that their gains in savings are more than offset by penalty charges[5].

The UK perspective

In the UK, the most common financially excluded groups are single pensioners, lone parents, the long-term sick or disabled, the long-term unemployed, part-time workers, and migrants. The Financial Inclusion Commission estimates that 3.6%, or nearly two million adults, don't have a bank account and around 2 million people took out a high-cost loan in 2012 as they were unable to access any other form of credit. The Commission also calculates that between three and seven million households use high-cost credit[6].

The reasons for financial exclusion are complex, however. Primarily, there is often a mismatch between people's needs and the products available. For instance, there is a lack of branches in some neighbourhoods, which limits locals' access to financial services, or the high cost of property insurance in unsafe areas makes it unaffordable for the inhabitants. Indeed, half of the UK's poorest households lack home contents insurance, compared with one fifth of those households on average incomes. Households with no home contents insurance were more than three times as likely to be burgled compared to those with insurance[7].

Part of the issue in the UK is that Britons save less than other European countries. A lack of savings can put many people in financial difficulty when they experience a cut in income.

Increasing saving rates and promoting financial inclusion to help people better manage their budgets, may create business opportunities and help banks' financial sustainability by increasing deposit levels. A lack of saving also has a direct impact on a person's ability to access credit. This is part of the reason why the payday lending market has grown so substantially (from £330 million in 2006 to £3.7 billion in 2012[8]) and why unsecured lending has tripled in the past 20 years (from £51.8 billion in 1993 to £160.4 billion in 2014[9]). There is clearly a growing need for credit and this needs to be provided in a more responsible way, preferably by mainstream financial services players who do not create the aggressive and unsustainable lending conditions that payday and unsecured lenders do.

The UK saves less than almost any other country in the EU.

Only 41% of British households are saving[4]

Are pay-day lenders the next tobacco?

Last year the Financial Conduct Authority (FCA) confronted short-term credit providers in a bid to regulate lending conditions. Payday lenders in particular have been accused of abusing lending practices with negative social impacts on low income groups. The regulatory framework for short-term lenders is now made up of a cap on total lending cost, limits on loan roll overs and strict marketing and advertising guidelines. The cap took effect in 2015. It implies that the daily interest rate for short-term credit loans is capped at 0.8%, and that the total cost for borrowers including fees and interest is capped at 100% of the original sum. Despite this, the representative APR (annual percentage rate) of a UK payday lender remains 1,509%.[10]

Some of our clients are already requesting that we exclude payday lenders from their investment universe. A global screen list of payday lenders and pawnbrokers was created by the World Acceptance Corporation and include companies such as:

- International Personal Finance (short-term financing – payday loans)
- Ezcorp Inc (short-term financing – payday loans)
- Cash America (short-term financing – pawnbrokers)
- First Cash Financial Services (short-term financing – pawnbrokers)
- H & T Group: (short-term financing – pawnbrokers)
- Manappuram Finance (short-term financing – pawnbrokers)

3 Global data G20 Financial Inclusion Action Plan (FIAP) 2014
4 HM Queen Maxima, UN Secretary General Special Advocate for Inclusive Finance for Development at Financial inclusion, Practical steps conference (London)
5 Financial Inclusion Commission http://www.financialinclusioncommission.org.uk/facts
6 http://www.financialinclusioncommission.org.uk/facts
7 http://www.poverty.org.uk/74/index.shtml
8 http://www.financialinclusioncommission.org.uk/facts (Beddows, S. & McAteer, M., 2014. Payday Lending: Fixing a broken market, London: Association of Chartered Certified Accountants)
9 http://www.financialinclusioncommission.org.uk/facts (Bank of England, 2014. LPQBI2O: Quarterly amounts of outstanding of ttal (excluding the Student Loans Company) sterling net unsecured lending to individuals (in sterling millions) seasonally adjusted, London: Bank of England)
10 "Payday loan caps come into force", Rupert Jones, 2 January 2015. http://www.theguardian.com/money/2015/jan/02/payday-loans-caps-fca

Risks and opportunities

Following the financial crisis, banks have had to rebuild customers' trust by demonstrating that they play a positive role in society. This means serving the real economy, including those customers that may not be particularly profitable. It is therefore important for investors to consider the risks that financial inclusion may pose to banks, insurers and consumer finance companies. However, including these customers in the financial system may create broader economic benefits over the long term and so there are a number of opportunities too.

Regulatory risks: These could arise from the introduction of new mandatory credit or bank account pricing or payments conditions as a means to promote financial inclusion.

Credit risk: For some companies, financial inclusion will increase credit risk as it means providing services to low income and financially uneducated customers.

Competition risk: As new banking models are emerging (online lending and mobile banking, for example) there is the risk that alternative lending companies in other sectors capture the new customers instead of mainstream banks and insurers.

We believe that **financial education** is crucial to mitigating these risks. Helping customers to improve their understanding of the products and services available to them will foster an ability to better manage their finances which in turn will help low income customers' raise their credit worthiness. This will be beneficial not only to the individual but also to the financial service providers themselves, especially as a means of reducing credit risk.

However, there are also a number of opportunities that financial inclusion presents.

Financial innovation: Mainstream financial services providers may be able to capture new business by designing products and services to meet the demands of this new type of financially excluded customer whilst overcoming the credit risk challenge. Micro-lending, micro-insurance and micro-savings are examples of initiatives that could be undertaken in this area.

Technology: Initiatives such as branch-less banking services and electronic data collection are a few examples of ways in which financial service providers can lower the cost of their financial infrastructure. This in turn could give them room to add less profitable, low income customers to their client pool.

Universal credit

We see the new Universal Credit welfare system, which is being rolled out between 2013 and 2017, as a financial inclusion issue.

The new system is a means of providing benefits claimants with a single monthly payment of several benefits, directly into a bank account. As such, people claiming these benefits (which include income-based Jobseeker's Allowance, income-related Employment and Support Allowance, Income Support, Child Tax Credit, Working Tax Credit and Housing Benefits) will need to manage their budgets in a much more autonomous way. Since the new system will be based online, beneficiaries will also need to access the internet to make claims and check payments.

Benefits claimants are typically unemployed or low income earners. As such, many may not have access to the internet or to a bank account so clearly the new system could create increased demand for basic bank accounts and other financial services. Furthermore, beneficiaries may not possess the necessary skills to manage a budget, which highlights how crucial it is that there are sufficient financial education initiatives in place to support these claimants.

How can companies address financial inclusion?

1. Customer centricity

Concerned that they have to rebuild society's trust following the financial crisis, banks have been in the process of developing customer-centric strategies. According to the Financial Inclusion Commission, customer satisfaction levels are below 60% for the four largest banks in the UK[11]. This is clearly a difficult time for banks though as they have to address customers' needs at a time when business models are evolving and require a reduction in operating costs.

We believe that tackling the financial education gap by providing better customer advice on finance management and the development of basic saving products may be a quick win for banks. Below we have listed a few business strategies that banks and insurers could consider in an attempt to address financial inclusion.

Financial inclusion business strategies

- **Product design:** what financing, credit, insurance or payments offering can be designed to address these potential customers' needs?
- **Delivery channels:** what new delivery channels should be developed to make these products and services accessible to the needy, including in areas underserved by financial facilities?
- **Financial education:** How can banks provide or support financial literacy to improve potential customer's financial management skills making them reliable customers over the long term?
- **Partnerships:** given the poor profitability of credit unions, leveraging on the role of credit unions, for instance (which provide low cost credit), can be a bridge to other financial services. Credit unions cover only 1% of the population. Can banks partner/fund/support credit unions further to facilitate potential customers' financial education and access to affordable financial services?

2. Branch closures vs. mobile banking

It is important to ensure that any restructuring of the banking sector is not exacerbating the effects of financial exclusion. The Financial Inclusion Commission has observed that between 1989 and 2012, more than 40% of all bank and building society branches have closed in the UK – a net loss of 7,500 branches[12] and that low income areas have been disproportionately impacted by branch closures.

Technology is seen as a way to transform the sector by creating a new type of low cost financial service. Whether it is through the development of online or mobile banking, technology is central to the new banking and the financial inclusion debates. In developing markets, offering mobile banking solutions in remote areas has proven a successful expansion strategy. Although in developed markets though, we need a different approach (different needs and financial profiles), servicing customers through their mobile or the internet present the same infrastructure cost advantage as in developing markets.

61% of the UK population owns a smartphone

77% of adults have access to broadband, either fixed or on their mobile[13]

11 Personal Current accounts https://assets.digital.cabinet-office.gov.uk/media/53c834c640f0b610aa000009/140717_-_PCA_Review_Full_Report.pdf

12 http://eprints.nottingham.ac.uk/2199/1/ChangingGeographyofBritishBank%26BuildingSocBranchNetworks2003-2012_FINAL.pdf

13 HM Queen Maxima, UN Secretary General Special Advocate for Inclusive Finance for Development at Financial inclusion, Practical steps conference (London)

Can companies overcome the regulatory challenge?

The ‘de-risking’ of the financial industry is proving a barrier to financial inclusion. For example, the strengthening of anti-money laundering (AML), anti-bribery and corruption (ABC), and know-your–customer regulations in the last few years have forced finance services organisations into more rigorous due-diligence processes. Underwriting new customers has now become an even stricter, more tedious and costly exercise. But most of these rules seem to go against the principles of financial inclusion, namely the idea of taking on board higher risk (lower income) customers for whom it is more difficult to provide the identification required by banks’ due diligence rules. The impact of financial integrity standards on the realisation of financial inclusion has been under discussion for some time, and it is a global debate. It is, however, in the regulator’s interest that most financial transactions occur in the formal banking system where illegal transactions at least become detectable. Banks are unlikely to relax their AML or ABC management systems because of the heavy litigation risks they would expose themselves to. It is therefore up to international banking authorities to find the solutions and promote regulatory flexibility to aid the development of financial inclusion.

How do UK companies compare on the issue?

Here we present an assessment of UK banks and insurers based on their financial inclusion-related initiatives against the following criteria:

- **Products and services:** including programmes specifically designed for consumers, households and small-to-medium-enterprises (SMEs) for which access to mainstream financial services is difficult or impossible.
- **Financial literacy:** programmes to provide consumers, households and small businesses the skills and knowledge that allow an individual to make informed and effective financial decisions.
- **Delinquency management:** how banks manage their customers' failure to repay their obligation. Extending repayment deadlines and resetting credit instalments can help people and businesses in financial difficulty to improve their financial situation.
- **Targets:** Are companies setting targets to achieve in the financial inclusion area?

UK banks

Lloyds is a UK leader in financial inclusion. Lloyd's Help Britain Prosper plan has a financial inclusion angle through the re-working of basic bank account terms to lower charges, working with credit unions and delivering financial education. RBS and HSBC have an average approach to financial inclusion. Despite being vocal on the financial inclusion debate, HSBC is an international bank lacking local action and it has little focus adapting products and services to meet the needs of the financially excluded in the UK. Barclays is also lagging behind its peers on this issue.

Lloyds	
Products and services	· SME lending and affordable credit facilities · Provides 1 in 4 social banking accounts in the UK and gives £1 million in annual funding to support Credit Unions
Financial literacy	Provides financial literacy to young people and adults
Delinquency management	Delinquency preventative management
Other	A Financial Inclusion Steering Group is led by a member of the Board to promote and drive objectives across the group through four action pillars: accessible products and services, partnership and sign-posting, culture and capacity and financial education
Targets	YES

RBS	
Products and services	SME lending, basic bank accounts to customers with poor credit history
Financial literacy	N/A
Delinquency management	1 million assisted customers in financial difficulty
Other	Programmes to help customers liaise with free money advice organisations
Targets	NO

HSBC	
Products and services	Mainly international programmes (Vietnam, Mexico) with less visibility on action for UK customers
Financial literacy	Financial literacy in emerging markets
Delinquency management	Some indication of delinquency management
Other	The HSBC CEO has committed himself to the issue of financial inclusion. He sees a direct benefit to shareholders and commercial benefits to the bank overall. A special adviser to the CEO has been appointed to deal with financial inclusion. He is also the chairman of the Financial Inclusion Commission
Targets	NO

Barclays	
Products and services	Cash card account
Financial literacy	N/A
Delinquency management	N/A
Other	
Targets	NO

Source: Schroders, SG.

UK insurers

L&G and Aviva seem the best placed companies in the UK in terms of financial inclusion, given their affordable insurance offering and disclosure of data and studies on underserved segments. Based on the below criteria, we believe that Prudential and Friends Life have average financial inclusion programmes while Standard Life has less advanced programmes than UK peers.

L&G	
Products and services	Social housing investments and affordable home contents insurance
Financial literacy	Financial literacy programmes targeting students
Delinquency management	Early delinquency prevention
Other	Discloses data on underserved segments which represent 26.8% of UK population and 14.5% of the company's business[13]. Programmes include international activities
Targets	YES

Aviva	
Products and services	Social housing investments and affordable home contents insurance to help low-income households access the cover they need
Financial literacy	N/A
Delinquency management	N/A
Other	· Studies on consumer financial concerns. · International initiatives (including micro-insurance in India)
Targets	NO

Standard Life	
Products and services	N/A
Financial literacy	Some financial education and advice initiatives (including on an international scale)
Delinquency management	N/A
Other	Some funding to financial education programmes
Targets	NO

Prudential	
Products and services	N/A
Financial literacy	Education training to adults and children. Financial capability teaching QualityMark developed with Personal Finance Education Group (pfeg): this is an accreditation system for financial education resources[14]
Delinquency management	N/A
Other	Some international initiatives
Targets	NO

Friends Life	
Products and services	N/A
Financial literacy	· Money management and debt advice to vulnerable communities · Financial education workshops to the youth · E-community discussions available for customers to discus their experiences and access financial material
Delinquency management	N/A
Other	Donations to money management and debts advice organisations
Targets	YES

Source: Schroders, SG.

Case study: Provident Financial

Provident Financial is a provider of personal credit products (including credit cards and home loans) in the non-bank credit market in the UK and some European countries. In 2014 we discussed the upcoming regulations regarding short-term credit with the company. CEO Peter Crook is a member of the Practitioner Panel at the FCA and he had been consulted during the FCA regulatory development's work in capping the total cost of lending.

Provident Financial's new online-lending business, Satsuma, was launched two years ago in response to demand for financial products that would help households reduce credit in the face of stretched budgets. The business is based on a very different model to payday loans – borrowers make small weekly payments (making it a more affordable product compared to those which require a monthly repayment) and are not permitted to rollover loans. Satsuma charges only an upfront fixed charge and APRs can be up to a maximum of 1000%.

The customer relationship has been key to Provident's business model success. Although Satsuma is an online product, phone contact with the customer is established before any transaction occurs. Satsuma has a low transaction completion rate (10 in 100 applications on average, 20 at most) due to the tight application rules which create a natural filtering of borrowers. Data is processed within 24 hours before the loan can be confirmed and the money transferred.

Provident Financials is also interested in mobile lending and is keen to explore how technology can play a role in the business' development, particularly in gathering unstructured data and enhancing their customer knowledge.

Conclusion

Financial inclusion may be an emerging reputational, regulatory or business risk for financial services companies. However, there are also social risks related to irresponsible lending and so business opportunities will exist only if they are sustainably designed credit (or insurance) models. There are a number of ways in which companies can address financial inclusion and we have already seen some progress in the UK banking sector.

However, there are remaining challenges that need to be overcome, particularly regarding international regulations. The implementation of Universal Credit is just one example of the challenges financial services companies face.

We would encourage all financial companies to take the issue of financial inclusion seriously given the risks it bears. Banks and insurers' commitment to financial education is a good starting point. As part of our engagement programme, we will continue to emphasise the development of inclusive solutions and low cost products and services.

We have welcomed so far the approach of Lloyds, HSBC, Aviva and L&G in this area.