Can Foreign Banks Contribute to Financial Inclusion?

Ramkishen S. Rajan[1] and Sasidaran Gopalan[2]

If the entry of foreign banks results in a concentrated banking sector, as has been the case in several Central and Eastern European countries, then the goals of achieving financial inclusion are detrimentally affected, finds a study of 57 countries.

Is the choice between efficiency and development complementary or necessarily competitive? India has been a laboratory of policy experiments since 1991 trying to strike a balance between the two. Two recent policy initiatives in the area of finance stand testimony to such an experiment. The first is in the area of financial inclusion – the launching of the ambitious 'Pradhan Mantri Jan-Dhan Yojana' in August 2014, aimed at providing universal access to banking facilities with at least one basic banking account for every household. The second relates to an impetus for entry of foreign banks -- the RBI's revised framework on foreign bank entry in November 2014 which encourages foreign banks to set up wholly-owned-subsidiaries (WOS). In return, it promises 'near-national' treatment in terms of branch expansion as well as the nod to acquire local private banks if they choose to create subsidiaries in India.

While neither of these policies was necessarily meant to be sequenced one after the other, there is an important connection between the two. The initiatives can be viewed as part of a broader objective of striking a balance between achieving efficiency and pursuing development. In fact, the policies also fit in squarely with the five pillars that the RBI governor unveiled to strengthen the banking system -- which include goals of financial deepening, inclusion and encouraging entry of new banks including foreign banks and 'better regulating' their organisation forms.

The World Bank's *Findex* database suggests that in 2011 only about 35 per cent of adults in India had access to a formal bank account and around 8 per cent borrowed from institutional and formal sources, indicating the significant proportion of population which is still excluded from access to formal financial system. In comparison – about 65 per cent of adult population in China had access to a formal bank account though the proportion of population borrowing from formal sources was comparable with India at 7 per cent. Thus providing access to affordable financial services to large segments of the population can potentially increase economic activities as well as employment opportunities for those left out by the formal financial system. This could translate into higher disposable incomes, higher degree of savings and a diverse deposit base for banks.

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[1] Ramkishen S. Rajan is Visiting Professor at Lee Kwan Yew School of Public Policy, National University of Singapore (NUS). Email: rrajan1@gmu.edu
[2] Sasidaran Gopalan is a Post-Doctoral Research Fellow at the Institute for Emerging Market Studies (IEMS) and Institute of Advanced Study (IAS) at Hong Kong University of Science and Technology (HKUST). Email: gopalan@ust.hk

How about foreign bank entry? True that India has a fairly sophisticated equity market which has attracted portfolio equity flows over the years. However, in the case of the banking system specifically, India has been fairly conservative. Foreign bank presence in India, as measured by their asset share in the domestic banking system has never exceeded 6 per cent. The share of domestic private banks has hovered around 25 per cent and the remaining represented by state-owned banks. On the one hand, a widely held view is that a liberal banking sector with greater role for foreign banks could bring in the much-needed efficiency to the system. On the other hand, critics maintain that foreign banks bring greater instability to the system which outweighs the supposed efficiency benefits. The debate continues. But do we know if an internationalised banking sector facilitates or hinders financial inclusion?

There is surprisingly very little research on this issue. The existing research emphasises how foreign banks contribute to financial sector deepening by contributing to equity and bond market development but hardly any mention is made of financial inclusion per se. The handful of studies that exist point out how foreign banks could potentially be negatively associated with financial inclusion because they have a tendency to cater to a smaller segment of the population, i.e. they tend to 'cherry-pick' customers.

Recent research by the authors empirically examines how foreign banks affect financial inclusion in 57 emerging and developing economies in the period 2004-2009. We find that foreign banks contribute positively to enhancing financial inclusion. More specifically, our results suggest that foreign banks tend to ease constraints such as inability to provide physical access points for delivery of financial services (such as ATMs). Since ATMs are much more cost-effective and require the least amount of investment commitment and many basic banking transactions occur through ATMs in the advanced economies, policies promoting such physical points of access would likely enhance financial inclusion. However, we also find an important qualification to our results in that the net positive impact of foreign bank entry on financial inclusion tends to weaken when an economy experiences greater banking concentration following entry of foreign banks.

In other words, if allowing foreign banks results in a concentrated banking sector, as has been the case in several Central and Eastern European countries, then this is likely to be detrimental to the goals of achieving financial inclusion (not to mention overall financial stability). The market structure is merely transformed from a government-dominated banking system to one controlled by foreign private banks, which can hinder financial inclusion if these private banks are free of social objectives.

Overall, liberalisation is certainly important as it provides much-needed resources and facilitates efficiency-gains but it is not a panacea for everything. Complimentary policy measures are needed to ensure that there are also development gains. Foreign bank entry, if done right, can encourage efficiency and growth. However, for it to be consistent with promoting overall development, policymakers need to both avoid concentration as well as put in place adequate regulations and policies to effectively promote greater financial inclusion.