IESE Business School University of Navarra

More efficient banking could turn fortunes of developing countries

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Withdrawing money, getting credit or paying with plastic are privileges within reach of only a minority of people in poorer countries.

The problem in many developing countries is not just that the credit markets are small, it's that there are so few people able to avail themselves of financial services. To give an example: in OECD (Organization for Economic Cooperation and Development) countries, private-sector credit represents 84 percent of GDP, while in sub-Saharan Africa, it's just 21 percent.

IESE's Francesc Prior and Javier Santomá have for some time been analyzing the shortcomings of the banking systems in developing countries. Banks there tend to serve the top levels of society, while sidelining the rest of the population. Those at the bottom are forced to resort to less-than-regular financial arrangements, which are more expensive and less efficient, effectively blocking them from reaching higher levels of economic development.

In their paper, "Distribution model of microfinance services for low income segments in developing countries," the professors recommend, as a way of ending this situation, financial services adapted specifically to the demand shown in the parts of society with the fewest resources. They suggest establishing more electronic means of payment and fully realizing the potential of remittances or money transfers.

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Electronic banking

Previous studies have shown the positive relationship that exists between the penetration of electronic banking and the development of a financial culture. With this in mind, Prior and Santomá believe improvements in electronic banking hold the key.

First of all, a card transaction can be nine times cheaper than a cash one. The simple cost savings of using cards over cash could amount to as much as 1 percent of GDP. With such drastic savings, financial entities would then be able to reduce their prices for the services they offered to the least advantaged segments of society, who represent the majority of the population. Cheaper products would be instantly more attractive for all.

Developing countries also need low-cost intermediary networks, say the authors. One of the most serious problems detected in developing countries is the capillarity of the networks: coverage is extremely low since high operating costs prevent a reasonable number of offices from being opened. Cheaper networks have a great impact on reducing operating expenses.

Finally, banking entities need to make greater use of customized risk-analysis methodologies. To study a potential credit risk, for example, banks usually focus on the "official" income of a client, that is, his or her monthly paycheck. However, such a test is largely irrelevant in countries where the underground economy counts for as much as, if not more than, the official one.

According to the authors, banking entities should start looking at other socio-demographic variables: age, social status, or utility bills in their clients' names. They also suggest the use of central credit offices to avoid debt overload, and especially getting to know the clients and visiting them to check information.

If the financial entities in developing countries carried out these changes, more credit would be given, resulting in fewer bad debtors, believe the authors.

Capitalize on cash

Every year, immigrants routinely send billions back to their home countries. These money transfers represent up to 30 percent of some people's income. Prior and Santomá believe that the potential of this movement of money is being wasted, that the relationship between transfer entities and banks is not being fully exploited.

To start with, the authors suggest, a company operating in both sectors could reduce its

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infrastructure costs dramatically. For example, a bank setting up the technological infrastructure for electronic banking has already gone some way toward having the systems in place for money transfers as well. This infrastructure could represent 30 percent of the operating costs of the business. The same reasoning applies to telephone and Internet banking.

The distribution network could represent another synergy. Bank and money transfer networks are perfectly complementary: while banks have their own employees, money transfer networks opt for non-financial agents located precisely where banking institutions have no presence.

But surely the clearest and perhaps most pressing advantage would be the one achieved if the money transfers were to end up in current or checking accounts, rather than being redeemed in cash.

Presently, developing countries do not offer interest on these accounts, and so banks would automatically earn the difference between the cost of the deposit and the margins gained by investing in the national debt. This is what the authors call "the synergy of revenue."

Entities can also obtain financial synergies. They result from the profits on all the credits that could be granted with the support of transfers.

Furthermore, these would be low credit risks, given that the bank would have the information about the movements associated with every account.

All these solutions proposed by Prior and Santomá require formidable technological and organizational structures, which, some might say, automatically rules out all small entities. Not true, they say: they only need to be united in a network where they share technological platforms, databases and risk analysis infrastructures.

So that each bank could manage its own accounts, an independent unit would have to provide these services. Also, the entities should have the choice of using this central hub or an external provider.

Prior and Santomá conclude that everything must focus on promoting competitiveness - the Achilles' heel of banking in developing countries. Lack of efficiency is what makes financial entities concentrate exclusively on the handful of clients of value to whom they have access. It is this that leads them to marginalize the majority of the population and which, finally, distances them from being catalysts in the economic growth of their country.

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