Investor Brief: Promoting Financial Inclusion in Canada's Financial Services Sector

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INTRODUCTION

For the majority of Canadians, appropriate and affordable financial products and services are readily available. Consumers can choose from a variety of institutions that are located close to their homes, transportation routes and/or workplaces, where they can safely save and access their incomes; obtain credit and loans for major purchases to start businesses or to study; and receive sound financial advice. Access to these combined services helps consumers build financial stability, save for retirement as well as capitalize on economic opportunities. However, a growing number of Canadians face seemingly insurmountable obstacles to gaining access to this system, leaving them underserved by the financial mainstream and more likely to turn to alternative financial service providers that meet only part of their financial services needs while charging very high fees. These alternative service providers, namely cheque cashers, payday loan providers, title loan stores and rent-to-own shops, are playing an increasingly prominent role in Canada's financial services industry.

Key Facts

- Approximately **13%** of Canadians have no bank account or have an account with a zero balance;
- Just **24%** of Canadians that are eligible to receive free government education savings contributions through the Canada Learning Bond have taken advantage of this education savings incentive;
- According to data compiled by the World Bank, Canada is the largest per capita remittance sending country in the world with an estimated **$23.4 billion** remitted from Canada in 2012;
- It costs almost twice as much to send $200 from a Canadian bank to India then to send the same amount of money from a US bank.

Financial exclusion and the growth of alternative financial institutions can partially be attributed to the failure of Canada's mainstream banks to offer appropriate financial products, services and advice to low-income and other financially underserved groups. For institutional investors with long-term investment horizons and whose returns depend heavily on the overall health of the economy, financial exclusion carries significant risks. These risks include economy-wide impacts such as low savings rates, low levels of physical and financial asset holdings and high levels of indebtedness. Declining levels of financial intermediation and limited access to financial services can contribute to higher levels of income inequality, bringing economic consequences such as the likelihood of shorter, less sustained periods of economic growth, social unrest as well as lower levels of productivity and educational attainment, and poorer health outcomes for low-income individuals. Other important risks include greater exposure to loan defaults as well as reputational and regulatory risks.

Opportunities, however, exist for Canada's financial institutions to improve financial services provision to underserved market segments, enabling these institutions to build new client bases and generate acceptable returns. In light of the risks and opportunities associated with financial exclusion, it is recommended that institutional investors engage with Canada's mainstream banks to encourage greater product, service and delivery innovations to improve financial service provision to low-income and underserved groups.

FINANCIAL EXCLUSION IN CANADA

Individuals need access to the full range of financial services to generate income, build assets, smooth consumption and manage risks. A person may be considered financially excluded when they have no access or limited access to the range of financial services offered by mainstream financial institutions or when they do not use the services of a mainstream financial institution. Mainstream financial institutions include Canadian chartered banks and second tier financial institutions, such as credit unions or foreign bank subsidiaries. A common indicator of financial exclusion is whether or not somebody has a functioning deposit account. The Financial Consumer Agency of Canada (FCAC) estimates that approximately 3% of Canadians do not have a deposit account.[1] Research considering those that have no bank account and those that have an account with a zero balance found that 13% of Canadians are outside of the financial mainstream.[2] Financial exclusion is concentrated among low-income households with estimates indicating that more than 8% of consumers with an annual income of less than $25,000 do not have a deposit account or any type of financial product with a bank.[3]

Financial exclusion also includes individuals that are underbanked, such as those who may have a deposit account but do not use other financial products such as savings or loans. For example, the federal Department of Finance reports that only 20% of Canadians with incomes of less than $20,000 per year have opened a Tax-Free Savings Account (TFSA)[4], despite the fact that TFSA incentives are better aligned with low-income peoples needs.[5] The Registered Education Savings Plan (RESP) is also an important savings tool, particularly for low-income families that can benefit from federal government contributions and matched incentives. However, there is very low uptake of RESP's among low-income families, with only 15% of funds in RESPs held by households with less than $40,000 annual income.[6]

FINANCIAL EXCLUSION AND ALTERNATIVE FINANCIAL INSTITUTIONS

The increasingly prominent role of alternative financial institutions in Canada is another important dimension of financial exclusion among low-income and other financially underserved groups. Alternative financial institutions include payday lenders, pawnshops, cheque cashers, title loan stores and rent-to-own shops. These institutions do not offer deposit accounts but provide credit and transactional financial products and services

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[1] Financial Consumer Association of Canada (FCAC), *General Survey on Consumers' Financial Awareness, Attitudes and Behaviou*r, December 15, 2006, accessed at: http://www.fcac-acfc.gc.ca/eng/resources/surveystudies/AttBehav2006/PDF/FCAC_GenSurvExec_2006-eng.pdf.

[2] J. Buckland, 2012, *Hard Choices*.

[3] Canadian Community Reinvestment Coalition*, Access to Basic Banking Services,* CCRC Position Paper #2, 1997, accessed at: http://www.cancrc.org/english/access.html.

[4] The TFSA is different from a RRSP because the investment income earned and withdrawals are tax-free (as opposed to contributions) and it is a better savings tool for low-income Canadians because withdrawals do not reduce entitlement to income supplements like the Guaranteed Income Support (GIS)

[5] Department of Finance, Tax Free Savings Accounts: A profile of account holders, 2012, accessed at: http://www.fin.gc.ca/taxexp-depfisc/2012/taxexp1202-eng.asp.

[6] M. Wong and S. Murray, *More than Money: Mining the human and financial potential of Canada's education savings programs for low-income families*, 2012, accessed at: http://maytree.com/wp-content/uploads/2010/11/More_than_Money-Final.pdf.

characterized by high fees, ease of entry (i.e. no credit check) and ease of access (i.e. extended operating hours and a large number of locations with concentration in low income neighbourhoods).

One of the reasons people use alternative financial institutions is to meet their need to access small-dollar, short-term credit. For many Canadian families, household income is insufficient to cover essential expenses, leaving them unable to save, vulnerable to financial shocks and in need of short-term credit such as payday loans in order to make ends meet.[7] Additional reasons low-income consumers use alternative financial institutions include greater convenience such as location, operating hours and wait times, as well as appropriate customer service and comfort with the institutional environment.[8] In addition, photo identification requirements, the practice of withholding funds on deposited cheques and the possibility that creditors can impose liens or garnishments on a deposit account for past consumer defaults leads people to intentionally want to stay out of the financial mainstream.

The growing use of alternative financial services exacerbates financial exclusion in Canada because it limits people's ability to access the full range of financial services offered by mainstream financial institutions and particularly to those that are developmental such as savings and long-term credit. In addition, because payday lenders do not report to the credit bureau, payday loan users are unable to build their credit rating in order to access cheaper sources of credit, which may contribute to repeat use.

IMPLICATIONS OF FINANCIAL EXCLUSION FOR INVESTORS

Financial exclusion poses risks for Canada's financial institutions, for the financial services sector and for the economy as a whole. Perhaps the most significant risks posed to investors are those that are system-wide. The inability of individuals to access a full range of financial services can have economic consequences, including low savings rates, low levels of physical and financial asset-holding and high levels of indebtedness. Evidence at the macro-level shows that economies with deeper financial intermediation and better access to financial services grow faster and have less income inequality.[9] Growing income inequality in Canada, which has been potentially exacerbated by financial exclusion, also has economic consequences, including the likelihood of shorter, less sustained periods of economic growth, social unrest as well as lower levels of productivity and educational attainment, and poorer health outcomes for low-income Canadians.[10] These system-wide impacts carry

[7] For example, the CGA survey found that only 18% of lower income households said they always or most of the time had money left over at the end of the week or month after paying essential expenses. CGA Canada, Money Talks: Emphasizing wealth in householder finances, 2013, accessed at: http://www.cga-canada.org/en-ca/ResearchReports/ca_rep_2013-05_household_wealth.pdf.

[8] J. Buckland et. al, *Choosing Financial Services Where the Options are Limited: A Report on a Survey of Financial Service Choice of Residents in Inner-city Neighbourhoods in Toronto, Vancouver & Winnipeg*, 2008, accessed at; http://financial-exclusion.uwinnipeg.ca/sites/financial-exclusion.uwinnipeg.ca/files/docs/Choosing_Financial_Services_Where_the_Options_are_Limited.pdf.

[9] The World Bank, *The New Microfinance Handbook: A Financial Market System Perspective*, 2013.

[10] A.G. Berg and J.D. Ostry, *Equality and Efficiency: Is there a trade-off between the two or do they go hand in hand?* International Monetary Fund, 2011, accessed at:

significant risks for institutional investors, who have long-term investment horizons and whose returns depend heavily on the overall health of the economy.

As discussed above, financial exclusion can lead individuals to use more expensive forms of credit such as from payday lenders, which are not required to report to Canada's credit bureau. The increasing use of payday loans coupled with the growth in other types of unsecured debt in Canada such as credit cards and lines of credit[11], has contributed to growing indebtedness among Canadian households and higher levels of financial vulnerability. These trends create significant default risks for individual financial institutions and for the financial system as a whole and were among the factors that contributed to Moody's decision to downgrade the banks' ratings in January 2013.[12]

In addition, Canada's mainstream chartered banks benefit from a number of regulatory protections including historical support in the creation of national banks that, through mergers and the ability to combine retail and investment banking, have enabled them to achieve a level of market dominance that has effectively protected them from foreign acquisitions and enabled them to dominate smaller competitors. These regulatory protections and privileges are based on the expectation that the banking sector will meet certain service standards including ensuring that services are extended on an equitable basis to all Canadians. Canada's banks could face greater reputational and regulatory risks if it is perceived that they are not sufficiently meeting the needs of all Canadians. Recently, the banking sector has been subject to increasing scrutiny from the media, consumer protection agencies and regulators, including recognition from the federal government in its 2013 federal budget that more competition is needed in Canada's financial services industry.[13] The proposal put forward by the federal government implies that Canada's mainstream banks may see changes to protective regulations where smaller financial institutions will be allowed to emerge and grow and where foreign bank entry will be easier. Such competition could incentivize greater innovation in Canada's financial sector and may facilitate greater access to certain products, but it also poses risks to the mainstream banks if they are unable to adapt to a more competitive market when they have benefited for so long from a *de facto* closed market.

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http://www.imf.org/external/pubs/ft/fandd/2011/09/pdf/berg.pdfhttp://www.imf.org/external/pubs/ft/fandd/2011/09/pdf/berg.pdf.

[11] For example, a report by Moody's Investor Service Inc. shows that for Canada's largest banks, unsecured debt represents between 14 per cent and 24 per cent of total managed assets. See http://www.theglobeandmail.com/globe-investor/unsecured-consumer-debt-puts-canadian-banks-at-risk-moodys/article4180772/.

[12] Moody's Investor Service Inc., *Ratings action: Moody's downgrades Canadian banks*, 2013, accessed at: http://www.moodys.com/research/Moodys-downgrades-Canadian-banks--PR_264767.

[13] The Globe and Mail, "Ottawa to explore more competition in banking industry," March 21, 2013, accessed at: http://www.theglobeandmail.com/globe-investor/ottawa-to-explore-more-competition-in-banking-sector/article10083399/.

Finally, financial institutions that fail to devise new products, services and delivery models that respond to unmet needs are missing important opportunities to build new client bases that could drive profit in the future. The intense competition among mainstream banks to meet the financial service needs of middle- and upper-income clients coupled with the increasing concentration of wealth and the growth of poverty in Canada suggests that Canada's banks will need to identify ways to make money from higher volume products targeted to lower-income consumers. Financial institutions that fail to do this will miss opportunities to improve their brand image and will likely face greater difficulties in maintaining a diversified and growing customer base.

Fair Fees: Improving Remittance Services in Canada

Money transfer services are an important transactional product for Canada's immigrant communities. The fees charged for this service in Canada, however are very high. According to the World Bank's Remittance Prices Worldwide database, the average total cost to send $200 from a Canadian bank to the Philippines in the third quarter of 2013 was $14.62. And to India the average total cost was $18.40. For purposes of comparison, the average total cost to send money from a US bank to the Philippines was $9.87; and to India was $9.88.

According to data compiled by the World Bank, $23.4 billion was remitted from Canada in 2012, making Canada the largest remittance sender in the world on a per capita basis. There are opportunities for Canada's banks to tap into the remittance market by providing more affordable and efficient money transfer services. Examples of successful innovations exist, such as Vancity's remittance product, which enables its Filipino members to send money quickly and at a relatively low price. Vancity partnered with a wireless service provider in the Philippines (Smart Communications) and a Philippine bank (BDO Unibank Inc). In order to send money, members must go to a Vancity branch to initiate the remittance transfer. Once the transfer is made, the recipient will receive a notification on their Smart Mobile phone that the funds have been received and with a Smart Money account and card (which costs a one-time fee of CAD $3) they can access the funds immediately. The maximum amount that can be sent is 40,000 Philippine Pesos (PAP) or approximately CAD $950 and there is a flat service fee charged by Vancity of CAD $5.

For more information on opportunities for remittance product innovations, see: http://responsiblebanking.ca/category/product-profiles/.

Source: Remittance Prices Worldwide, November 2011, an Analysis of Trends in the Average Total Cost of Remittance Services, Available online at: http://remittanceprices.worldbank.org/

SUPPORTING FINANCIAL INCLUSION: OPPORTUNITIES FOR INVESTORS

Investors have a role to play in promoting more inclusive and responsible financial service provision in Canada by engaging with Canada's banks individually and at the sector level in two key areas. The first is to encourage investment in product and service innovations to meet the needs of low-income consumers. The second is to identify ways to improve financial service infrastructure to ensure broad-based delivery of financial services.

Viable product and service innovations need to address the structural barriers on both the supply and demand side of financial service provision, including devising products that are appropriate and accessible to underserved groups and profitable for financial institutions. Our analysis of the literature suggests that the financial products and services most needed by low-income and other financially underserved groups are those that: 1) facilitate saving and asset-building; 2) meet short-term, small dollar credit needs and build credit history; 3) simplify and reduce the costs associated with basic transactions such as money transfers, cheque cashing and bill payments; and 4) extend

sound advice and provide accurate information catered to the unique financial situations of low-income and other underserved consumers.

To ascertain the level of commitment by Canada's mainstream banks to improving these kinds of financial products and services, investors need to determine the extent to which banks have made efforts to understand the needs of this segment of the market and to what extent they have invested in new products and/or service delivery methods to meet these identified needs. It is recommended that investors encourage the banks to collaborate with individuals and organizations that work with low-income communities in order to develop a broader understanding of the unique financial needs of low-income people. The knowledge obtained from these processes should be incorporated into front-line staff training and internal decision support tools and be applied to improving communication of current products and services as well as to new product and service development.

Product and service innovations alone will not be sufficient in contributing to financial inclusion in Canada. Another important dimension is improving financial service infrastructure in order to ensure broad based delivery of financial services. Examples of how financial institutions can achieve this are maintaining a sufficient branch network, adopting innovative delivery models and methods and extending hours of operation. Most of Canada's mainstream banks have in fact made significant efforts to extend their branch hours of operation in order to meet the needs of people who may find it difficult to visit a branch during regular working hours.

Bank branch closures can also affect segments of the population who rely on having their bank branch close to their place of residence or work. Our own analysis of current bank branch, payday lending and credit union locations in Toronto and Vancouver in relation to the 2010 Canadian Census tract income data showed that payday lender locations are heavily concentrated in low and very low income neighbourhoods.[14] The evidence that alternative financial institutions tend to concentrate their operations in low-income neighbourhoods can also contribute to financial exclusion and the growing use of high-fee financial services offered by payday lenders. It is important for investors to analyse bank branch closure policies in order to mitigate the risks associated with the rapid growth of alternative financial institutions and the subsequent decline in people's ability to access a full range of affordable and appropriate financial services.

[14] See bank branch, payday lender and credit union location maps in Toronto and Vancouver at: http://responsiblebanking.ca/category/services-location-maps/. The maps are colour coded with average neighbourhood income levels based on Canadian Census tract income data to identify potential financial institution biases to certain neighbourhoods. While the maps show payday lender locations concentrated in low and very low-income neighbourhoods, we did not find a pattern that bank branch locations were biased to higher-income areas over lower-income areas but rather were concentrated along transportation routes and in commercial zones.

Perhaps the most complex and difficult aspect of improving financial service infrastructure in Canada is devising new financial service delivery models and methods that are more appropriate for meeting the needs of low-income Canadians. While some examples of innovative business models exist in Canada in the form of community banks and micro-credit funds, these are very few and far between, with Canada's mainstream banks having played a limited role in supporting such developments. There are several ways for Canada's banks to help develop innovative financial service delivery models and methods in order to meet the needs of low-income consumers. Possibilities include seeking out and identifying opportunities to partner with community-based organizations, government agencies and microfinance institutions in order to build a base of expertise that would allow the development of innovative business models. The appropriate application of technology, supported Internet banking locations, mobile banking services for targeted communities, prepaid cards and automated saving are all delivery methods that could be considered to better serve low-income and other underserved groups. Investors could also encourage the alignment of banks' philanthropic efforts with the goals of financial inclusion in order to allocate resources towards research and development in the innovations mentioned above as well as supporting pilot projects to test these innovations in the market place.

Making RESPs work for Low-Income Canadians

Through the Canada Learning Bond (CLB) and the Canada Education Savings Grant (CESG), Canadians can access free education money from the Government of Canada. By setting up a Registered Education Savings Plan (RESP) – a tax-free savings account to help Canadians save for their child's post-secondary education – eligible Canadian families can benefit from government contributions and matched incentives offered through the CLB and CESG. However, evidence shows that there is very low uptake by low-income consumers of these government programs. Across Canada, the take up rate for the CLB is only 24%. There are a number of barriers to increasing participation in these education savings programs including the fact that consumers and front-line financial institution staff have limited knowledge about RESPs and the available benefits. Moreover, RESP products are complex and consumers often do not know if they are eligible. The time and costs associated with getting the required identification can also be a disincentive for consumers. Additionally, financial institutions do not actively promote RESPs, which according to industry representatives, is due to the relatively modest financial contributions made to RESPs, the complexity of the product to both seller and buyer and the heavy administrative requirements. Canada's financial institutions have an important role to play in making RESPs work for low-income Canadians including devising straight-forward, low fee options; improving marketing strategies to clients; incorporating RESPs into front-line staff training and internal decision support tools; exploring innovations such as automated enrolment for eligible clients; and working with the Government of Canada to distribute information to eligible families.

For more information on savings product innovations, see: http://responsiblebanking.ca/category/product-profiles/.

Source: SEDI, Making RESPs Work for Low-Income Canadians, 2011, available from: http://www.osc.gov.on.ca/documents/en/Securities-Category4-Comments/com_20100621_41-101_naresp.pdf

Innovation Case Study: Mzansi Basic Banking Account in South Africa

In 2004, four of the largest South African commercial banks and a state-owned bank embarked on an interesting innovation in response to the political and economic imperative of making financial services more accessible to the majority black population. Through a voluntary initiative, these five banks cooperatively developed a low-cost basic banking account that they would collectively offer called the Mzansi Account. The key characteristics of this innovation are the banks agreed to share their operational platforms, create a national brand and compete on additional services and functionality. By December 2008, more than 6 million Mzansi accounts had been opened, increasing the percentage of banked South Africans from 45% to 63%. Research conducted by Finmark Trust reveals that the incomes of account holders had increased along with higher savings rates. At the same time, a survey of account holders found that bank usage had increased from an average of 2.9 transactions per moth to 5 and that bank balances had increased from 33% of financial assets to 48%. Of those who never had a bank account before, 7% of them have migrated upward into the mass-market products of the individual banks. That equates to about 400,000 new customers that the banks would not have had without the Mzansi initiative. Two of the five banks that have been most successful in marketing the Mzansi account have noted that the basic banking product provided them with a platform to grow their mass market. Studies indicate that the Mzansi account was an important factor in bringing unbanked households into the mainstream banking system and that the account has allowed participating banks to grow new customer bases and move some of those customers to other financial products and services.

For more financial sector innovation case studies, visit: http://responsiblebanking.ca/category/innovation-case-studies/.

Source: Bankable Frontier Associates, 2010, South African Financial Diaries and the Mzansi Initiative: Five Years Later, www.bankablefrontier.com.

CONCLUSION

Providing financial services to low-income groups brings financial challenges for profit-driven organizations. Innovation from Canada's banks is necessary in order to devise products, services and delivery methods that can achieve higher levels of volume and greater efficiency. There are important business-based arguments for banks to improve financial service provision to underserved market segments including building new client bases, improving brand image and maintaining a favourable regulatory environment. In addition, the imperative of tackling financial exclusion speaks to the banks' broader social responsibility to ensure that their services are offered on an equitable basis to all Canadians. We believe that the case for investors to support these processes, as shareholders in Canada's banks and as long-term investors that are highly sensitive to the risks associated with financial exclusion, is strong. It warrants initiating a conversation and engaging with Canada's banks on this issue.

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