AN OVERVIEW OF FINANCIAL INCLUSION, DEPOSIT INSURANCE AND FINANCIAL STABILITY

Shengxia Li, PhD-Student,
Institute of Finance, University of Miskolc, Hungary

Abstract: Financial inclusion, which defines peoples' accessibility to financial services, has brought numerous benefits for individuals as well as the stability of financial development. Deposit insurance, as one of the pillars for safety net, helps to alleviate risk among banks and enhance trust between depositors during economic turmoil, also contribute to the financial stability. This paper tries to find the mutual interaction between deposit insurance and financial inclusion on financial depth and banking stability, with the conclusion that deposit insurance stabilizes banking crisis and promotes financial depth, contributes a positive effect to a broaden financial inclusion. This paper also highlights some barriers for achieving higher level of financial inclusion, concluded with future developments that can be made from the perspective of deposit insurance.

Keywords: financial inclusion, deposit insurance, development, bank stability

INTRODUCTION

Evidences of strong relationship between financial development and whole growth of economic were found in a wide range of literature reviews (Beck et al, 2000). An inclusive financial system has highlighted its merits by potentially reducing cost of capital, enhance the management of finances, provide avenues for secure and safe saving or investment practices, hence promote economic growth and depth (Sarma, 2011). Conversely, if access to funds is limited and constrained by people's own funds, a lower level availability of funds thus increases the cost and lower the economic growth.

Financial inclusion, defined as accessibility of deposit and credit service for the integration of households, corporates and financial intermediaries, can enhance the financial stability by increasing costumers' access to the formal financial system, which will increase the aggregate saving (Gortsos, 2015). Higher level of financial inclusion also influences the behavior of individuals and firms and lead to a more productive and efficiency financial system.

For central banks, financial inclusion matters on the macroeconomic level by the way of poverty reduction and long-term economic growth, allow the poor to invest in physical assets and education, reducing income inequality and contributing to the economic growth (Levine, 2005).

An increased financial inclusion also gives a stable deposit-funding basis for depositors, especially when they are backed by an effective deposit insurance. Core principles for deposit insurance also highlights that deposit insurers should stay abreast of initiatives related to financial inclusion in order to protect unsophisticated and small-scale depositors (IADI, 2014).
As an important segment of the safety net, deposit insurance aims at reducing the risk of system failure and prevent bank runs hence to stabilize the financial system during financial turbulences. There are debates and different results from researchers when investigating. If deposit insurance enhances financial depth and banking stability, Deniz Anginer and Asli Demirgüc-Kunt (2013) concluded that deposit insurance has a significantly stabilizing effect on bank crisis. But there is also a moral hazard effect of deposit insurance dominating in good times; Cull, Robert J., Lemma W. Senbet (2001) found a limited impact on the financial stability, deposit insurance will enhance financial stability only if the deposit insurance accompanies a sound regulatory; Davison, Lee and Carlos D.'s findings (2016) support that deposit insurance promotes financial depth.

With a proper regulatory authority and efficient bank supervision, deposit insurance can help to enhance trust in banks among depositors, thus overcome the barriers of financial inclusion and further contribute to the bank sector and the financial system.

**FINANCIAL INCLUSION, DEPOSIT INSURANCE AND FINANCIAL STABILITY**

During financial crisis, bank runs happened as depositors withdraw their deposits. This scenario can be mitigated if bank deposits diversifies the adult population in use of deposits increases. Significant improvement can be achieved to resilience the banking sector funding and financial stability if the financial inclusion in bank deposits increase (Cull et al, 2012). To prove this hypothesis, Han, Rui and Martin Melecky (2013) use a sample of 95 countries' in three categories (Low-income, middle-income, and high-income) during 2007-2010, tried to find, whether the differences in drop of deposit growth over can be explained by a larger share of a country's population. They find that for the entire sample of HICs, MICs and LICs, broader access and use of bank deposits can significantly mitigates bank runs and financial slowdowns during crisis, while at meantime most significant in MICs, where large population still lack access to bank deposits. Their results give implications for policy makers achieving higher level of financial inclusion and stability.

Hannig and Alfred (2010) argue that great financial inclusion presents opportunities to enhance financial stability from the insights of risks and costs that financial inclusion may lead to financial institutions: low-income depositors tend to maintain solid behavior during crisis, which illustrates that these risk posted by financial inclusion can hardly be systematic in nature. While on the other hand, the potential cost that financial inclusion brought are compensated by dynamic benefits in the long run due to a deeper and more diversified financial system. Thus, financial exclusion countering is crucial in helping strengthen financial system.

Findings on effect of deposit insurance to the financial stability is nevertheless not uniformed. Cull, Robert J. (2001) acclaimed that deposit insurance can be counterproductive if the system is not appropriately structured, i.e. in a lax regulatory environment; moral hazard is more likely leading to greater systematic instability.

Lee K. Davison and Carlos (2016) applied a two schemes operative in the US during 1920s, the postal saving system and deposit insurance system to test the
hypothesis that deposit insurance promote financial depth by through its influence on depositor behavior. Using country level data, they examine the relative growth of postal savings deposits in pairs of border cities when bank suspensions occurred within a short radius. Their results show a 16 percent of deposit increase in the neighboring postal savings office located in deposit insurance states than the non-deposit states within only 10-mile radius bank suspension and the effect decrease with bank suspension distance until there it disappears when there is no deposit insurance enforcement. They documented a 56 percent of banking capacity because of the presence of deposit insurance, thus concluded that deposit insurance promotes financial depth.

Cull, Senbet & Sorge (2001) provide an agency-theoretic framework to characterize the impact of deposit insurance. They use a unique dataset developed by Word Bank and draw the conclusion that while the regulatory environment of a country is weak and the banking sector unstable, financial depth may decline following the adoption of explicit deposit insurance system.

The literatures investigate the extent to the stability of financial are helpful in quantifying the stability-enhancing component of financial inclusion and deposit insurance, especially during crisis and under certain regulatory environment.

FINANCIAL INCLUSION AND DEPOSIT INSURANCE: ISSUES FOR BANKS

Banking sector has taken a leading role in promoting financial inclusion. Policies that foster the expansion of regional banking services can be an effective tool to enhance financial inclusion by facilitating the access to deposit services, while in return, financial inclusion can expand the base of banking deposits with positive flow of financial stability (Busch, 2017).

Ardic (2011) investigates the legal environment for lending and found that a favorable legal environment may enable banks to operate more profitably, eventually leading to an expansion of deposit services and higher level of deposit penetration, especially with the presence of deposit insurance scheme. In addition, there is a positive link on the business climate to the access of financial services, which is essential to higher level of financial inclusion.

Allen, Franklin et al (2012) focus on the use of deposit account that is typically comparable in countries, analyzed three indicators of account use including ownership of an account, use of the account to save, and frequent use of account. In their results, individuals report lower barriers in countries with lower costs of accounts and greater penetration of financial service providers. Their data proves that increasing ATM penetration and branches can broaden financial inclusion, greater financial inclusion is associated with lower banking costs and greater proximity to branches. They also use a variable measures the scope of explicit deposit insurance which tends to show a positive effect on deposit insurance coverage and political stability among lowest income quintile.

While some of the studies suggest that deposit insurance can induce moral hazard in bank lending and increase the likelihood of banking crisis (Demirguc-Kunt, 2002),
Anginer, Deniz et al (2014) use a sample of 4109 banks in 96 countries to examine the impact of deposit insurance on bank stability for the crisis period and the pre-crisis period. Despite the moral hazard raised, deposit insurance can also enhance depositor confidence and reduce bank runs during turbulences. The net effect of deposit insurance on bank risk and stability depends on whether the benefits of deposit insurance can outweigh its costs. To mitigate the effect of shocks on economy practices, International initiatives focus on achieving higher level of harmonization of banking regulation, such as endeavor of Basel III. The proportionality of banking regulation will create spillovers on financial inclusion by attracting new depositors.

**BARRIERS TO DEVELOPMENT OF FINANCIAL INCLUSION AND DEPOSIT INSURANCE**

Regulatory burdens and lack of infrastructure may have a negative effect on the expansion of bank services, which will hinder potential level of financial inclusion. What's more, under a not appropriated structure, the enforcement of deposit insurance will more likely to induce higher moral hazard, thus work adversely as the intention of customer protection and bridge the trust in banks.

Cost of bank service and use of accounts is another barrier for higher financial inclusion and stability. With a high cost of bank account and other financial services, some customers can be "voluntarily" self-excluded from the financial system—simply because they cannot afford it. Higher cost of deposit insurance is also associated with higher raised systematic bank risk, moral hazard problems.

Trust in banks can constitute a barrier that is hard to overcome. Depositors' mistrust can amplify the incidence of bank failures and systemic consequences for the real economy. Deposit insurance, designed to build trust among depositors and prevent bank runs, if placed under good bank supervision, will enhance depositor confidence and stabilize the financial system. Thus, through bank supervision can be a key for the trust. Empirical analysis also confirms that income as measured by per capital GDP is an important factor in the level of financial inclusion (Sarma & Pais, 2010). It gives hints that efforts should have made to fight with poverty and income inequality in order to achieve a higher level of financial inclusion. They also found that among banking variables, the proportion of non-performing assets is negatively associated with financial inclusion, which highlights that banking regulation is also a crucial determinant for broadening financial inclusion. On the other hand, banking regulation is a drive for deposit insurance by helping to cultivate an appropriate infrastructure and environment.

**CONCLUDING REMARKS**

According to the Global Findex Database (Demirgüç-Kunt et al., 2014), 38 percent of adults' population remain unbanked. Access to formal financial services is increasing in many economies, coped with financial inclusion initiatives, all together intends to maintain overall financial stability.

From the perspective of financial inclusion and deposit insurance, this paper investigates the role of financial inclusion and deposit insurance play in affecting depositor and banking behavior. It concluded that a higher level of financial stability and banking system is associated with a higher level of financial inclusion, with the support of explicit deposit insurance that influence depositors' behavior and trust in
banks, thus broaden the access to deposit accounts and financial services, alleviate bank risks. While literatures have documented various ways to prove that increased financial inclusion benefits financial stability, too strong on improving access to credit may also lead to risks, especially when the system is not appropriately structured, deposit insurance may work adversely under this scenario to bring higher cost and encourage excessive risk taking by banks.

REFERENCES