The development political importance of retail banks for the financial sector

Role of the financial sector

In particular the financial sector crises in Asia and Latin America have shown that a functioning financial sector is crucial for the economic development of a country. Thus, measures supporting the development of a functioning financial sector are important and worth to be promoted.

What is the role of the financial sector? The financial sector channels all funds ("savings") available in an economy into productive utilisation. This process is accomplished with the help of the capital market and the various financial institutions operating in the financial sector. Even in highly industrialised countries it is not possible to allocate these funds through the capital market alone, as the relations between investor and borrower are characterised by asymmetric information.

Thus, the financial sector includes all institutions contributing to overcome these problems and transmitting savings into investments through loans. But also all institutions exerting regulating forces are part of the financial sector, such as the central bank, bank supervision authority and other national and international supervisory authorities. Regulation is necessary – it determines the scope within all players are allowed to act on the financial market. However, the regulating authorities do not control all institutions operating in the financial sector – especially in developing countries, but also in transformation countries (and even in developed nations) there is an informal financial sector. Part of this sector are microfinance institutions (NGOs) along with private money lenders and „merry-go-rounds".

Target groups and their needs

Development political measures are not only targeted towards marginalised population strata, but also towards large or even very large parts of the population in urban and rural regions, depending on the development status of the respective country. Target group of financial institutions are all people, who are capable of earning their own living, even on a low level. Target group are – apart from medium-sized companies – also small and micro enterprises, offering the majority of all jobs available within an economy.

In recent years the supply with loans was predominantly in the focus of international discussions. However, all people, including the poorer population strata, have a need for secure savings and even for money transfers as well as for simple insurance products to provide for various life risks.

Gaps in the financial sector

In principle, the financial sector should be structured in such a way that all population strata can be supplied with the financial services they need – therefore, it should be broad and deep enough. For various countries, the task to build up a broad and deep financial sector is basically similar. Nevertheless, it can be suitable for a threshold country to promote a highly complex form of mezzanine financing; but the relatively high status of an economy should not obscure the fact that large parts of the population might be denied access to financial services. This often holds true for the population of rural areas.

For that reason the predominant task of financial sector development policy must be the creation of a solid basis – this includes measures to stabilise and regulate the financial sector and to promote institutions, which are able to supply broad segments with financial services.

As a rule, the financial sector in development and transformation countries comprises various kinds of financial institutions, which can be allotted to the formal or informal financial sector and pursue different goals. While in these countries primarily profit-oriented national and international commercial banks are generally likely to serve larger (inter)national companies and a small portion of rich private customers (and this often only in urban conurbations), microfinance institutions concentrate on lending to poorer population strata – the supply of micro, small and medium-sized enterprises with loans and the promotion of savings as most important source of domestic capital formation are as much neglected as money transfers or other financial services.

This gap can be closed by such banks, which are able to operate economically sustainable (at least achieving cost coverage) without losing the development political focus. This requires that these institutions only have moderate profit expectations. In development and transformation countries often the public authorities fill in this gap – at least temporarily – by supplying and promoting financial institutions. In many countries financial institutions in form of retail banks take over this role.

Role of retail banks

Retail banks can be defined as banks that are managed according to the same standards or as networks of banks. They operate countrywide, collect savings (in local or foreign currency) and utilise these savings to extend loans to mainly small and medium-sized enterprises. Retail banks are characterised by coping with large-scale transactions, although the average transaction volume is relatively low. Due to their countrywide branch network, retail banks are predestined to carry out national and international payment transactions and offer further basic financial services. Generally, the collection of savings and the possibility to execute payment transactions require to formally integrate the institution in question in the financial sector – in most of the countries such institutions are subject to government regulation.

Due to the features mentioned above, retail banks become an important partner of development policy. Based on an internal decentralised structure, they are able to collect funds in the region for the region. Thus, they can tap and utilise economic potentials more efficiently than a large number of just locally or regionally operating NGOs. In addition, retail banks are able to contribute to combating rural exodus.

Development approaches for retail banks

Basically there are three different approaches to build up retail banks, which are of development political relevance and up-to-date:

Sustainable Retail Bank

Identical development political objectives

Criterion	**PSB**	**MFB**	**NGO**
Regional coverage	+	-	o (regional)
Savings	+	o	-
Loans	-	+	+
Money transfers + other	+	o	-

Identical target groups **Population + SMME**

1. In almost every country there are institutions with retail banking features. Often, these institutions are (postal) savings banks (PSPs) or other government institutions. These already existing retail banks generally do not pursue a down-scaling approach, as their business operations are already target-group-oriented. Their development political focus rather lies on ensuring their long-term sustainability and developing products adequate for their target groups (e.g. introduction of lending products in institutions that formerly only collected savings).
2. In recent times, special microfinance banks (MFBs) have been newly founded as private institutions (predominantly in Southeast Europe). However, these institutions are lacking a dense branch network, at least during the initial years. Setting up such a branch network requires a lot of money and time. But these microfinance banks have the advantage of offering profound banking skills, which NGOs are often lacking. Furthermore, they do not have to cope with inherited burdens, a problem existing retail banks often have to face. In most cases, however, it is more difficult to set up a new institution than to rectify faults within existing retail banks.

3. For a long time, NGOs were in the focus of development policy. In order to ensure a countrywide loan supply of the population and small entrepreneurs through microfinance NGOs, it is necessary to create a framework, interlinking all NGOs operating in a country and integrating them in the formal financial sector, thus catering for a long-term sustainability of the single NGOs. In some countries, promising approaches have already been made.

Unimportant which of the three approaches described above is ever selected to set up a countrywide supply of broad strata of the population and of SME: only with its existence the prerequisite for the introduction of additional "modern" financing instruments is given. The financing instruments are the icing on the cake – but first of all it is necessary to bake the cake.