Latin America Policy Journal

SHIFTING WINDS IN LATIN AMERICA

Seventh Edition
2018

A Harvard Kennedy School Student Publication

Tackling Financial Exclusion in Paraguay: Banks with Souls and the Role of Public Financial Institutions as a means to reach the Underserved

By Juan Manuel Gustale Cardoni

Abstract

In her book How the Other Half Banks, Mehrsa Baradaran (University of Georgia Law School) examines the relevant role of postal banking and Community Development Financial Institutions, and introduces the notion of "banks with souls."[1] This paper seeks to discuss some of Baradaran's main recommendations and incorporate relevant applications to the case of Paraguay's public financial sector, in accordance with the goals set by the National Strategy for Financial Inclusion.[2] A state-owned institution, Paraguay's Banco Nacional de Fomento (also referred to as BNF)[3] is the ideal channel to conduct and empower increasing levels of banking penetration to the population, by efficiently employing its branched networks to reach the underserved, where commercial banks are, for the most part, absent. Through the inclusion of more people in the formal sector, access to credit will be enhanced. This could result in a virtuous circle of opportunities including higher levels of financial literacy, decreased average indebtedness across the country, poverty reduction, and, overall, better quality of life for families.

Banks with Souls and Community Development Financial Institutions

In her book How the Other Half Banks, through the lens of historical perspective, Baradaran chronologically presents the evolution of postal banking and explains how a banking crisis paved the way for postal banks to emerge. After decades of debate, the United States Congress finally embraced the concept of postal banking in 1910, and the system soon proved efficient as an ancillary tool for banking panics.[4] However, two decades later, the advent of the Federal Deposit Insurance Corporation (1933) led to the postal banking system's demise, which finally took place in the late 1960s. The author also introduces the notion of "banks with souls," taking into consideration (based on Nobel Prize winner Muhammad Yunus' reflection)[5] the following question: Should credit availability be considered a human right?

Baradaran focuses on the case of Chicago's ShoreBank, which represents an emblematic example of a financial company lending to the poor. The oldest and largest community bank in the United States, this institution played a key role in the development of a new banking movement, which resulted in the rise of Community Development Financial Institutions (CDFI). The driving force of community banks was to facilitate access to credit to communities as a mechanism to foster their development. Nonetheless, ShoreBank's venture also demonstrated the disadvantages of banking for the poor: in 2010, the firm was declared insolvent, having failed mainly because its loans were concentrated in struggling geographical areas, exposing them to more risk during the economic downturn. Analysts speculated that the main cause of the institution's failure was that its model was based "too much into the social welfare thing."[6]

The Riegle Community Development and Regulatory Improvement Act,[7] also known as the Community Banking Act (enacted in 1994), was passed as a means to financially revitalize communities.[8] However, a vast majority of the funds ended up being diverted to "development projects" instead of being destined to help the unbanked.[9] Lawrence Summers conceived CDFIs as "market scouts" seeking out profits in overlooked markets, a notion that supported the assumption that such a segment of entities could both serve the poor, and at the same time lend profitably and achieve returns.[10] In alignment with Summers, Baradaran has argued for increasing government support to enable these institutions' survival with minimal profits. Accordingly, this group of institutions could function effectively and profitably, insofar as government support is available.

The Case of Paraguay: Current Economic Landscape at a Glance

Paraguay is one of the fastest-growing economies in Latin America. An average growth rate of 5 percent (over the last 10 years) has led its economy to be considered one of the healthiest in the region.[11] Over the period 2005-2017, Paraguay's financial system experienced a remarkable evolution by all measures: it increased its levels of deposits and assets and exhibited robust and consistent signals of solvency, liquidity, and profitability, while maintaining levels of non-performing loans below 3 percent.[12]

Commercial banks dominate the domestic financial scene,[13] with their assets representing approximately 73 percent of the total assets in the financial sector, while the assets of finance companies amounted to only 2.9 percent.[14] The second-largest group of financial institutions consists of cooperative institutions,[15] with a 15 percent market share of total assets, scattered in more than 300 deposit-taking entities.[16]

It is commonly argued that an appropriate legal regime should be introduced in order to boost long-term investment (the economy relies too much on short-term financing).[17] As a matter of fact, Paraguay's banking sector is very short-sighted, with deposits remaining the most important source of funding.[18] The only state-owned, first-tier bank, Banco Nacional de Fomento, was created in 1961, and its liabilities are fully guaranteed by the Paraguayan government.[19]

Paraguay is a leading case in the field of digital financial services,[20] which quickly spread throughout the country, gaining great acceptance and enhancing the banking sector's development. Approximately four million transactions take place on a monthly basis.[21] Undoubtedly, technology has played a pivotal role in facilitating capital flows and in consolidating the financial sector's growth. The extraordinary rise in assets and liabilities in Paraguay's banking sector was supplemented by an amplification of its geographic coverage.[22]

Paraguayan financial markets evolved from a traditional, conservative deposit-taking system into a more sophisticated group of entities. In this regard, the implementation of the new payment system (Law 4595/2012, "Sistemas de pagos y liquidación de valores")[23] encompasses the growth of home banking transactions, electronic payments made through the Automated Clearing House, Real-Time Gross Settlement, and the proliferation of non-bank transfers via mobile phones, as well as the rapid development of electronic money.

The ubiquitous penetration of mobile phones in Paraguay (over 109 percent)[24] has dramatically altered the way transactions are conducted. This is especially due to the development of electronic wallets and the implementation of a new regulatory framework for entities offering products and services associated with electronic money and non-bank transfers.[25] Digital financial services have become one of the most salient instruments for financial inclusion worldwide. Paraguay is no exception: higher levels of mobile phone penetration have generated the ideal conditions for cell phones to become a user-friendly, safe, and reliable tool to store electronic money, pay bills, and process non-bank transfers.

Promoting a More Active Role of Public Banking in the Implementation of Paraguay's National Strategy for Financial Inclusion

As the global economy reshapes the way of doing business, the ongoing process of adapting public policies to the dynamic development of the international financial system becomes a rather daunting task. Thus, a gradual process of regulatory reform is ideal. The institutional feature plays a relevant part.[26] Paraguay's former finance minister, Santiago Peña,[27] quoting Timothy Besley,[28] emphasizes the relevance of state participation in financial markets, insofar as scarce development of institutions and market failures occur. In these cases, the state should facilitate the link between lenders and borrowers, complementing the private sector, but not necessarily substituting it.

A great challenge for the Paraguayan government is to trigger a paradigm shift to boost long-term productive investments that will consolidate development. In this endeavor, the state-owned Banco Nacional de Fomento (BNF) has a leading role in enlarging its base of products and services and tapping into its network of branches.[29]

The BNF should also maximize the potential of technology to fill gaps and reach places where the private sector does not reach the underserved segments of the population. This will result in access to credit and financial services for the population of remote rural areas with limited access and resources, and whose entitlement to credit is equal to that of any other citizen.[30] The role of public banking in Paraguay should not undermine that of the private sector. Instead, it should add value and complement the private sector, filling market gaps without replacing private financial participants.[31]

The BNF retains a great market share of public payrolls (around 95 percent) and, as of January 2018, public funds are gradually migrating towards this increasingly prominent institution.[32] A dynamic lending process to boost the productive sector, the small and medium enterprises (SMEs), and the housing market should become a priority for this institution. Definitively, all these factors will largely contribute to Paraguay's broader goal of including increasingly more people in the formal financial sector.

Quid Pro Quo? Revising the Social Contract Between Banks and the Government as a Means to Promote Financial Inclusion

To achieve higher levels of banking penetration, one of the key components of financial inclusion – the social contract between the government and the banking sector – should be reevaluated. The last global financial crisis portrayed banks being bailed out by the government. However, Baradaran, in an effort to stimulate lending to small businesses and the underserved, has argued that those funds were not necessarily redirected towards the public.[33] This poses the question of the validity of such a social contract between the government and the banking system: Once the government has secured financial support by providing credit to banks, then shouldn't it also assure that banks will provide credit to the people?

The social contract should be revised to guarantee that the public interest is not neglected – to the detriment of the underserved – in future adverse financial situations.[34]

Hence the conception of "banks with souls" should be revitalized, by virtue of which the government should prioritize the idea of serving the public as the core purpose of public banking. Paraguay's Banco Nacional de Fomento stands in a privileged position to be the main vehicle through which the government could reach this purpose to the benefit of the underserved.

Conclusions

This paper argues that as a means to counteract financial exclusion in Paraguay, the government must concentrate on delivering secure access to regulated financial services, under a straightforward scheme where reasonable products are offered in a timely manner. Baradaran's conception of postal banking and Community Development Financial Institutions depicts the figure of public legal entities encompassing a wide range of products and services, at a much lower cost than banks, by relying on economies of scale and scope.

The case of Paraguay's Banco Nacional de Fomento presents similarities, given its broad network of branches located throughout Paraguayan territory, its potential to engage in more innovative financial products, and to offer timely, affordable, and transparent services. Accomplishing such an ambitious goal entails considering the importance of emerging technologies, as well as its capacity and potential to reach remote, underserved areas. This, in turn, would contribute to the capacity-building process by improving financial literacy and protecting families against onerous forms of credits obtainable through unscrupulous mechanisms (made available by loan sharks).

Graduating to "bank status" could enable thousands of creditworthy families to escape poverty and have access to more sophisticated financial products.

NOTES

1 Mehrsa Baradaran, How the Other Half Banks: Exclusion, Exploitation, and the Threat to Democracy (Cambridge, Massachusetts and London, England: Harvard University Press, 2015).

2 See http://enif.paraguay.gov.py/. Consulted 20 January 2018.

3 The Decree-Law 281 of 14 March 1961, Presidency of the Republic of Paraguay, created the National Bank of Development.

4 The Postal Savings Depository Act of 1910 was passed on 25 June 1910, but only became effective on 1 January 1911.

5 Randeep Ramesh, "Credit is a Basic Human Right," The Guardian, 5 January 2007, https://www.theguardian.com/world/2007/jan/05/outlook.development.

6 David Greising, "Recession Played a Part, but ShoreBank Wounded Itself Too," The New York Times, 22 May 2010, http://www.nytimes.com/2010/05/23/business/23cncshorebank.html.

7 Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, 108 Stat. 2160 (codified as amended in scattered sections of 12 U.S.C.).

8 Under this law, banks were given specific charters to serve poor areas. Legislation triggered a competitive market, with up to 1,000 institutions of this nature operating in a short period of time after the law had been passed.

9 Baradaran, How the Other Half Banks, 168.

10 Lawrence Summers, "Building Emerging Markets in America's Inner Cities," remarks to the National Council for Urban Economic Development, 2 March 1998, www.treasury.gov/press-center/press-releases/Pages/rr2262.aspx.

11 Moody's Investors Service, "Rating Action: Moody's Affirms Paraguay's Ba1 Government Bond Ratings and Maintains a Stable Outlook," 21 June 2016, https://www.moodys.com/research/Moodys-affirms-Paraguays-Ba1-government-bond-ratings-and-maintains-a--PR_350843.

12 Central Bank of Paraguay, "Financial Stability Report 2016," https://www.bcp.gov.py/informe-de-estabilidad-financiera-i103.

13 Commercial banks and finance companie fall under the scope of the Organic Law of the Central Bank

(Law 489, 1995) and the Banking Law (Law 861, 1996, partially amended by Law 5787/16).

[14] Jose Insfrán Pelozzo, "Where Is the Paraguayan Financial System Headed?", published in Beyond Macroeconomic Stability: Achievements and Challenges (Banco Central del Paraguay, 2016).

[15] World Bank Group, "Paraguay's National Financial Inclusion Strategy 2014-2018," December 2014, https://www.bcp.gov.py/estrategia-de-inclusion-financiera-i459.

[16] According to a survey conducted by the World Bank in 2014, 19 percent of adults reported having an account at a cooperative, as compared to 12 percent for banks. See World Bank Group, "Paraguay National Financial Inclusion Strategy 2014-2018," December 2014, https://www.bcp.gov.py/estrategia-de-inclusion-financiera-i459.

[17] See International Monetary Fund, "Press Release: Staff Completes 2016 Article IV Mission to Paraguay," 26 February 2016; and International Monetary Fund, "IMF Country Report 16/116," May 2016.

[18] As explained by Insfrán, "Certificates of Deposit are the installment savings scheme par excellence." See José Insfrán Pelozzo, "Where Is the Paraguayan Financial System Headed?"

[19] The National Bank of Development's operations must abide by its Charter (Law 5800, 2017). Where appropriate, the Banking Law and prudential regulations issued by the Central Bank and the Superintendency of Banks are also applicable.

[20] Christian Tondo, "The Paraguayan Experience with Digital Financial Services," Alliance for Financial Inclusion, 31 October 2017, https://www.afi-global.org/blog/2017/10/paraguayan-experience-digital-financial-services.

[21] Tondo, "The Paraguayan Experience with Digital Financial Services."

[22] Data indicates that the degree of expansion across the country went from 264 agencies and branches of banks and financial institutions in 2002 to 408 in 2009, and to as many as 647 in 2017. See National Report of Financial Inclusion, Estrategia Nacional de Inclusión Financiera, November 2017, 36.

[23] Effective as of 2012, Law 4595/2012, "Sistemas de pagos y liquidación de valores."

[24] BuddeComm, "Paraguay – Telecoms, Mobile and Broadband – Statistics and Analyses," 2015, https://www.budde.com.au/Research/Paraguay-Telecoms-Mobile-and-Broadband-Statistics-and-Analyses.

[25] These institutions are under the supervisory scope of the Central Bank, according to Resolution No. 6, "Reglamento de Medios de Pagos Electrónicos de Pagos," Board of Directors, Central Bank of Paraguay, 13 March 2014, https://www.bcp.gov.py/otras-normas-vigentes-i596.

[26] As the celebrated British economist Goodhart underlines, "the institutional structure of regulatory agencies has significance beyond simple bureaucratic tidiness." See Charles Goodhart (emeritus professor at The London School of Economics) et al., Financial Regulation: Why, How and Where Now? (London and New York: Routledge and the Bank of England, 1998).

[27] Santiago Peña, "Financial Inclusion," published in Beyond Macroeconomic Stability: Achievements and Challenges (Banco Central del Paraguay, 2016), 147.

Timothy Besley, "How Do Market Failures Justify Interventions in Rural Credit Markets?", World Bank Research Observer 9, no. 1, (January 1994): 27-47.

[28] As of December 2017, there are more than 75 across the country. See Banco Nacional de Fomento, "Red de Sucursales y Centros de Atención al Cliente," n.d., www.bnf.gov.py/sucursales.

[29] The BNF should also embark (along with an array of other public and private institutions) on the nationwide program of financial education.

[30] According to the World Bank, the involvement of public financial institutions "should be evaluated and determined if they are providing services that are not already being provided by private financial institutions." See World Bank, "Technical Note: Financial Regulation for Financial Inclusion - Paraguay," First Initiative/World Bank, Washington, D.C., November 2014.

[31] This was given as a result of a recently enacted legislation (National Budget Law 2016, No. 5554/16), which establishes the compulsory transfer of funds of public entities (reaching a staggering estimated amount of $354 million).

[32] Baradaran, How the Other Half Banks.

[33] Baradaran concludes by asserting that "Subsidies for banking have been justified because they provide a benefit to all citizens. Mainstream banks have met part of their obligation, but a large portion of the population, namely the poor, has been left out. It is time, then, for the government itself to meet the demand for credit." See Mehrsa Baradaran, "It's Time for Postal Banking," Harvard Law Review Forum 127 no. 165 (24 February 2014), https://harvardlawreview.org/2014/02/its-time-for-postal-banking/.

[34] A significant feature of the National Bank of Development is that this institution might be conceived as more flexible and user-friendly, which makes people feel more comfortable when initiating a relationship, as opposed to the case of traditional commercial banks.

—

Juan Manuel Gustale Cardoni is a Member of the Board of Directors of the National Bank of Development - Paraguay. He holds a Master in Public Administration (MC/MPA'17) from Harvard University and a Master of Laws, Banking Law and Financial Regulation (LLM'12) from London School of Economics.