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Review

Financial inclusion and financial stability: the important role of financial regulation in explaining the relationship. Empirical review

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Whilst the importance of financial inclusion has primarily been attributed to its strong links to poverty alleviation, of major interest recently had been attempts by researchers to also link financial inclusion with financial stability. The focus on the relationship between financial inclusion and financial stability is now shifting from merely believing that financial inclusion is linked to financial stability, but to exploring specific conditions under which financial inclusion can be used to foster financial stability. Whilst financial inclusion may be linked with financial stability in several ways, it is important to note that an effective financial regulatory framework still plays an important role in ensuring the stability of financial systems. By mitigating some of the risks that financial inclusion may pose to the financial system, financial regulation plays an intermediary role. A regulatory mechanism that would ensure that financial inclusion leads to financial stability would include regulation biased consumer protection, financial literacy and financial integrity. With policymakers and regulators looking for specific linkages that would ensure that financial inclusion leads to financial stability, such a regulatory mechanism may form the basis of an effective financial inclusion-financial stability framework that can be used in ensuring the attainment of such noble objectives.

Keywords: Financial inclusion, financial stability, financial regulation.

INTRODUCTION

The term “financial inclusion” gained importance since the early 2000s and is a result of findings that financial exclusion has a direct impact on poverty alleviation (Shiimi, 2010:2). Since then, financial inclusion experts have been working hard to ensure that financial inclusion is given much significance in development policy issues. In November 2010 at the G20 summit held in Seoul South Korea, financial inclusion was given a major boost when it was recognized as one of the main pillars of the development agenda (Global Partnership for Financial Inclusion Work Plan, 2011-12). With such major recognition by the world’s richest countries, financial inclusion has now become common objective for many central banks among developing countries and even among developed nations (Shiimi, 2010:2). This is evidenced by the increasing numbers of countries who are embracing the concept of financial inclusion by committing themselves to financial inclusion objectives (World Bank, 2012:8).

Whilst the importance of financial inclusion has primarily been attributed to its strong links to poverty alleviation, of major interest recently had been attempts by researchers to also link financial inclusion with financial stability. In a world plagued by recurring episodes of financial crises, possible links between financial inclusion and financial stability are a welcome development. This is because if such a link exists, financial inclusion will be used as one of the solutions towards achieving greater financial stability. Much importantly, the pursuit of financial stability will provide

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further basis for financial inclusion, thereby encouraging formulation, adoption and implementation of financial inclusion policies across many countries. Unfortunately, the conclusion that financial inclusion is linked to financial stability lacks concrete empirical evidence and has thus been a subject in financial circles. Financial inclusion may pose risks to the financial system, which may ultimately lead to financial stability (Ghosh, 2008:2). With some arguing that financial inclusion may be source of financial stability, questions has been raised as to how financial inclusion can be used to foster financial stability without comprising the stability of the financial system. Hence, the focus on the relationship between financial inclusion and financial stability is now shifting from merely believing that financial inclusion is linked to financial stability, but to exploring specific conditions under which financial inclusion can be used to foster financial stability.

A number of researchers have provided several ways in which financial inclusion may be linked to financial stability. However, none have emphasized the important role of an effective regulatory framework in explaining the relationship between financial inclusion and financial stability. Whilst financial inclusion may be linked with financial stability in several ways, it is important to note that an effective financial regulatory framework still plays an important role in ensuring the stability of financial systems. In this paper, we emphasize the role of an effective financial regulatory framework in ensuring that financial inclusion leads to financial stability. Furthermore we argue that financial regulation, since it forms an important component of efforts which are aimed at ensuring that financial inclusion leads to financial stability, should form the basis of any financial inclusion–financial stability framework that policymakers and regulators may use in ensuring that financial inclusion leads to the achievement of financial stability.

The following shall be covered in this paper:

- importance of financial inclusion,
- the intricate relationship that exist between financial inclusion and financial stability,
- explanations of the relationship between financial inclusion and financial stability
- the important intermediary role of financial regulation in explaining the link between financial inclusion and financial stability and in providing a basis for the development of a financial inclusion-financial stability framework that ensures that financial inclusion leads to the achievement financial stability,
- importance of financial regulatory mechanism to policy makers and regulators and then
- conclusion.

The importance of financial inclusion

Financial inclusion, also referred to by some as access to financial services, has various interpretations (Shiimi, 2010:2). In general terms, financial Inclusion is defined as the process of ensuring access to appropriate financial products and services needed by vulnerable groups such as weaker sections and low income groups at an affordable cost in a fair and transparent manner by mainstream Institutional players (Joshi, 2011:2). Financial inclusion is based on the premise that 'financial services should reach everyone who can use them, including disabled, poor, and rural populations' (Gardeva and Rhyne, 2011:1). According to Cheriyan (2011:24), financial inclusion includes access to financial products and services such as no frill bank account, check in account, micro-credit, savings products, remittances & payment services, insurance, healthcare, mortgage, financial advisory services, entrepreneurial credit, pension for old age, business correspondence and self-help group branchless banking etc**.** Full financial inclusion is said to have been reached if all people have access to a suite of quality financial services, provided at affordable prices, in a convenient manner, and with dignity for the clients (Gardeva and Rhyne, 2011:1).

What causes financial exclusion? There are various reasons why some people remain excluded from accessing financial services. The reasons include;

- cultural mistrust of mainstream financial institutions, maybe due to the fact that individuals may come from countries where banks are not safe places to deposit funds or may be sources of information (or mis-information) for government authorities in repressive regimes;
- lack of understanding or familiarity with traditional financial services, maybe due to language barriers, especially with immigrant populations;
- unavailability of ready access to financial services in rural areas and even in urban areas;
- mismanagement of financial services by some individuals in ways that make them higher risk to the financial institution, to an extent that there are deterred from using such services; and
- implementation of consumer protection policies that are designed to protect those who are disadvantaged , but which end up becoming barriers that actually restrict access to financial services, for example, steps that add to the costs for prepaid products may make them less appealing to those living on the margin (FATF/OECD,2011:13)

How do we achieve financial inclusion? According to WSBI (2010:2) achieving financial inclusion involves;

- giving access to an entire range of affordable, safe, accessible, adapted and usable financial services and products (credit, savings, remittances, insurance etc.);
- the development of innovative financial services techniques, not only related to the delivery modes (branchless banking), but also to the design of products and the business partnerships;
- the development of a diversity of sound and efficient financial services providers operating in a level playing

field;

- the development of an enabling and proportionate regulatory and supervisory frameworks conducive to financial inclusion, i.e. with the right balance between the risk to mitigate and the implementation costs;
- the underlining of financial literacy efforts; and
- ensuring an appropriate level of consumer protection, as a core element to build long-term relationships, based on trust and confidence.

In essence, a comprehensive approach to financial inclusion addresses at least three aspects:

- access to financial services and products;
- usage of financial services and products; and
- Quality of financial services and products, defined by consumer ability to benefit from new financial services and products and linked to consumer protection and financial capability.(World Bank,2012:6).

Why should we be concerned about financial inclusion? According to (Subbarao, 2011) financial inclusion is important because it is a necessary condition for sustaining equitable growth due to the fact that it provides the poor with opportunities to build savings, make investments and avail credit and, much importantly access to financial services also helps the poor insure themselves against income shocks and equips them to meet emergencies such as illness, death in the family or loss of employment. In other words, access to a wide set of financial tools provides low-income people with much greater capacity to increase or stabilize their income, or build assets, or foster their resilience to economic shocks (WSBI, 2010:3). Moreover, financial exclusion has a direct and indirect impact on the way in which individuals manage their money and as such it is also part of a much wider social exclusion as it affects the overall quality of life of individuals – their patterns of consumption, participation in economic activities or access to social welfare and distribution of incomes and wealth (European Commission, 2009:8). In other words, financial inclusion is an important component of the efforts aimed at alleviating poverty and economic growth. According to Ndung'u (2011:1), inclusion is an essential pre-condition to enhancing wealth creation and poverty reduction and ultimately broad based economic development. Hence, many countries are making concerted efforts to increase levels of financial inclusion.

According to Shiimi, (2010:2) financial inclusion is common objective for many central banks among developing countries and even among developed nations. Statistics show that many countries are committing themselves to increasing levels of financial inclusion. According to the World Bank(2012:8) more than 60 countries have introduced reforms to stimulate an expansion of financial inclusion in recent years and financial regulators from more than 20 countries have made financial inclusion commitments under the Maya declaration to create an enabling environment that increases access and lowers costs of financial services, including through new technology; implement a proportionate regulatory framework that balances financial inclusion, integrity, and stability; integrate consumer protection and empowerment as a pillar of financial inclusion; and finally use data to inform policies and track results.

Through internationally-sanctioned organizations, such as the Alliance for Financial Inclusion (AFI), the Global Partnership for Financial Inclusion (GPFI), continuous efforts are being made to ensure that countries prioritize financial inclusion in their development policy issues. Despite such efforts, many people, particularly in the developing world remain unserved by the formal financial institutions. According to Cheriyan (2011:24) more than two billion people worldwide are still without access to formal financial services, and many of them are the world's poorest**.** Low income levels, low financial literacy levels and lack of adequate financial infrastructure particularly in developing countries have resulted in many people remaining excluded from accessing formal financial services. Figure 1, shows financial exclusion levels for a number of countries in Africa.

Though financial inclusion is severe in developing countries, it is important to also note that it also an important issue in developed countries. This is because financial inclusion is not only about access, but also about being equipped with the right knowledge to make wise and informed financial decisions. In other words, financial literacy is a key component of financial inclusion. Whilst financial inclusion acts from supply side providing the financial market/services that people demand**,** financial Literacy stimulates the demand side –making people aware of what they can demand, such that in advanced economies, financial Inclusion is more about the knowledge of fair and transparent financial products and a focus on financial literacy and in emerging economies, it is a question of both access to financial products and knowledge about their fairness and transparency (Chakrabarty,2011:4). Hence, efforts aimed at increasing financial inclusion have become important in both developed and developing countries.

The intricate relationship between financial inclusion and financial stability

What is financial stability? Unlike price stability, financial stability is not easy to define or measure (Gadanecz and Jayaram, 2009:365). This is because it has a multidimensional scope that depends on the interplay of key elements of the system and requires that the key institutions and markets in the financial system remain stable (Hannig and Jansen, 2010:22). According to Ndung'u (201:1) a financial system is described as being stable if it exhibits some of these attributes: public

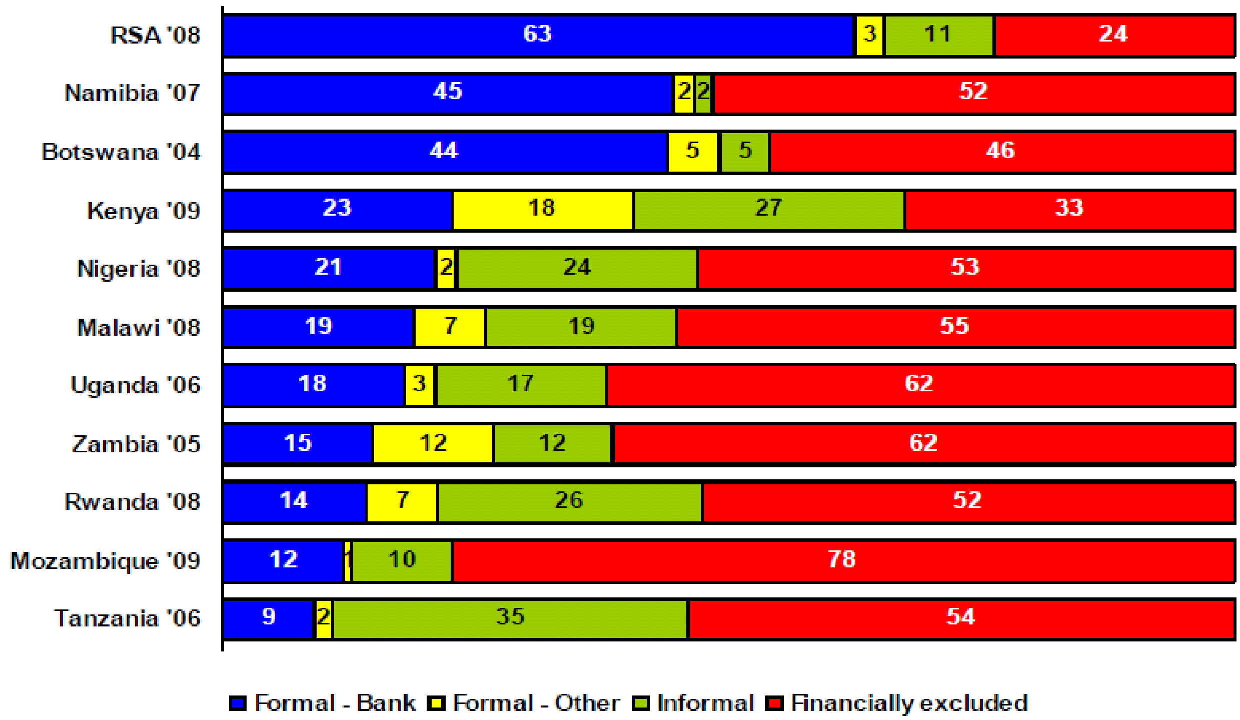

Figure 1. Financial Exclusion Levels
Source: Makanjee, M (2009)

confidence and trust in the institutional framework owing to sound design of the infrastructure; predictability; efficiency; sound ethical behavior by market participants and competence of financial authorities, among others. In narrow terms, a financial system can be characterized as stable in the absence of excessive volatility, stress or crises (Gadanecz and Jayaram, 2009:365-366). Using a more broader definition that captures the macroeconomic dimension of financial stability the European Central Bank(2007), quoted from (Gadanecz and Jayaram,2009:366), defines financial stability as a condition in which the financial system, comprising of financial intermediaries, markets and infrastructure, is capable of withstanding shocks and the unraveling of financial imbalances, thereby mitigating the likelihood of disruptions in the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities.

Whilst in the past the basis for financial inclusion has been about ensuring inclusive growth and alleviating poverty, in recent times there has been a new strand of literature linking financial inclusion with financial stability. More specifically, there is a growing opinion among policy makers and regulators that financial inclusion and financial stability are intricately related.

Muliaman D. Hadad, Deputy Governor of the Bank of India, as part of a presentation at the 2010 Alliance for Financial Inclusion (AFI) Global Policy Forum which was held between the 27-29th of September 2010 in Bali, asserted that there is a relationship between financial inclusion and financial stability by saying the following:

"Financial inclusion is usually linked to poverty alleviation. However, it has strong links to financial stability as well". (Hadad, 2010:5).

The Deputy Governor of the Philippines Central Bank, Nestor A. Espenilla, Jnr as part of a presentation at a Meeting on Microinsurance – Promoting Successful Regulatory and Supervisory Approaches for Increased Access to Insurance in Basel, Switzerland on the 26th of July 2010, mentioned the following points concerning the mutual relationship between financial inclusion and financial stability:

"Financial inclusion and financial stability are mutually reinforcing. Financial inclusion is a worthy policy objective, alongside the promotion of stability and efficiency in the financial system" (Espinella, 2010:6)

Shri H R Khan, the Deputy Governor of the Reserve Bank of India, speaking at BANCON 2011 meeting organized by the Indian Bankers Association and Indian Overseas Bank, in Chennai on the 4th of November 2011, said the following concerning the importance of achieving simultaneous objectives of financial inclusion and financial stability:

"…..most importantly, we have learnt that while financial instability can hurt even the most advanced economies, the damage it can cause in poor and developing economies can be particularly severe. People with low levels of income have no headroom to bear downside risks, and their livelihoods can be disrupted by financial instability. It is therefore even more important that

countries such as ours pay particular attention to preserving financial stability even as we deepen and broaden our financial sector at home and integrate with the rest of the world"(Khan,2011:1)

As part of his keynote remarks for the session on "Financial Stability and Financial Inclusion, 2012 Financial Sector Reform", Amando Tetangco summed up the intricate relationship between financial inclusion and financial stability by saying the following:

"Moving forward, it would stand to reason that financial stability would thrive when the market framework allows for the different stakeholders to participate. Financial stability can thrive when different needs are recognized, but addressed as appropriate and governed under the same overarching core principles of market governance and prudential oversight. This is nothing more than financial inclusion. Stripped to its core, inclusion is a participatory framework to work towards a holistic market and break down barriers between bankable and unbankable, serviced and underserved. Once such a holistic market is upon us, we would have created the environment where stability can more likely be sustained (Tetangco, 2012)

As part of his opening remarks on the topic, 'Financial inclusion and the regulation of microfinance', Muhammad Yunis had this to say about the relationship between financial inclusion and financial instability:

"Financial crises illustrate a fundamental flaw in the way the current financial system is

organised. The financial institutions and banking systems of advanced economies focused on big banks and big customers. This system embodies a kind of financial apartheid; two thirds of the world's population is excluded. Unless we bring these people into the financial system, crises will keep recurring" (Yunis, 2011:7)

At the at the 5th Joint CMA/CBK/RBA/IRA Board Members retreat on collaboration among domestic financial sector regulators in Kenya, Mombasa on the 13th of October 2011, Prof Njuguna Ndung'u, Governor of the Central Bank of Kenya said the following, concerning the link between financial inclusion and financial stability:

*"…as financial sector regulators, we share common aspirations of making the financial sector more stable, efficient and accessible. Though these objectives may at times appear competing, they are for the most part complementary. Stability is a pre-requisite for efficiency, while both are in turn required to raise inclusion". (*Ndung'u, 2011:2*)*

Why is there so much attention towards the relationship between financial inclusion and finical stability among regulators and policymakers? Financial stability is widely accepted policy goal because a sound financial system is one of the cornerstones for economic growth (Hannig and Jansen, 2010:21). More precisely, financial stability is important for the sound and efficient functioning of the financial system. This is because it serves to instill confidence in users of financial services. In contrast, financial instability reduces public confidence in the financial system and also has negative consequences for the normal functioning of the financial system. The recent financial crisis has shown that financial instability has the potential to spread from within the financial system to the real economy and damage growth (Barnier, 2012:10). Thus, preserving financial stability is an important objective of many regulators and policymakers.

"Since the collapse of the Bretton Woods system increased global capital mobility has been accompanied by greater frequency of financial crises in both developed and developing countries. The episodes of financial instability and crisis in industrial countries include the banking and real estate crises in the United States lasting more than a decade from the late 1970s, the major slumps in the global stock market in 1987 and 1989, several episodes of extreme instability in the currency markets of industrial countries of which an outstanding instance was the currency crisis of the European Monetary System (EMS) in 1992, and the instability in Japanese financial markets that started with the bursting of the bubble in the early 1990s, whilst those in developing countries include the Southern Cone crisis of the late 1970s and early 1980s, the debt crisis of the 1980s, the Mexican crisis of 1994- 1995, the East Asian crisis beginning in 1997, the Russian crisis of 1998, and a number of other more limited currency and banking crises"(Alici and Ozgoker,2006:3). Much more recently, the world financial crises which emanated from the United Sates housing bubble further brought the focus on financial stability to the center stage (Khan, 2011:1). Thus, with the frequency at which financial crises are happening, preserving financial stability has become a key policy objective form in most countries around the world (Praet, 2011), to an extent that the envisaged link between financial inclusion and financial stability is widely seen as one of the solution to preserving the stability of financial systems.

Explaining the relationship between financial inclusion and financial stability

Whilst a number of policy makers and regulators have asserted that financial inclusion is intricately related to financial stability to an extent that financial inclusion may be used as a solution towards efforts at achieving financial stability, the key question among many is that; Does financial inclusion automatically leads to financial stability? The relationship between financial inclusion and financial stability is a complicated and complex relationship. The complications and complexities of the relationship between financial inclusion and financial stability are due to the interdependence and complex interactions of the various elements of the financial system that also influence financial stability and financial inclusion. Financial literacy, consumer protection, financial integrity, financial inclusion and financial stability are intertwined to an extent that the failure of one dimension may result in the in the failure of other dimensions (Cull et al, 2012). In other words, the relationship between financial inclusion and financial stability is not a straightforward relationship. It thus involves some key elements that influence it; such that it is only under the right conditions does financial inclusion leads to financial stability.

Moreover, financial inclusion has the potential to engender financial fragility (Ghosh, 2008:2). In other words, financial inclusion has the potential of posing risks to the financial system. This is because financial inclusion changes the composition of the financial system with regard to the transactions that take place, the clients that use the various services, the new risks created, and possibly the institutions that operate in newly created or expanded markets, Hannig and Jansen (2010:22). More specifically the processes of increasing financial inclusion changes the nature of risks and these changes result from a variety of factors which include the characteristics of currently financially excluded customers (which differ from the "already served"), as well as the nature of the products, services, and providers capable of reaching them, and especially the innovative approaches needed to accomplish significant increases in financial inclusion (CGAP, 2011:2). One only has to recall the savings and loan crisis in the US in 1980s to appreciate that even financial institutions geared to cater to the retail investors and, thereby, to foster financial inclusion, could be a source of financial instability (Khan, 2011:5). The recent crisis in US subprime markets is another case in point in which loans were marketed to subprime borrowers as a way of promoting financial inclusion, but the resultant over-extension of credit, which has the potential to affect the quality of the credit portfolio of banks and financial institutions, ended up sowing the seeds of financial fragility, and ultimately of financial instability (Ghosh, 2008:2). In essence, financial inclusion can actually lead to financial instability rather than financial stability.

The concerns that financial inclusion can pose risks to the financial system that will eventually result in financial instability were however disputed by Hannig and Jansen (2010) who pointed out that greater financial inclusion presents opportunities to enhance financial stability. Their arguments were based on the following insights:

- Financial inclusion poses risks at the institutional level but these are hardly systematic in nature. Evidence suggests that low income savers and borrowers tend to maintain solid financial behavior throughout financial crises, keeping deposits in a safe place and paying back their loans.
- Institutional risk profiles at the bottom end of the financial market are characterized by large numbers of vulnerable clients who own limited balances and transact small volumes. Although this profile may raise some concerns regarding reputational risks for the central banks and consumer protection, in terms of financial stability, the risk posed by inclusive policies is negligible.
- In addition, risks prevalent at the institutional level are manageable with known prudential tools and more effective customer protection.

Despite the argument that financial inclusion mitigates the risks that the financial inclusion may pose to the financial systems, the possibility that financial inclusion may result in financial instability imply that there must be specific conditions under which financial inclusion may lead to financial stability. Some proponents of the financial inclusion-financial stability link have provided several ways in which financial inclusion may lead to financial stability. Cull et al (2012:2) pointed out four distinct ways in which financial inclusion is related to financial stability. Firstly, since financial inclusion attracts small savers, the authors argue that such savings bolster stability at the individual and household level and given their large numbers, small savers potentially contribute to stability at the financial system level. Secondly, since an inclusive financial system lead to healthier household and small business sector, the authors argued that it could also contribute to enhanced macroeconomic and financial stability. Thirdly, since, at the country level evidence suggest financial inclusion can lead to greater financial intermediation (for example, via intermediation of greater amounts of domestic savings), the authors argue that this should lead to the strengthening of sound domestic savings and investment cycles and thereby greater stability. Fourthly, the authors argue that since greater diversification in clientele served associated with financial inclusion might also be expected to lead to a more resilient and more stable economy, consequent reduction of income inequality through financial development and inclusion could lead to greater social and political stability which in turn could contribute to greater financial stability.

Khan (2011:4-5) points out seven ways in which financial inclusion promotes financial stability. Firstly, financial inclusion improves the efficiency of the process of intermediation between savings and investments, whilst facilitating change in the composition of the financial system with regard to the transactions that take place, the clients that use the various services, the risks created, and possibly the institutions that operate in newly created or expanded markets. Secondly, because low income savers and borrowers tend to maintain stable financial behavior, financial inclusion provide a more stable retail source of deposits for financial institutions (especially banks) and such sources enhance the soundness and resilience of financial institutions. Thirdly, financial inclusion facilitates greater participation by different segments of the economy, thereby increasing the share of the formal sector. The large presence of the informal sector tends to impair the transmission of monetary policy and as such an increase in the share of the formal sector improves the effectiveness of monetary

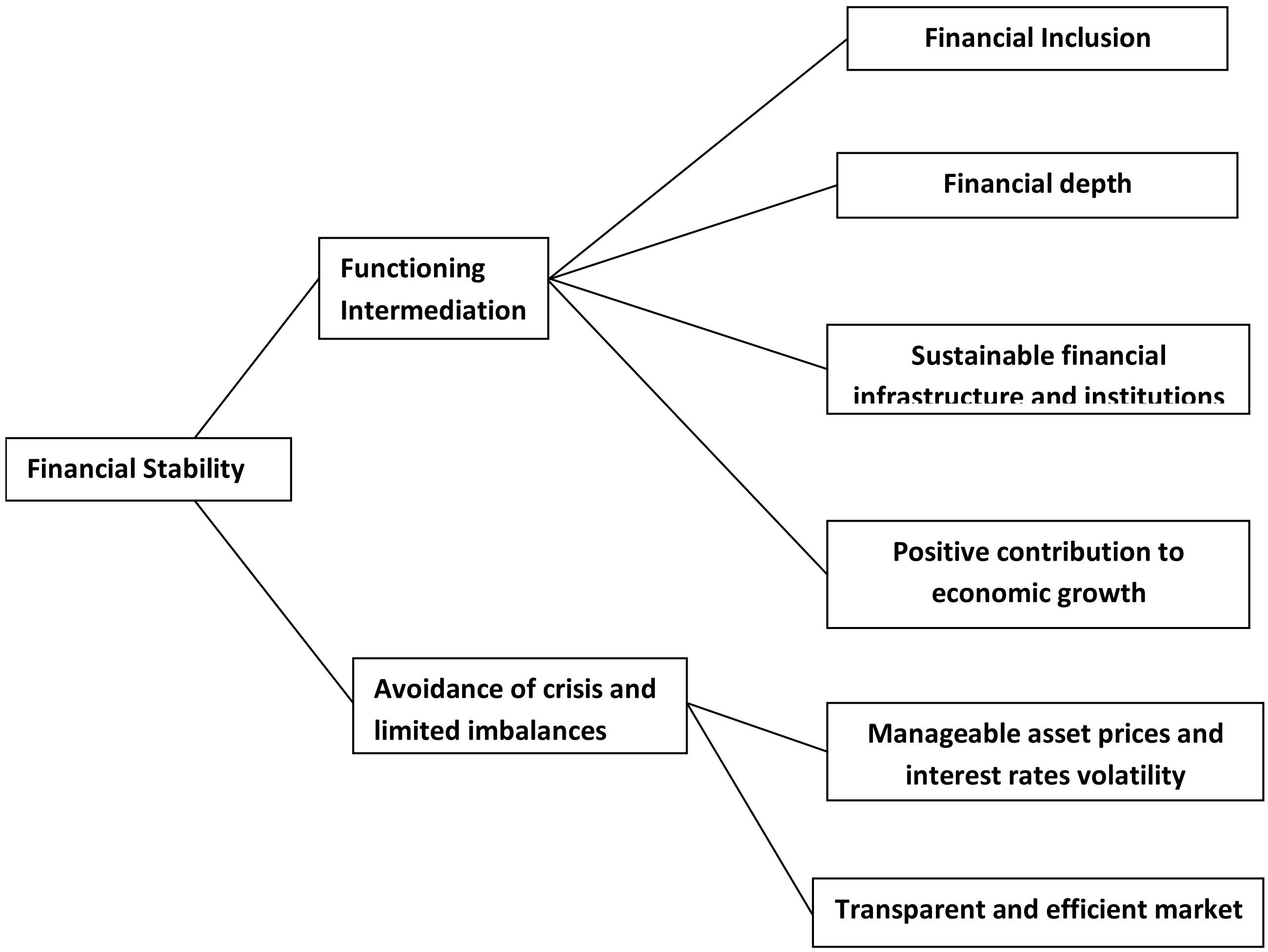

Figure 2. Financial Stability Components
Source of diagram: Hadad (2010)

policy transmission. Fourthly, financial inclusion helps people move from the cash economy to bank accounts which can be monitored, thereby helping to facilitate implementation of Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) guidelines and making it possible to deploy suspicious transactions' monitoring and reporting to a larger share of financial transactions in the economy. Fifthly, financial inclusion can contribute to enhanced financial stability through contributing to the improved health of the household sector, of small businesses and, to some extent, that of the corporate sector. Sixthly, in most cases, efforts to include an increasingly larger section of the population within the fold of formal banking and financial services have resulted in the deployment of innovative solutions and outsourcing arrangements and such financial innovations have the potential of reducing costs and thereby contributing to increasing the overall efficiency of the economy and the financial stability. Lastly, financial inclusion, through careful policy orientation, may help facilitate reduction in income inequalities and, by bridging the gap between the prosperous and the poor, can foster social and political stability.

Hadad (2010) asserts that financial inclusion has strong links to financial stability. The author argues that financial stability is a consequence of a well-functioning financial intermediation and financial inclusion is one of the important states of financial intermediation and consequently financial stability. The following diagram, Figure 2, illustrates how financial inclusion is one of the key states of financial stability according to Hadad (2010:4).

The intermediary role of financial regulation in explaining the link between financial inclusion and financail stability

The rationale for financial regulation is that there are externalities involved in the operation of financial markets, so that in unregulated markets private costs are not aligned with social costs (Bank of Uganda, 2010:6). In other words, financial regulation aims to address market

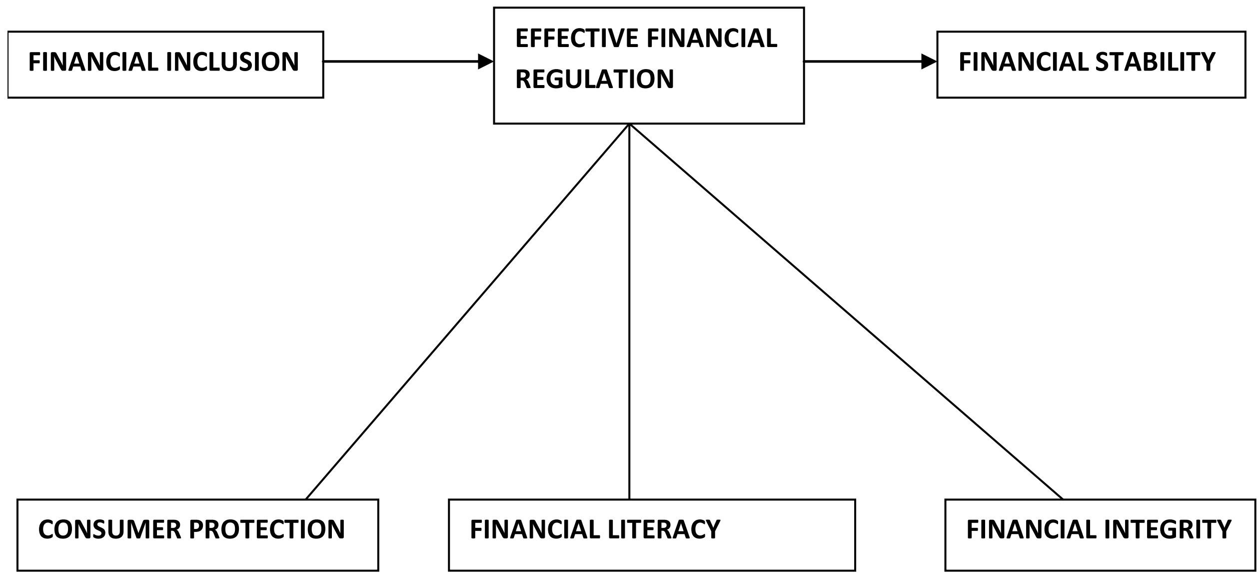

Figure 3. intermediary role of financial regulation

failure in the functioning of financial systems. Much importantly, financial regulation plays a key role in efforts aimed at preserving financial stability. In many instances, lack of financial regulation is cited as the major cause of financial instability. For example, the failure of regulation is cited as the major cause of the recent world financial crisis (Subbarao, 2011:1). According to Subbarao and Caruana (2011) the costs of financial instability in terms of lost growth and foregone welfare can be huge to an extent that it is right for regulatory reforms to give primacy to securing financial stability. In other words, financial regulation under any circumstances should be at the centre of any efforts aimed at achieving financial stability. Thus, as we make efforts towards achieving financial inclusion, it is important to understand that financial regulation still plays an important role in promoting financial stability.

Despite financial regulation being the basis for a stable financial system, it is surprising that financial regulation is not given much attention in explaining the relationship between financial inclusion and financial stability. As the recent financial crisis shown, there are real possibilities that financial inclusion can pose risks to the financial system that can subsequently lead to financial stability. The effect of financial regulation is to mitigate some of the risks that can be posed by financial inclusion, thereby balancing the relationship between financial inclusion and financial stability. Whether broad-based access to formal financial services promotes financial stability depends on how that access is managed within the regulatory and supervisory framework, especially in terms of financial integrity and consumer protection (Cull et al, 2012:1). In other words, financial regulation help to counteract some of the risks that financial inclusion pose to the financial system. According to Ndung'u,(2011:3), the continuous evolution of the financial sector towards greater sophistication and value provision requires the regulators to move ahead in surveillance and vigilance to maintain the requisite stability and efficiency. Hence, it is important to create a facilitative regulatory and supervisory structure which ensures that the formal financial system delivers affordable financial services to the excluded population with greater efficiency without compromising on the acceptable levels of safety and soundness (Khan, 2011:7).

With financial regulation clearly being a key component of the relationship between financial inclusion and financial stability, 'the key question is – What is the kind of regulatory and supervisory mechanism that will ensure that the formal financial system delivers affordable financial services to the excluded population with greater efficiency without compromising on acceptable levels of safety and reliability? (Thorat,2010:1). In the diagram we illustrate the relationship between financial inclusion, financial regulation and financial stability. Figure 3 shows that financial inclusion, if it leads to effective financial regulation should lead to financial stability. In other words, financial inclusion and financial regulation should complement each other in order to achieve the goal of financial stability. The diagram emphasizes the intermediary role of financial regulation in ensuring that financial inclusion leads to financial stability.

The diagram shows the specific linkage that ensures that financial inclusion leads to financial stability. An effective regulatory framework that leads to financial stability should adequately address issues of consumer protection, financial literacy and financial integrity. Consumer protection is an essential element of efforts aimed at preserving financial stability. This is because financial consumer protection plays an essential role in reinforcing the benefits and mitigating the risks of financial inclusion by building consumer trust and improving service value (CGAP, 2011). Without protection from responsible authorities, users of financial services are prone to abuse by financial institutions who may sell to them products which are either harmful or unfit for their needs. Such misuse of individual products by financial institutions can be a source of financial instability. The recent financial crisis have shown that the effects of irresponsible lending practices can be transmitted globally through the sale of securitized risk, also called mortgage based securities (Financial Stability Board, 2011). In order to promote financial stability, low-income and small customers need regulatory protection against abuses by service providers (Claessens et al, 2009:2). Thus, an effective consumer protection policy framework is a critical component of any regulatory environment which aims at meeting the goal of financial inclusion while promoting the soundness and resilience of institutions and of the financial system, Khan (2011:7).

Financial literacy is also another important element of a regulatory framework that is aimed at ensuring that financial inclusion leads to financial stability. Consumer protection is not only about protecting consumers from bad decisions but also about enabling consumers to make informed decisions in a marketplace free of deception and abuse (Financial Stability Board, 2011:3). Regulation aimed at equipping consumers of financial products with the right financial knowledge will enable customers to assess the risk attached to financial products, and therefore make the right choices regarding financial products and services. According to the World Bank (2012:1) informed and financially educated customers will benefit more from financial services—for example, through a better understanding of what type of financial product best suits their individual needs, and more accurately assessing risks associated with that product. This implies that financial literacy will result in better risks management by households, which will eventually contribute to the overall stability of the financial system. It is therefore important that regulation aimed at promoting financial literacy efforts also become a core element of a regulatory framework that is aimed at preserving the stability of the financial system.

Finally, financial integrity is also another important component of a regulatory framework that should ensure that financial inclusion leads to financial stability. Financial integrity refers to the reputation of financial institutions. Financial scandals, which include fraud, money laundering and insider trading, tend to affect the integrity of the financial system. According to Vogl (2012), greed, secrecy, arrogance, lack of a moral compass and opportunity all combine in too many financial institutions, thus prompting very highly paid executives to abuse their offices for their personal benefit at the expense of their own institutions, colleagues, shareholders, bank customers, and more broadly the financial system itself. High levels of financial integrity increases the level of public confidence in their use of financial services. Public trust and confidence in the financial system would effectively encourage people to access financial services, thereby promoting financial inclusion. Much importantly, in order to maintain financial stability, it is important to ensure that the public have confidence in the financial system. This means that through managing financial integrity, financial inclusion would also promote financial stability as well. This implies that managing the reputational risk (financial integrity) of the financial institutions and the financial system as a whole is important in ensuring the stability of the financial system. Thus, together with consumer protection and financial literacy, regulation aimed at ensuring financial integrity should be part of any regulatory and supervisory framework that ensures that financial inclusion leads to financial stability.

In many countries, prudential regulation which is aimed at preserving the stability of the financial system is the most common motivation for regulatory frameworks (Bank of Uganda, 2010:11). In this case, we can also develop prudential regulations that encompass consumer protection, financial literacy and financial integrity issues, so as to ensure that we achieve simultaneous objectives of financial inclusion and financial stability. However, prudential regulation is known to sometimes impede financial inclusion by deterring financial institutions from providing services to people whom they regard as marginal (Bank of Uganda, 2010:13). This means that as we develop a prudential regulatory framework that addresses consumer protection, financial literacy and financial integrity issues, we should always ensure that the resultant prudential financial regulation framework does not end up discouraging financial institutions from reaching wider sections of the society. In other words, it is important that regulators maintain the balance between efforts aimed at promoting financial stability lead to the achievement of financial inclusion as well. In essence, regulation biased towards financial literacy, consumer protection and financial integrity all require equal attention to ensure that financial inclusion leads to financial stability.

Importance of financial regulatory mechanism to policy makers and regulators

Figure 3 does not only show the important intermediating role of financial regulation in ensuring that financial inclusion leads to the achievement of financial stability, but can also act as a basis for a financial inclusion-financial stability framework that ensures that financial inclusion leads to the achievement of financial stability. As earlier noted, the assertions that financial inclusion is intricately related to financial stability have increased the eagerness of policymakers and regulators to use financial inclusion to achieve the financial stability. Considering that the relationship between financial inclusion and financial stability is a complex relationship and that financial inclusion can be a source of financial stability, it is important that policymakers and regulators develop a financial inclusion –financial stability framework that ensures that financial inclusion leads to financial stability. Such a framework is important because it will be used as a guide in developing policies that will ensure that financial inclusion leads to the achievement of financial stability. Since financial regulation plays an important role on ensuring that financial inclusion leads to financial stability, it should therefore be at the center of any financial inclusion-financial stability framework. The diagram, Figure 3, can be used by regulators in developing an effective financial inclusion-financial stability framework that ensures that financial inclusion leads to the attainment of financial stability.

CONCLUSION

Financial inclusion has become a key topical issue that has caught the attention of regulators and policy makers. This is not only because of its strong links to poverty alleviation and economic growth, but also of its close relationship with financial stability. Though, there is lack of empirical evidence that concretely proves evidence that financial inclusion is intricately related to financial stability, there is growing opinion among policymakers and regulators that such a relationship exist. However, such assertions that financial inclusion is intricately related to financial stability have become subject of debate. This is due to the fact that financial inclusion has the potential to pose new risks to the financial system, that if not properly managed would become a source of financial instability. This has raised questions as to whether financial inclusion would automatically lead to financial inclusion Thus, proponents of the financial inclusion-financial stability, in their attempt to convince people that a relationship between financial inclusion and financial stability really exist, are exploring various ways in which financial inclusion is related to financial stability.

Financial regulation is a key instrument used in ensuring the stability of financial systems. However, despite the important role of financial regulation in preserving financial stability, it is surprising that proponents of the financial inclusion –financial stability link does not give it much attention in explaining the relationship between financial inclusion and financial stability. By mitigating some of the risks of that financial inclusion may pose to the financial system, financial regulation plays an intermediary role. Much importantly it ensures that financial inclusion leads to financial stability. A regulatory mechanism that would ensure that financial inclusion leads to financial stability would include regulation biased consumer protection, financial literacy and financial integrity. With policymakers and regulators looking for specific linkages that would ensure that financial inclusion leads to financial stability, such a regulatory mechanism would surely form the basis of a an effective financial inclusion-financial stability framework that can be used in ensuring the attainment of such noble objectives.

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