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A new idea in banking for the poor

By teaming up with retail outlets in low-income, often hard-to-reach areas, financial institutions can create value both for themselves and their new customers.

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Correspondent banking has become one of the most promising strategies for offering financial services in emerging markets. In this model, financial institutions work with networks of existing nonbank retail outlets—such as convenience stores, gas stations, and post offices—to deliver financial services. This approach can be especially powerful when serving the unbanked poor because of its ability to reduce banks' cost-to-serve and reach low-income workers where they live. In Brazil, where the strategy has enjoyed its greatest successes, about 1,600 municipalities (approximately one-third of the total) are served solely by correspondent-banking outlets.

Correspondent (or agent) banking benefits a range of stakeholders. The poor gain convenient access to financial services in their own communities. Financial institutions reach a vast new customer segment. Agents increase their sales volumes and have an opportunity to develop deeper relationships with customers.

But implementing correspondent strategies can be tough. It may be hard to build networks of partners that can fulfill the correspondent role. The economics are still uncertain for players that don't offer a range of services. And because the strategy is relatively new for financial-services providers, it is difficult to know exactly what will work in each particular community.

Through our research and experience working with pioneering providers, we have identified four guiding principles to help organizations implement correspondent strategies successfully: (1) move quickly to capture early-entrant advantages, (2) build partner networks rigorously, (3) create diversified product offerings, and (4) conduct pilots that can be rapidly implemented and constantly refined.

These principles have enabled organizations to establish sustainable operations that dramatically increased the use of financial services by the poor. Four years after Brazil, for instance, passed legislation enabling the expansion of correspondent banking, providers had extended formal financial services to every municipality (about a third of which previously did not have any outlets offering formal banking services). In Mexico, a program of electronic transfers through the country's Diconsa stores, which sell food and other basic goods in the poorest and most rural communities, reached 200,000 households within two years of being launched and could reach two million to three million more. Kenya's M-Pesa, a highly successful mobile-payment provider, has developed a network of over 16,000 agent points since 2007. They operate like correspondent outlets, putting most citizens within reach of a physical location providing cash-in, cash-out services.[1]

[1]Frederik Eijkman, Jane Kendall, and Ignacio Mas, *Bridges to cash: The retail end of M-Pesa: The challenge of maintaining liquidity for M-Pesa agent networks*, Bill and Melinda Gates Foundation, PEP Intermedius, 2010.

Reaching out through correspondents

A majority of the emerging markets' 2.2 billion low-income workers[2] who do not use financial services live in areas that are difficult and expensive to serve. Most of these communities lack bank branches but do have other retail outlets, such as convenience and grocery stores, gas stations, lottery kiosks, pharmacies, or post offices.

Correspondent banking enables financial-services providers to reach these communities through existing retail outlets that potential customers use for other purposes. People know the businesses, since they already frequent them for other purposes—for instance, purchasing groceries or fuel or picking up mail. They may even have developed a level of comfort with the proprietor and the staff. That could make customers likelier to entrust such a retailer with their finances.

This correspondent strategy is effective because it enables organizations to establish a physical presence near their customers without building new branches and thus to expand their reach dramatically at a lower cost. Providers do not have to incur the expense of building new branches and can share fixed outlays with their retail partners. Correspondent models therefore have lower average costs per transaction than traditional bank branches do.

The World Bank's Consultative Group to Assist the Poor (CGAP) estimates that the average overall monthly cost to customers of using correspondent and mobile phone–based models is 19 percent lower than the cost of these services in traditional branches—and up to 50 percent lower for some products, such as medium-term savings and bill payment.[3]

We came to similar conclusions in our own research. In Mexico, the all-in cost of offering savings accounts (including marketing, opening an account, and per-transaction costs) through correspondent outlets is about 25 percent lower than offering them through traditional branches (exhibit). Correspondent models thus help organizations serve low-income consumers at a lower cost, which is particularly important because people in the segment typically transact in small sums.

The use of correspondent agents is leading to a significant expansion of low-income workers' physical access to financial services:

- Brazil: In 2000, nearly 30 percent of Brazil's municipalities had no access to formal financial services. But between 1999 and 2003, the government revised its regulations to allow correspondent banking and facilitated its expansion by improving the country's

[2] Alberto Chaia et al., *Half the World is Unbanked*, Financial Access Initiative, October 2009.

[3] "Study finds branchless banking cheaper than banks," cagp.org, May 25, 2010.

interbank transfer system. By 2004, every municipality in Brazil had access to formal financial services, and about 1,600 (one in four) were served only by the correspondent network.

- Mexico: More than 5,000 correspondent outlets, supported by 11 banks, have sprung up since the government authorized correspondent banking in late 2009. The government is using it to build a basic financial-services offering through more than half of the 23,000 state-owned Diconsa stores. Since 2009, a pilot program using point-of-sale devices and fingerprint-based identity cards has delivered government payments to nearly 200,000 households. Mexico's government could use the network to reach two million or more beneficiaries[4] and to add savings and insurance to the range of services it provides.[5]

- Kenya: M-Pesa, a successful mobile-money transfer service in Kenya, depends on physical locations that operate like correspondent outlets to give users quick and convenient opportunities to withdraw or deposit cash. Its approach involves exchanging cash for float (in an electronic form issued by the mobile operator) at one of the organization's 16,000 retail outlets, also known as agent points. This capability is a critical component of all mobile-financial-services offerings, since consumers must be able to convert digital funds to cash, and it is much more cost effective for providers to fulfill this need by tapping into existing physical networks than to build their own from scratch.[6]

Formidable challenges

Correspondent banking can have a significant impact. But in many markets, the window of greatest opportunity may be open for only a short time, and the uncertainties related to implementation are not trivial.

Some small communities have very few retail outlets, for example, and those few may belong to small operators with little or no reach across regions. Opportunities to strike partnerships may be limited.

Identifying the right retail partner can be hard, in particular because most financial institutions have no experience operating in nonfinancial retail contexts. As a result, they may find it difficult to determine which retailers have the necessary relationships with customers or struggle with how to build the reach that would deliver sufficient volume to justify the investment.

[4]Interview with Jaime Gonzalez, CEO of Bansefi, *Milenio*, April 20, 2010.

[5]"Creating change at scale through public–private partnerships," McKinsey & Company working document, September 2009.

[6]See Christopher P. Beshouri and Jon Gravråk, "Capturing the promise of mobile banking in emerging markets," mckinseyquarterly.com, February 2010.

The economics can be challenging, especially for institutions that do not have diversified product offerings. Revenues generated by the small accounts and the cost of the frequent transactions typical of the working poor make it difficult for providers to generate sustainable returns through savings and payment services alone.

Perhaps above all else, correspondent banking is still relatively new in the context of financial inclusion. The rules of the game vary by geography, and the game itself changes as the strategy develops: competition is increasing, the regulatory landscape is shifting, and customer attitudes are evolving. While uncertainty opens opportunities for innovative institutions, it also presents risks, particularly for companies that can't refine their approaches by incorporating what they learn during implementation.

Guidelines for success

Correspondent banking is one of several models that should be deployed to advance the cause of financial inclusion. Traditional microfinance institutions and branch-based models will continue to be important but on their own cannot provide the scale needed to reach the vast population that does not use formal financial channels.

The success of organizations in countries such as Brazil, Kenya, and Mexico suggests a path for the next generation of correspondent-banking models. Drawing on these experiences, as well as on our research, we have identified four guidelines that can help organizations implement successful correspondent strategies.

Move quickly to capture early-entrant advantages

Moving early is risky, particularly because the pioneers often incur hefty development costs that laggards avoid. But we believe that the risks (which of course must be managed) are justified in the case of correspondent banking because early entrants may sew up the most attractive partners before later competitors arrive.

Success in correspondent banking—a play for scale in a low-margin business—depends on the ability to develop an extensive network of retail outlets in underserved communities. The fewer partners the better, since complexity can overwhelm institutions that must manage too many relationships. The most efficient correspondent operations involve partnerships between one financial institution and one distribution network that has extensive reach across the entire relevant geography.

Early entrants often have the greatest freedom to select the best partners, leaving followers to patch together networks of smaller chains and independents—more difficult to manage and more expensive to operate. Early entrants also have an opportunity to build the first formal relationships with their low-income customers, which may create loyalty that proves beneficial when competitors emerge. Even in markets such as India, where large-scale partners with broad reach are hard to come by, early movers can pick the most attractive smaller players to join their networks. (Moving early may be less advantageous, however, in markets that limit exclusive relationships between financial-services providers and distribution partners.)

In Brazil, the bank Bradesco gained a significant advantage in 2001 by quickly securing exclusive access to distribute financial services through the agencies of the country's post office, Empresa Brasileira de Correios e Telégrafos. That gave the company a network of 5,532 post offices, including more than 1,700 in municipalities that lacked banks.[7] Through Banco Postal, a wholly owned subsidiary, Bradesco extended correspondent services to the entire network in just five years.[8]

Build the partner network rigorously

Financial institutions must take into account a range of factors when picking retail partners. Reach is one of the most important, but others, such as cost-to-serve and local consumer trust, also play a role.

Providers can use a cost curve analysis to understand the relative expense and potential reach of different channels in different communities of varying population densities. Such an analysis of the Mexican market suggests that correspondent banking would be a good way to expand capacity in large cities and the only viable option in small villages. But it would be more difficult in midsize towns where large retail networks are scarce. This kind of evidence can help financial institutions understand how to configure a correspondent network so they can find retail partners that provide the appropriate reach into the communities they want to serve.

Trust can also be an important factor, particularly early in the effort. The case of Diconsa, in Mexico, bears out the point that existing retail outlets often have relationships with target customers, who may therefore be more likely to trust the retailer to act as their financial representative. Diconsa stores are owned cooperatively by the communities where they are located, and community members elect the storekeepers. This cultural context is an important success factor for Diconsa. In the village of San Miguel Tecpan (which has a population of 800 people), for example, Elba Arias has served as storekeeper since she was elected, 14 years ago, creating a familiarity that makes correspondent banking easier. In her words, "the same way I sell corn, rice, and canned tuna, I sell savings accounts." Up to a third of Elba's current customers now make transactions.[9]

Organizations can build trust over time by providing a consistently high-quality experience. Those that already operate correspondent networks and have a good

[7]Anjali Kumar, *Access to Financial Services in Brazil: A Study*, Washington, DC: The World Bank, 2004.

[8]Hannah Siedek, "A joint venture gets disjointed. Will Banco Postal customers suffer?" Consultative Group to Assist the Poor (CGAP), September 10, 2007.

[9]José Eseverri, "El Banco Menos Pensado," *Expansión*, Volume 41, Number 1040, May 10, 2010.

reputation with the customer base may gain trust more easily when they open new correspondent locations. Likewise, financial institutions that are starting up networks may benefit from identifying and prioritizing partners that have good relationships with target consumers to increase the likelihood of their using correspondent services once they are available.

Create diversified product offerings

Providers must develop product offerings that not only attract consumers but also generate sufficient value to sustain banking operations. Correspondent partnerships that offer more than bill-payment services and savings accounts are likelier to thrive than those that do not.

In addition to savings accounts, providers should consider offering four promising services: government payments, domestic remittances, international remittances, and direct deposits. Each offers significant value for customers, and they also enable providers to generate value through transaction fees and lay the basis for them to provide other services in the future.

CGAP estimates that at least 170 million poor people worldwide get regular payments from their governments, either as social transfers or as small salaries and pensions. Less than 25 percent of the recipients get the payments in a "financially inclusive" account—one that is safe, convenient, and easy to use for other transactions.[10] These programs represent a possible source of immediate transaction activity for any electronic-delivery system, which can in turn add significant value for the recipients. In Mexico, for example, Diconsa's electronic-transfer program enables customers to collect government payments in 30 minutes—down from 6.5 hours—and virtually eliminates the customer's travel costs, which averaged $3 a trip. The correspondent service provides its customers with significant value in money and time saved.

Correspondents could also create value for consumers by making international remittances cheaper and more convenient. The cost of sending money to a developing country largely reflects the volume of flows into it, the quality of the retail payments infrastructure, and the number of options available to receiving consumers. When such a remittance goes to countries (like Indonesia and the Philippines) with competitive cost structures and relatively large volumes, its cost can be 5 to 7 percent of its value—and two or three times as much for other destinations.[11] The proliferation of safe and convenient correspondent outlets could help not only to increase the volumes and reduce the costs

[10] Mark Pickens, David Porteous, and Sarah Rotman, *Banking the Poor via G2P Payments*, Consultative Group to Assist the Poor (CGAP), Focus Note, Number 58, December 2009.

[11] World Bank, Payment Systems Development Group, *Remittance prices worldwide*, www.remittanceprices.worldbank.org, Version 1, April 23, 2010.

of international remittances but also to reduce the costs and increase the reliability and security of domestic ones; this market is typically dominated by cumbersome, inefficient, and risky informal channels.

Direct-deposit services also offer value for both consumers and providers of correspondent services. Much like government transfers, the electronic payment of salaries or pensions is convenient for consumers. Such products could also serve as the foundation for credit offerings based on expected cash flows from employers. In Brazil, the volume of payroll-linked loans grew by more than 110 percent annually—four times the pace of credit cards—in the first four years after regulators authorized the products, in 2003.

Conduct pilots that can be rapidly implemented and continually refined

The learning curve for correspondent banking in the context of financial inclusion is steep. Organizations should expect to make mistakes when they develop their models. The most successful operations design processes that enable them to learn from their mistakes and to develop solutions as they proceed.

To promote rapid and continual learning, organizations should develop processes to conduct targeted pilots that can be quickly revised through customer feedback and then relaunched. By enabling organizations to learn as they go, this approach minimizes the risks they run while experimenting to find the best way forward.

Mexico's Diconsa partnership, for instance, relied extensively on user-centered prototyping. Rather than trying to launch a perfect product at scale the first time around, Diconsa conducted a series of field experiments. It launched its first pilot soon after the partnership began and managed this experiment aggressively, placing members of the delivery team directly in the community so they could observe customer behavior and make real-time refinements. This approach gave the partnership early successes and helped it expand its offerings more quickly.

Safaricom, a telecom provider, took a similar approach to piloting when it developed its M-Pesa mobile-payment service. Originally conceived as a platform for receiving and making payments on small loans, M-Pesa partnered with the local microfinance company Faulu to gain access to clients. Piloting suggested that the service would undercut Faulu's offering but that the population would value general payment and remittance services. M-Pesa redefined its value proposition as a result, and today it is one of the world's most successful mobile-money transfer services.[12]

[12]Ignacio Mas and Dan Radcliffe, *Mobile Payments go Viral: M-Pesa in Kenya*, Bill & Melinda Gates Foundation, March, 2010.

Related thinking

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Pioneering organizations around the world are demonstrating the value of correspondent banking. As the strategy evolves, it will become increasingly important as a way to develop scale in financial inclusion. It is not only an effective alternative to building new branches but also an important adjunct to mobile financial services, providing cost-effective outlets for cash-in, cash-out services. Experience suggests that early entrants gain the most. Organizations that start now could promote social and economic benefits for poor people by dramatically expanding financial inclusion and thus helping a growing number of low-income workers gain access to financial tools that they can use to improve their lives.

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