Deepening the Nigerian Financial System:
The Role of Financial Inclusion and Innovative Financing Options

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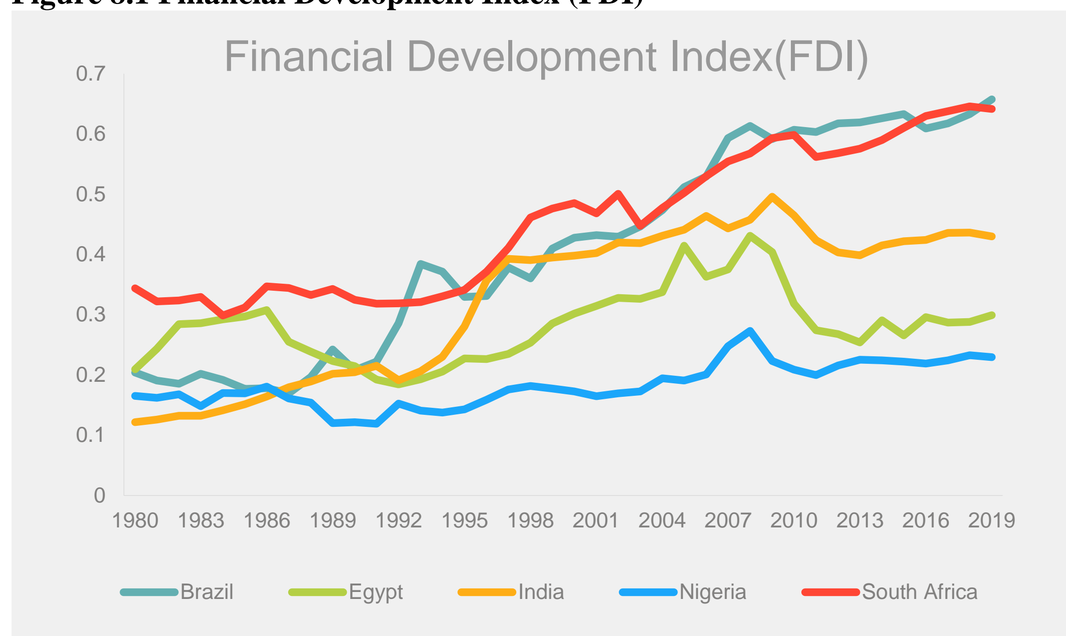
8.0 Introduction

At the macro level, financial deepening generally means an increased ratio of the money supply to GDP. One widely accepted measure of financial deepening is the IMF financial development index which summarizes how developed financial institutions and financial markets are in terms of three broad dimensions: depth (size and liquidity), access (the ability of individuals and companies to access financial services), and efficiency (the ability of institutions to provide financial services at low cost and with sustainable revenues). Particularly for developing countries like Nigeria, financial deepening is of interest due to its potential for poverty reduction and economic development. At a micro level, financial deepening can be seen as increased provision of financial services with a wider choice of services geared to all levels of society. Financial inclusion relates to financial deepening at the micro level, and this paper explores the role of financial inclusion and innovative financing options in deepening the financial system. This paper answers the question: of why the focus is on financial deepening; explores the role of financial inclusion, the Nigerian experience, existing gaps, and opportunities for driving financial inclusion; and concludes with some recommended actions for moving the needle.

8.1 Deepening the Nigerian Financial System - Why is this important

Nigeria has the highest absolute number of poor people in the world (nearly 90m). Although this poverty is linked to issues beyond the financial sector[5], financial sector development remains central to achieving inclusive economic growth, sustained poverty reduction, and creating new markets. Comprehensive indicators of financial development - access, depth, and efficiency – across financial institutions and markets suggest that Nigeria has witnessed much lower levels of financial development than other large emerging markets. The IMF estimates that improving Nigeria's financial system would increase growth by 0.8% per annum, which, at current rates, would accelerate economic growth beyond population growth (IMF, 2022).

Figure 8.1 Financial Development Index (FDI)



Source: IMF, Financial Development Database, 2022

Economic growth is critical for poverty reduction. As the acclaimed Commission on Growth and Development stated in their 2008 report, no country has reduced poverty "en masse" without economic growth. Take the East Asian growth and poverty reduction record as an example: on average, 30 million people came out of poverty every year in East Asia between 1990-2015. Adaptive and inclusive economic growth policies were at the heart of this. They are fundamental in achieving sustainable poverty reduction and, as such, are the lynchpin of successful economic development strategies. Investment is one of the key ingredients of sustained high levels of economic growth. Within the range of policy tools available to the government, stimulating and financing investment is at the core of countries' growth strategies. The Asian Tigers focused on mobilizing domestic resources for this investment, keeping external debt levels at a manageable level. The relationship between investment and growth is, however, complex. It requires a strong and trusting relationship between the state and the private sector to ensure investments are made into assets and capital that further a country's economic development.

An inclusive and transparent financial sector is integral to ensuring investment is financially sustainable. The financial sector is a key enabler – assessing risk and allocating capital to the most productive parts of the economy. The positive role the financial sector plays in supporting economic growth is well documented (Levine 2005), including for the poor (Ayyagari et al. 2013), and perhaps especially for Lower Middle-Income countries (LMICs) catching up with Higher Middle-Income countries (HMICs) (Aghion et al., 2005). By mobilising savings, financial sectors have a positive impact on inclusion, and by allocating that capital well, they improve economic productivity. It's also an important sector supporting household resilience and financial management.

In sum, there are three theories of change that demonstrate how a deeper and broader financial sector contributes to poverty reduction:

a) First, by improving the ability of the financial sector to mobilise investment into productive sectors: more transparent and efficient financial sectors – both the financial intermediaries operating in it and the financial markets, improve the allocation of capital to more productive areas of the economy. It also allows for innovation and greater liquidity so that firms can access the type of finance they need to grow (longer term and in the right currency). These firms employ people, pay taxes and provide citizens with economic engagement and agency
b) Second, by supporting sustainable financial markets and financial sector stability: a well-regulated and transparent financial sector balances the need for prudential prudence with the consumer's voice. It is closely tied to the economy's overall macro-stability. Greater levels of financial sector stability create an environment that raises the confidence of investors. It can also mean it is easier and cheaper for governments to raise finance in the capital markets. A stable and well-run financial sector improves the ability of banks to intermediate capital. A transparent one improves the governance of assets and trust in the system.
c) Third, by improving access to better financial services – financial inclusion. Empirical evidence points towards two main pathways between financial inclusion and poverty reduction – a resilience pathway, which ameliorates and manages the effects of shocks, and an opportunity pathway which generates new prospects for income and employment. This paper discusses this concept in-depth in terms of its role in deepening the Nigerian financial system.

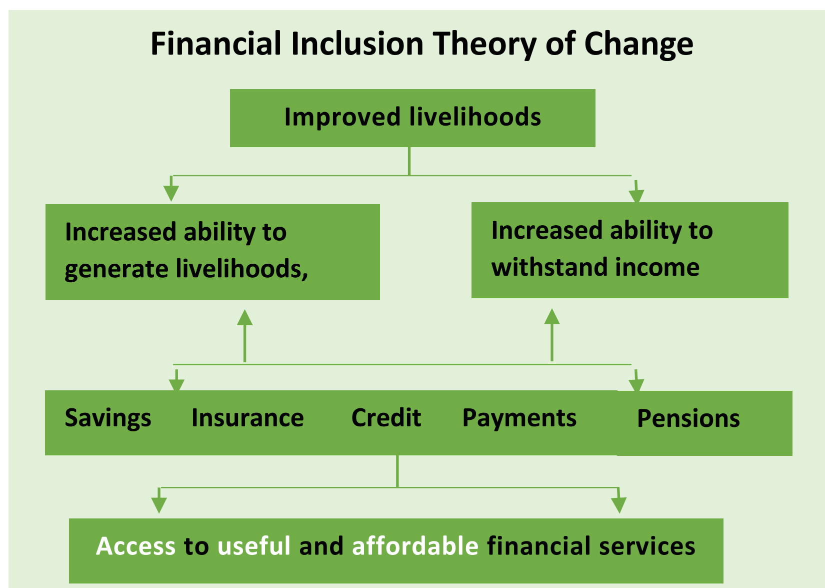
These theories of change are interrelated. By bringing people into the financial sector, deposits are being mobilised, increasing overall liquidity in the financial sector. Furthermore, the shift to digital is improving the transparency of financial flows. Greater levels of financial inclusion are also good for financial sector stability. A more stable financial sector and, therefore, macro-environment is good for investment and long-term financing. By supporting the financial sector's breadth and depth, there is a positive reinforcing circle of impact.

8.2 The Role of Financial Inclusion

Financial inclusion means access to useful and affordable financial products and services – transactions, payments, savings, credit, and insurance – that meets their needs and is delivered in a responsible and sustainable way. Financial inclusion, a feature of financial deepening, entails increased access, uptake, and usage of efficient (quality and affordable) financial services**.** This begins with access to a transaction account which allows people to store money and send and receive payments. In 2018, 69% of adults worldwide had an account; this includes an addition of 1.2 billion adults worldwide who had opened an account since 2011. Still, 1.7 billion adults remained unbanked in 2018 (Demirgüç-Kunt et al., 2020). The World Bank Group's Universal Financial Access 2020 initiative, for example, focuses on ensuring that people worldwide have access to a transaction account.

Next is the depth of inclusion which focuses on the ability of individuals or businesses to access and use a landscape of financial services – credit, insurance, pension, etc. This level of financial inclusion requires more intentional efforts. For example, individuals need proof of identification or credit history to use these services. Building the infrastructure that allows for widescale access to these services is lacking in many developing countries, including Nigeria. Hence, even for

individuals with a transaction account, the majority are often excluded from a wide range of financial services. The final layer of financial inclusion is the quality of inclusion. On the demand side, this requires that individuals can use financial services in a way that allows them to be resilient and pursue opportunities over time. On the supply side, this requires customer-centred product design, useful and affordable products, and strong consumer protection. These three levels of financial inclusion facilitate the three dimensions of financial deepening.



Financial inclusion has been shown to positively impact individuals' resilience by enabling consumption smoothing during difficult times, particularly through the appropriate use of savings, insurance, and credit products. Improved access to, and use of, a range of suitable financial services increases the ability of individuals and businesses to manage their financial lives, withstand shocks, maximise economic opportunities, and save for productive investments in education or health, which can improve the overall quality of their lives. An increase in the number of formally financially included people also generates local savings, which increases productive investments in local businesses, and drives productivity and economic growth. Financial inclusion also promotes financial education, which supports the efficient use of financial services and products, which in turn accelerates inclusive growth. A greater ability to manage your financial life is also shown to improve the agency and empowerment of marginalised groups (Demirgüç-Kunt et al., 2020).

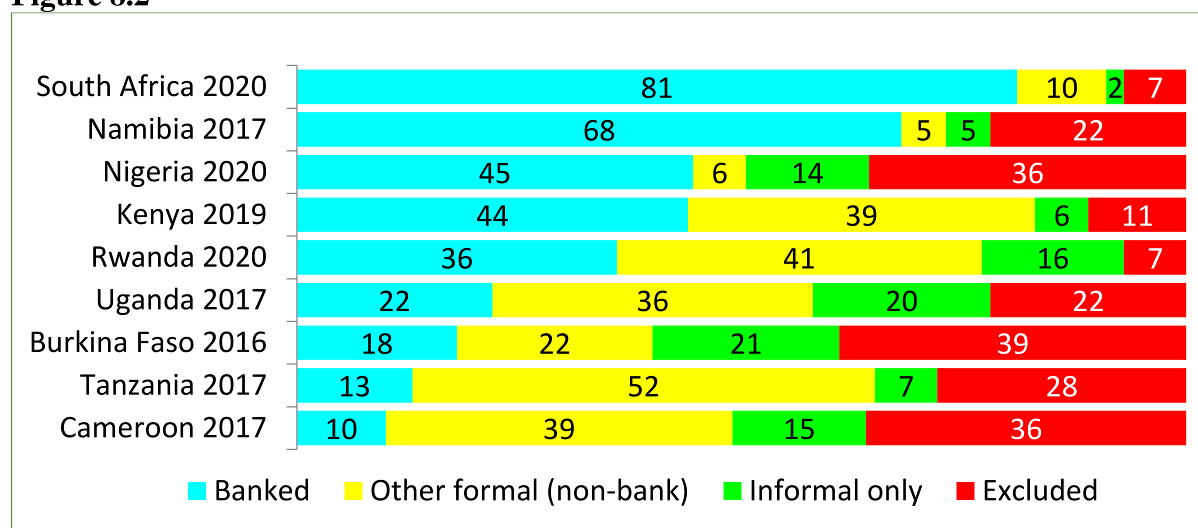
Access to reliable payment services brings people into the formal financial sector and has other positive spillovers, such as expanding the tax base and improving personal security. This is especially true of digital finance, whereby access to mobile money can lead to quicker and better risk sharing, including through access to remittances (Suri and Jack, 2014; Blumenstock et al., 2016). There is increasing evidence that digital payment platforms linked to essential services enable quick and efficient access to things like energy, healthcare, and education.

8.3 The Nigerian experience

In 2010, Nigeria made a commitment under the Maya declaration to reduce Nigeria's adult financial exclusion rate from 46.3% to 20% by 2020, thereby developing and launching its

National Financial Inclusion Strategy in 2012 to attain the set target. Financial inclusion is a priority focus for both public and private sectors; the government and regulators set policies that encourage the distribution of financial services and influence the design of inclusive products that promote financial inclusion. Financial inclusion in Nigeria increased from 47% in 2008 to 64% in 2020. About half of Nigerian adults (53.6 million) now use formal financial services, up from 48.4 million in 2018 (EFInA, 2021). However, Nigeria still lags significantly behind its peers in Sub-Saharan Africa. Although Nigeria has a relatively high proportion of banked adults than many comparator countries, a quarter of Nigerians still rely on informal institutions only, and it has a high proportion of financially excluded adults at 36% (38 million).

Figure 8.2



Source: EFInA (2021)

The inclusion figures also mask large cross-sectional disparities. Exclusion levels remain largely concentrated in the North and are persistently higher for women, rural dwellers, and youth. The depth and quality of financial services remain weak (only 7% have a pension, while only 2% have insurance). Data shows that several of the comparable countries have expanded financial inclusion via innovative non-bank mobile money (reflected in yellow sections). So far, mobile money has failed to create the step change in financial inclusion seen in countries like Kenya, owing to the primarily bank-led approach to date. Only 4% of Nigerian adults have mobile money accounts (EFInA, 2021).

Traditional banking, which is poorly placed to support inclusion, still dominates the Nigerian Financial Sector (77% of financial sector assets). The majority of balance sheets and profits are linked to Government loans and to the oil and gas sector. In addition, high levels of non-performing loans and an over-reliance on regulatory forbearance point to structural problems. Banking assets are equivalent to about 30% of GDP in 2018, while the microfinance sector only has assets of 0.3% of GDP. Due to these weaknesses, as well as the high-risk business environment, commercial interest rates are up to 25% p.a and require high levels of collateral to access. The cost of finance is at the heart of Nigeria's financial exclusion and precludes finance for long-term investment. Government schemes to direct lending towards the real sector have also not achieved success at scale.

For approximately 53 million Nigerian adults who do not have access to/use formal financial services, the key barriers to access are the lack of proximity to formal financial access points, attitudes/perceptions about formal financial service providers, low/irregular income, and institutional exclusion in terms of product design and accessibility to financial services providers. Out of the 59 million unbanked adults, 43m (73%) do not have the required documents to open a Tier 3 bank account. Hence, while overall financial inclusion continues to grow incrementally, progress has been too slow to meet National Financial Inclusion Strategy targets. These sticky challenges listed above have particularly hampered the growth of formal inclusion as well as the depth of inclusion (EFInA, 2021).

			Status as at						
	Focus Areas	**Target by 2020**	**2010**	**2012**	**2014**	**2016**	**2018**	**2020**	**Variance to 2020 Target**
% of the Total Adult Population	**Payments**	**70%**	22%	20%	24%	38%	40%	**45%**	-25%
	Savings	**60%**	24%	25%	32%	36%	24%	**32%**	-28%
	Credit	**40%**	2%	2%	3%	3%	2%	**3%**	-37%
	Insurance	**40%**	1%	3%	1%	2%	2%	**2%**	-38%
	Pension	**40%**	5%	2%	5%	7%	8%	**7%**	-33%
	Formally served	**70%**	36.3%	43.0%	48.6%	48.6%	48.6%	**50.5%**	-19.5%
	Financial Exclusion	**20%**	46.3%	39.7%	39.5%	41.6%	36.8%	**35.9%**	-15.9%

Source: EFInA (2021)

The characteristics of the unbanked as well as the nature of the challenges faced, require innovative solutions that can drive access, reduced risk/cost to serve this target population, and ensure the viability of business models. Financial sector regulation has recently been positive in terms of creating an enabling environment for digital financial services to address these challenges. For example, the Shared Agent Network Expansion Facility (SANEF) for licensed MMOs and super-agents improved access to financial access points through the rollout of over 500,000 financial service agents nationwide. Reduced KYC requirements for opening and operating a bank account; adoption of cashless payment channels, notably in person to Government (P2G) and Government person (G2P) payments; recent 'approval in principle' of five telco-led 'Payment Service Banks' (PSB) licenses; and widespread support for FinTechs who are facilitating access to a wide range of financial services, are all indications of positive moves to embrace digitization

Beyond access and usage, more attention has recently been paid to the quality dimension, which basically explores how well financial services are being used to improve livelihoods. Two frameworks that are useful for evaluating this dimension are the Fin Needs and Financial Health frameworks. The Fin Needs Framework is designed to help us understand what mechanisms people use to meet specific needs and understand the portfolio of financial devices used to meet financial needs. It tells us how different types of financial services are utilized as complements or substitutes for meeting financial needs and highlights untapped market opportunities. On the other

hand, the financial health framework seeks to assess how well one's daily financial systems help build resilience from shocks and create opportunities to pursue one's dreams.

EFInA's Access to Financial Services in Nigeria 2020 survey showed that of the 72 million adult Nigerians experiencing liquidity distress, 24% used financial mechanisms, while 34% used physical and social mechanisms to cope with the distress. When it comes to meeting life goals, about 40% of Nigerians rely on non-financial mechanisms. About 3 out of 5 adults experienced a financial shock or an event that had a large negative impact on their finances. Nigerians were more likely to do nothing, sell assets, or cut down on expenses than to use savings to cope with these crises. About 20 million adults used physical mechanisms (non-financial savings) to cope with risks and liquidity and to achieve their life goals. When we explore financial health, only about 1 in 4 Nigerian adults (27%) are considered financially healthy. Although banked adults are twice likely to be financially healthy compared to unbanked adults, nearly 1 in 4 banked adults remain financially vulnerable, meaning that they are struggling with all, or nearly all, aspects of their financial lives (EFInA, 2021). These insights suggest that more needs to be done to ensure that individuals and businesses are able to maximize the potential gains from the formal financial sector.

8.4 The Role of Innovation

Achieving the national financial inclusion targets will require widespread use of digital financial services – the provision of formal financial services through electronic channels. Digital financial services include mobile money, mobile/internet banking, the use of cards and Point-of-Sale (PoS) machines, and ATM services. The typically lower costs associated with digital financial services allow low-income customers to transact in irregular, tiny amounts, helping them to manage their characteristically uneven income and expenses. Using agents to expand reach into under-served areas reduce costs and engage customers that are reluctant or unable to interact with banks. Digital financial services providers can thus encourage mass-market customers to use technology for financial transactions that they currently use on an informal basis. EFInA's Access to Financial Services in Nigeria 2020 survey showed that expanded agent networks could extend the reach of formal financial services to more than 24 million adults not currently using formal services but are financially active (EFInA, 2021a)

4 out of 5 financially excluded adults have access to mobile phones. 17 million adults not currently making electronic payments own phones and are interested in mobile money (EFInA, 2021a). It is noteworthy that demand is a major driver for the DFS evolution as customers now demand to be better connected to their money. Customer expectations have shifted as people want tools that make moving and managing their finances convenient to have better control of their financial lives. Mobile phones have, however, set the tone for the future of financial services. Digital financial services providers that build reliable, affordable services can capitalise on this market while improving the financial well-being of those that are currently under-served by the formal financial sector. New financial technology companies are now deploying digital financial solutions to the Nigerian market, and new partnerships are emerging.

There are growing innovative activities, driven by FinTechs and other third parties, to develop new types of products, including alternative financing and digital financial products. Lagos, in particular, is home to a thriving tech sector, with dozens of 'tech-hubs,' including those set up by traditional banks to capture new innovations. Many financial service providers are focused on

new digital financial services enabled by a real-time payment system that has been established. The new PSB licenses, and the willingness of both the CBN and the Nigerian Interbank Settlement System to explore sandbox approaches, are all causes for guarded optimism.

The anticipated growth of mobile payments infrastructure offers the tremendous opportunity to unlock inclusive new business models directly targeting the poor (e.g., affordable credit, savings, Microinsurance, and financing for basic services) – digitisation improves the commercial viability of serving these markets. FinTechs use technology and innovation to offer affordable products/services which support households and businesses to manage other development challenges (e.g., school fees payment and collections, education loans, accessing health grants and products, off-grid solar, payment for water and sanitation services).

Between 2017 and 2020, the Fintech sub-sector mobilised funding of about $560mn with an estimated long-term economic impact of $3bn potential investment, $1bn increase in retail banking revenue, and $50bn DFS contribution to GDP (EFInA 2020). Additionally, with a daily saving of NGN50, low-cost scalable digitised Micropension solutions can derive an ₦60,000 inflation-indexed monthly pension for a 25-year-old by the time he turns 60. Additionally, if just 10% of the informal sector workers begin saving N50 a day, this will result in about $8.2bn in long-term savings mobilised over the next decade (PinBox, 2021). With the recent introduction of PSB regulations, Nigeria has the potential to experience the Mobile Money revolution witnessed in other African Countries. Projections from World Data Lab using multiple sources, including EFInA's survey, shows that if Nigeria experiences rapid uptake of mobile money experienced in some neighbouring countries, financial inclusion targets could be met much faster (EFInA, 2021)

8.5 What more needs to be done?

The recommendations set forth in this section align with priorities set forth by the Nigerian government and the financial sector regulators, which have emphasised the importance of digital-led and market-led growth, working off a foundation of macroeconomic stability.

It is extremely important to balance financial integrity with financial inclusion. Many Nigerians, particularly in marginalised communities, have difficulty proving their identities, excluding them from accessing financial services and enjoying livelihood gains. We must continue to support KYC-driven integrity by supporting innovations in KYC processes and requirements that help to ensure the right balance of protection and access is driving KYC policy and practice, including a robust digital identity. Although increased access could drive a more robust financial system, the enormous risk to the economy that comes from digitization can best be addressed through initiatives to strengthen the regulatory capacity of regulators and the financial capability of users. Given the size of the Nigerian economy, there is significant potential for the capital markets to play a role in mobilising investment into productive sectors for development, infrastructure, and innovation. Nigeria has the economics of scale to develop a deep and liquid capital market that provides funding to its domestic corporate sector and potentially supports much-needed investment for development. Capital market development, banking supervision, and improved governance must all play a role in enabling Nigeria's major financial institutions to be part of the development process. This includes facilitating long-term, local currency funding flows to projects with high development impact, e.g., health, education, agriculture, infrastructure, and climate change is needed. This requires supporting capital market reform –both the soft infrastructure and the instruments needed to mobilise local institutional investors.

More needs to be done in terms of marginalised groups, the majority of whom are far removed from access to appropriate financial services than can help improve resilience and reduce vulnerability to financial shocks. This is a call for all stakeholders to come together to address the need of this population by studying their financial patterns/behaviours and tailoring products and services to suit them.

There is insufficient credible data to support strategy development, understand the dimensions of financial exclusion, and make product decisions. Greater levels of data and information about poorer income groups facilitate innovation that is consumer-centric, not just in the financial sector but also in the real economy. Stakeholders must continue to provide high-quality information on access and usage of financial services and produce market studies that innovators use to design products targeted at the base of the pyramid and regulators to design policies.

Supportive policies that will develop the FinTech offer enable digital financial services and other interventions are needed. Equivalent adoption of mobile money, as in Kenya, will be the single most important determinant of Nigeria reaching its financial inclusion target (80%). Operationalizing the payment service bank licenses and rapidly rolling out mobile money is an urgent priority. In addition to this, more needs to be done to lower the costs of financial services, link the financial sector to the real economy, and address development challenges. A broader shift to modernising financial systems is needed to ensure efficiency gains are made and we are not creating a digital divide. The National Financial inclusion strategy must focus on strengthening the depth of inclusion – increased access and usage of credit, insurance, and pension, and also pay attention to financial health, consumer protection, and financial capability to promote useful, responsible, and sustainable financial services.

8.6 Conclusion

The development of the financial sector in Nigeria in the next five years will be driven by improving the financial stability of the banking sector, the growth in the payment system and the mobile money environment, and the development of the capital markets. This will require a concerted effort from all stakeholders, including the government, providers, regulators in the financial industry, and the development community. However, more needs to be done to ensure that individuals and businesses are able to maximize the potential gains from financial deepening; it is certainly not a given.

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