Journal of Indian Research (ISSN: 2321-4155)
Volume 10, Number 3&4, July-December, 2022

CORPORATE SOCIAL RESPONSIBILITY AND FINANCIAL INCLUSION: EVIDENCE FROM BANKING SECTOR IN NEPAL

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ABSTRACT

Financial institutions are crucial in executing successful CSR programs within local communities, through substantial efforts that promote financial inclusion. The objective of this research is to build upon the extensive body of previous research studies by examining the relationship between corporate social responsibility expenditures and financial inclusion. To examine the relationship between CSR expenses and financial inclusion proxies, random-effect model is used. This model demonstrates that there is no influence of CSR initiatives of commercial banks on financial inclusion in case of Nepal. The research results indicate that the CSR expenditure does not lead to the expansion of ATMs and bank branches, proxies to financial inclusion. The results of this research directly challenge the existing literature that highlights the importance of these influencing factor. The findings indicate that the regulatory requirement for Corporate Social Responsibility (CSR), which mandates spending 1% of the net profit, has not been efficiently utilized. The study not only identifies this contradiction but also offers potential avenues for further research and practical implications for policymakers and banking professionals. The research findings can assist policymakers in crafting effective strategies that encourage banking institutions to view CSR in a different light when it comes to enhancing financial inclusion.

Keywords: Banking sector, corporate social responsibility, financial inclusion, non-performing loans.

INTRODUCTION

The past ten years have seen market instability due to the major global events including the early 2010s financial crisis, the COVID-19 pandemic, Russia's Ukraine invasion, and failures of Credit Suisse, Silicon Valley Bank, and Signature Bank. These occurrences have had serious economic, social, and emotional impacts on people and businesses (Buganda *et al*., 2021). This vulnerability is of particular interest in banking sector as they hold a prominent

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position within a financial sector. Contemporary researchers believe that banking institutions are closely linked to communities and social networks by offering accessible and affordable financial services (Barman *et al.*, 2009; Cutcher, 2014). This underscores the importance of the connection between banks and the local communities they serve. Furthermore, it highlights the banks' obligations to the societies in which they function. The increasing focus on these responsibilities is apparent in the ongoing Corporate social responsibility efforts undertaken by banking organizations (Birindelli *et al.,* 2015).

Corporate social responsibility serves as a tool that can assist banks in enhancing financial inclusion. By offering access to unbanked adults, financial inclusion can foster human development, enabling individuals to actively engage with and utilize necessary financial products and services, thereby contributing to a nation's economic growth (Vo *et al.*, 2020). The relevance of financial inclusion lies in the current development theories which propose that enhanced financial inclusion can improve the lives of economically disadvantaged and marginalized individuals (Bhattacharyya *et al*., 2021). Financial Inclusion (FI) denotes a system that guarantees simple access, presence, and utilization of formal financial services for every individual in an economy. It encompasses the provision of affordable financial solutions to the underprivileged and low-income sections of the population (Ullah, 2013). In light of this context, the present study seeks to examine the impact of CSR on financial inclusion within Nepal's banking industry.

LITERATURE REVIEW

CSR (corporate social responsibility)

Corporate Social Responsibility (CSR) represents a company's commitment to various stakeholders, adhering to the principles of stakeholder theory, which entails that the organization has a responsibility to consider the interests of diverse parties impacted by its activities (Freeman *et al*., 2004). Much of the current research indicates that a key aspect of CSR practices involves the efforts of business management to address the valid and reasonable expectations of various stakeholders (Kumar & Tiwari, 2011). One example, Naseem *et al.* (2020) suggests is that a corporation can contribute to the growth of its local community by financing elements like roads, hospitals and schools.

Contemporary business leaders worldwide no longer perceive CSR as a compulsory or optional expense. They now recognize it as an investment yielding long-term advantages for the organization, such as increased profits, enhanced customer loyalty, trust, a favorable brand reputation, and the ability to counteract negative publicity (McDonald and Rundle-Thiele, 2008). Effective strategies for CSR should enhance both the financial and nonfinancial performance of a company thereby boosting its overall value (Schaltegger *et al.* 2019). CSR initiatives are gaining traction in Nepal, with a growing number of domestic companies focusing on and actively carrying out CSR programs in recent times.

Financial Inclusion (FI)

Financial inclusion (FI) encompasses the provision of relevant and affordable financial products and services to both individuals and businesses, addressing their needs for transactions, payments, savings, loans, and insurance in a sustainable and responsible manner (Agudelo *et al*., 2019). FI refers to the accessibility and utilization of official banking facilities, both essential components for individuals and businesses to be considered financially included (Hasan & Liu, 2022). It plays a crucial role in enhancing financial efficiency by fostering the growth of services that cater to diverse needs. Essentially, FI ensures that all members of society have equitable access, especially for the deprived ones, to financial services at reasonable costs (Gabor & Brooks 2017; Zhnag & Posso, 2019). FI has emerged as a crucial and inseparable aspect of economic development and has gained significant attention in recent times (Sarma, 2010: World bank, 2014). The range of financial services covers saving, lending, insurance, credit, and payments, with the goal of assisting people in overcoming poverty (Demirguc-Kunt *et al*, 2018). One of the most important objectives of FI is to incorporate the marginalized population who are presently operating outside of the official, documented, monitored, and regulated system, into the authorized, visible, and secured financial system (Thorat, 2006; Lai *et al*, 2020). Over time, it helps to create investment prospects, boost savings and investment, reinforce financial stability and effectiveness, promote capital movement, and foster greater economic expansion and progress (Park & Marcado, 2018). Enhanced FI allows companies to allocate sufficient funds for CSR initiatives, which in turn strengthen their public standing and image. This contributes to the overall improvement of a company's financial performance.

Promoting FI is a key goal for organizations within the financial sector. FI aids in narrowing the wealth gap between rich and poor and fosters social equilibrium (Raddatz, 2006). Beck *et al.* (2007) emphasize that FI allows individuals to utilize a broader range of financial services. Additionally, Han and Melecky (2013) state that FI serves as an instrument to financial stability, as increased bank deposits are predicted to strengthen the banking sector's stability. Consequently, FI plays a significant role in enhancing economic growth and alleviating poverty.

FI, or conversely, financial exclusion, is often discussed within the broader framework of social inclusion or exclusion in a society. Factors such as limited access, unfavorable terms, pricing issues, marketing strategies, or voluntary exclusion due to negative experiences or perceptions can contribute to financial exclusion. A financial system that promotes inclusion offers numerous advantages. Inclusive finance plays a crucial role in the overall financial system by enabling families and business owners to obtain affordable financial services and products. This not only promotes and strengthens the financial system, but also supports the achievement of seven simultaneous objectives within the framework of the sustainable development goals. FI promotes increased savings, which in turn boosts household expenditures and agricultural production. As a result, this inclusivity assists nations such as Nepal, where many people live below the poverty line, in alleviating poverty. Similar to numerous other developing nations, Nepal can utilize FI as a foundation not solely for expanding the financial sector, but also as a catalyst to promote inclusive economic growth. In Nepal, FI is a top priority on the national agenda, as a significant portion of the population remains outside the scope of the conventional financial system (NRB, 2022).

Banks utilize branches, ATMs, and point-of-sale (POS) locations to extend their customer reach, attract deposits, and provide services (Shihadeh *et al*. 2018). Banking services in

Nepal is experiencing rapid expansion, either through traditional branches or ATM facilities. Additionally, banks are increasingly inclined to open ATMs to reduce the burden on branches and as part of their cost-control efforts. According to Chatterjee (2020), the introduction of ATMs has empowered bank customers with greater autonomy in accessing their accounts. ATMs serve as a proxy measure for the ownership of accounts. ATM penetration rate indirectly reflects the rate of account penetration because financial institutions in Nepal typically provide customers with either a debit card or an ATM card linked to their accounts. The number of bank branches serves as another indicator of the extent to which financial institutions have spread within a country. This is because we can gauge the level of presence of financial institutions by examining the quantity of bank branches. Both branches and ATMs play a pivotal role in facilitating economic activity by offering convenient financial access to both borrowers and savers. Branch expansion is crucial for ensuring the sustainability of the banking system and reaching out to underserved populations (Maity & Sahu, 2019). Banks in Nepal provide a banking service without branches for clients who aren't able to access their physical locations. This enhances the availability of financial services for communities lacking traditional banking facilities. Authorized representatives conduct this service on behalf of the bank via a registered EFTPOS or Tablet device. Transactions, including withdrawals and payments, are securely conducted with online biometric fingerprint and card validation for each operation.

At the same time, number of employees in a commercial bank also has an influence on customer service, outreach, innovation and product development that helps in FI. Though higher number of bank employee can facilitate financial inclusion, it is important to note that it is not the sole determinant.

Several studies have explored the relationship between the leverage ratio and FI. Generally, higher leverage ratios tend to have a negative impact on FI. Excessive debt burdens can impede the ability of financial institutions to provide inclusive services, limiting access to credit, savings, insurance, and other financial products. This is particularly true for marginalized populations and individuals with limited resources or creditworthiness. A higher leverage ratio can constrain the lending capacity of financial institutions, making it more challenging to extend credit to underserved populations. It may also result in higher interest rates and stricter lending criteria, further excluding individuals and businesses with limited financial means. Additionally, higher leverage ratios can lead to increased financial risk and instability, potentially limiting the availability and affordability of financial services.

The relationship between the loan-to-deposit ratio and FI is complex and context-dependent. While a high loan-to-deposit ratio can indicate proactive lending for financial inclusion, careful management and regulatory oversight are necessary to ensure stability. Striking the right balance between lending activities, deposit mobilization, and risk management is essential for promoting inclusive access to credit and supporting economic growth.

When FI is low and a significant portion of the population lacks access to formal financial services, it can lead to various challenges. These challenges may include limited opportunities for saving, difficulties in obtaining credit, and a reliance on informal and often predatory lending sources. In such situations, individuals may resort to borrowing from unregulated or informal lenders, often at high interest rates. This can increase the risk of default on loans and contribute to the formation of non-performing loans within the financial system. Improper usage of officially sanctioned loans contributes to the rise in bad loans, also known as non-performing loans (NPLs), which in turn fuels financial exclusion. For example, when a client uses a business loan for personal purposes, it limits their capacity to pay it back, leading to a defaulted or non-performing loan. In other words, the increase in NPLs due to financial ignorance negatively impacts financial inclusion. Conversely, when financial inclusion is improved and more people have access to formal financial services, it can contribute to reducing non-performing loans. Access to savings accounts, insurance, and affordable credit can enable individuals and businesses to manage their finances more effectively and reduce the likelihood of default. Additionally, improved financial literacy and financial education initiatives that often accompany efforts to enhance FI can help individuals make more informed financial decisions and better manage their debt obligations, further reducing the occurrence of non-performing loans.

The main goal of FI is to extend financial services to a wider user base, thereby bridging the gap between rich and poor. Given the operational similarities between the FI system and the banking sector, there could be potential risks leading to the occurrence of non-performing loans in commercial banks. Chen *et al*. (2018) found that in the case of China, FI had a positive effect on the rate of non-performing loans. Similarly, Ozili (2019) discovered that a well-functioning and steady financial system tends to increase the rate of NPLs.

When considered independently, these indicators offer limited and insufficient insights into the overall inclusiveness of the financial system. Relying solely on individual indicators can potentially result in misconceptions regarding the extent of financial inclusion within an economy (Sarma, 2016).

The Context of Nepal

Nepal shares borders with India on three sides and China to the north. Since 2015, it has been a Federal Democratic Republic, with inclusive growth playing a vital role in the nation's financial and macroeconomic stability. The Constitution of Nepal is founded on inclusiveness and federalism, which endorse FI, fair access to financial services, and the education, empowerment, and protection of financial consumers.

The establishment of Nepal Bank Limited in 1937, as the nation's first formal institution, and the founding of the Nepal Rastra Bank (NRB) in 1956, as the country's central bank, were groundbreaking efforts that enhanced financial access and inclusion in Nepal. The NRB Act of 1955 emphasized the expansion of bank branches throughout the country. After the restoration of democracy in 1989, Nepal embraced a more liberal economic and financial policy, paving the way for further opportunities for banks, financial institutions, and other industries. This liberalization attracted private sector investments in various economic and social sectors.

FI has long been a top policy priority in Nepal. The NRB and various donor agencies have historically worked together to improve access, literacy, and consumer protections. To enhance financial access, the NRB has implemented directives on privileged credits, including priority sector credits, productive sector credits, deprived sector credits, and interest-subsidized credits. Out of 753 local levels, commercial banks set up branches in 750 by mid-November

2021. Banking and Financial institutions (BFIs) are required to allocate five percent of their Corporate Social Responsibility Fund (CSRF) to financial literacy training and programs, with a focus on women and socially marginalized groups. Over the years, Nepal has made remarkable progress in the proportion of adults having a bank account. According to the NRB report of 2021, approximately 67.3% of the population has access to banking services, and in 2019, formal insurance was accessible to around 26% of the population as opposed to just 11% in 2015. Nonetheless, possessing a bank account constitutes only one aspect of an all-encompassing financial system. A successful FI approach incorporates account ownership alongside other elements like accessibility to services, cost-effectiveness, engagement, and utilization of the financial system (Sarma and Paris, 2011).

Although the overall count of BFIs has dropped in the year 2023 due to successful merger and acquisitions, there has been a notable growth in the quantity of financial access points over time. The amount of bank branches, ATMs, and branchless banking centers has risen, expanding throughout all provinces and local areas. As of mid-July 2022, BFIs had established 11,528 branches in 752 out of 753 local regions (NRB, 2022).

In spite of all these achievements in FI, small enterprises and farmers in rural Nepal can only obtain financing at a steep price at the mercy of loan sharks. This elevated financial expense increases the likelihood of them becoming insolvent, particularly if they do not possess sufficient liquid assets to cover interest and principal repayments (Hess and Immenkötter, 2014). Loan sharking is rampant in rural villages of Nepal. Loan sharks in the southern plains districts have been exploiting vulnerable individuals by using a deceptive and unjust system called "*meterbyaj*" to calculate compound interest on loans. This has resulted in victims being burdened with exorbitant debt that is difficult to repay. Loan sharking is a complex issue, primarily originating from the financial exclusion faced by marginalized populations.

CSR and FI

Banks faced escalating scrutiny owing to a deficiency in ethical conduct and commitment to CSR (Rundle *et al.* 2021). The main goal of FI in relation to CSR is to make financial products and services available to those in need and improve the well-being of individuals who are excluded from the existing financial system. As a result, it is crucial for the formal banking sector to direct their CSR efforts towards economically vulnerable segments of society, enabling them to access financial products and services more easily. Prior research indicates that CSR initiatives by banking institutions can address various social and economic challenges, such as poverty, agricultural production, agricultural credit, income inequality, and unemployment (Swamy, 2014; Mader, 2018). In their study on India's rural economy, Binswanger and Khandker (1995) noted that FI through banks' social endeavors has contributed to poverty alleviation and decreased reliance on informal financial sources. Eastwood and Kohli (1999) discovered that CSR activities from financial institutions for FI programs had considerable potential to boost small-scale industrial output and help curb the growth of the informal economic sector, which is often exploitative. Companies that actively engage in CSR initiatives may be more likely to promote FI, as they tend to prioritize social and environmental concerns, including equal access to financial services.

Kim *et al.* (2018) investigates the connection between FI and economic growth. They use proxy measurements for FI, including the number of ATMs, bank branches, deposit accounts, and borrowers, and ultimately determine a positive correlation between FI and economic growth. In a separate study, Haldar *et al.* (2016) analyzes the link between FI and corporate social responsibility (CSR) initiatives within the banking sector of Bangladesh. Their research indicates that commercial banks participate in a higher number of CSR activities and offer improved FI in comparison to banks owned by the government. Based on the above literature, following hypothesis is formed: CSR expenditures have significant and positive relationship on FI.

RESEARCH METHODOLOGY

The data, gathered from respective bank's annual reports for the period 2020 to 2022, included CSR spending and proxies to FI such as Bank branches and ATMs. The literature reviewed for this study indicates that corporate social responsibility (CSR) activities have an impact on financial inclusion. The expansion of bank branches is considered an effective measure to gauge the level of financial coverage and inclusion within a country. Therefore, the number of bank branches is taken as a dependent variable to assess improvements in financial inclusion. Additionally, the number of ATMs is suggested as another effective financial service that successfully includes previously excluded individuals in banking activities. Therefore, number of branches (NOB) and number of ATMs are two dependent variables used one after another as the proxies for financial inclusion. The total CSR expenses of the banks is used as an independent variable that might explain variances in the number of branches and ATMs, aiming to determine the influence of CSR on financial inclusion. Other control variables, such as loan to deposit ratio (LDR), leverage ratio (LR), non-performing loans (NPL) are also considered. The analysis of panel data is generally done using Pooled OLS regression, fixed effect model or random effect model based on data's heterogeneity. Breusch-Pagan Lagrange Multiplier (LM) test is used to check for the data's heterogeneity and to check autocorrelation we apply Breusch-Godfrey/Wooldridge test. Hausman test is used to guide model selection between Fixed Effect and Random Effect model.

FEM can have issues like high standard errors and multi-collinearity. REM, which assumes no correlation between individual effects and independent variables, is often more appropriate. In our analysis, the presence of heterogeneity excludes Pooled OLS Regression method. Hausman test suggest we should go for Random Effect Model.

The random effect model used in the study can be shown in the equation form as below:

… … … (i)

where,

and (in year)

In equation (i), is not constant across various banks and is assumed to be a random variable with a mean of where,

… … ... (ii)

In above equation (ii)

= Intercept of bank and is a random error term that is distributed normally i.e., $\varepsilon \sim N(0,\sigma^2)$.

Now, combining equation (i) and (ii),

… … … … (iii)

In equation (iii), can be replaced by, where is the cross-sectional random error and is the error. Thus, equation (iii) can be rewritten as

… … … … (iv)

In a similar manner, we can present the random effect model with number of atm as dependent variable as below:

… … (v)

Regression Analysis

Regression Analysis is done taking number of branches (Br) and number of ATMs (Atm) as dependent variable, CSR expenses as independent variable, and other variables (Leverage ratio, Loan to deposit ratio and NPL) as control variables using Random-effect model.

The results obtained from REM model for Number of branches and Number of ATM as dependent variable and CSR expenses as independent variable is presented below.

Branch ~ Csr + Levr + Ldr + Npl

Balanced Panel: n = 14, T = 3, N = 42

Term	**Estimate**	**Std.error**	**Statistic**	**P-value**
(Intercept)	189.0075	89.64767	2.108336	0.035002*
Csr	-0.23246	0.289447	-0.80312	0.421903
Levr	337.3728	157.9106	2.13648	0.03264*
Ldr	-10.2957	94.22327	-0.10927	0.912989
Npl	8.187678	8.009046	1.022304	0.306637

Signif. codes: 0 '***' 0.001 '**' 0.01 '*' 0.05 '.' 0.1

R-Squared = 0.25177, Adj. R-Squared = 0.17088 and P-Value = 0.0143 *

Atm ~ Csr + Levr + Ldr + Npl

Balanced Panel: n = 14, T = 3, N = 42

Term	**Estimate**	**Std.error**	**Statistic**	**P-value**
(Intercept)	96.05860772	51.81272665	1.853957781	0.0637452 .
Csr	-0.204593432	0.153786844	-1.330370188	0.18339633
Levr	77.25143922	84.21890289	0.917269598	0.35900138
Ldr	101.0173462	49.96900667	2.021600047	0.0432176 *
Npl	1.98409962	4.340412086	0.457122407	0.64758306

Signif. codes: 0 '***' 0.001 '**' 0.01 '*' 0.05 '.' 0.1

R-Squared = 0.42351, Adj. R-Squared = 0.36119 and P-Value = 1.8264e-05 ***

RESULTS AND DISCUSSION

To understand the influence of CSR activities in FI, we have taken CSR expense as independent variable and major FI indicators such as number of branches and ATM as dependent variable. In the first equation, where number of branches were taken as dependent variable, CSR expenses as independent variable and other variable as control variables, the FEM model result shows no significance or strong evidence that CSR expenses might affect the number of branches or helps in increasing financial inclusion, after controlling other independent variables. Similarly, in second equation too, where number of ATM were taken as dependent variable and other variables remaining same, the results show no significant effect of CSR expenses on changes in other financial inclusion indicator ATM, after controlling other independent variables. The results are in line with a study done by Ibne Afzal *et al*., (2023) which shows that CSR activities does not necessarily bring FI in all cases. These results are in contrast with the findings by Singh *et al*., (2021) which states that CSR expenditures help in FI.

Although banks are engaged in CSR in Nepal, they would achieve greater CSR outcomes by strategically revising their core business vision. Without a clear CSR vision, funds might be spent on practices that offer minimal benefits to companies and society. Companies are failing to sufficiently focus on issues related to the community and development (Chapagain, 2020). One could make a case that the banks in Nepal are aiming to uphold their image in the eyes of the general public by participating in prominent, recognizable initiatives. But at the same time, their CSR initiatives seem to be primarily cosmetic, window dressing in nature, with little genuine influence on society. The government and Nepal Rastra Bank have a crucial role in fostering a CSR culture. They should spearhead initiatives, including creating forums for stakeholder dialogue. These fora can help align societal goals, such as poverty reduction and financial inclusion by involving all relevant parties. The government should also focus on CSR research, knowledge dissemination and incentivizing business through rewards for CSR initiatives. Ultimately, CSR suggests that private companies should behave like public entities. While CSR is increasingly being recognized as important in Nepal, it is still a relatively new concept and its practices can be inconsistent. Many businesses in Nepal are small to medium-sized, and their ability to engage in CSR can be limited by resources. Furthermore, there isn’t a well-defined legal framework in Nepal, which also contributes to the inconsistent practice. However, the trend is towards increased CSR activity, especially among larger companies and multinational companies operating in Nepal.

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