

Building Inclusive Financial Sectors for Development



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This report is a joint product of the United Nations Department of Economic and Social Affairs (DESA) and the United Nations Capital Development Fund (UNCTDF). It provides an overview of the outcome of multi-stakeholder consultations held in 2004 and 2005 in follow-up to the International Conference on Financing for Development (18-22 March 2002, Monterrey, Mexico) and as part of the activities within the framework of the International Year of Microcredit (2005).

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FOREWORD BY THE SECRETARY-GENERAL

Building inclusive financial sectors improves people's lives, in particular those of the poor. A small loan, a savings account or an insurance policy can make a great difference to a low-income family. They enable people to invest in better nutrition, housing, health and education for their children. They ease the strain of coping with difficult times caused by crop failures, illness or death. They help people plan for the future.

In many developing countries, small-scale enterprises and micro-entrepreneurs face severe financing constraints. But with access to finance, they can participate fully in the economic life of their societies, create employment for themselves and others and realize their full potential. Where such businesses are given opportunities to develop, countries will have a better chance to flourish. Indeed, the importance of access to financial services was recognized by world leaders in the outcome document adopted at the 2005 World Summit. The designation of 2005 as the International Year of Microcredit has also helped to raise global awareness of the pivotal role that more inclusive finance can play in achieving the Millennium Development Goals.

This publication aims to help policymakers develop national policies and strategies for building inclusive financial sectors. Based on experiences from around the world, it offers a menu of options for overcoming impediments to financial inclusiveness and also covers the policy, legal and regulatory environments. It is the product of global multi-stakeholder consultations held during 2004 and 2005 as part of the follow-up to the Monterrey Consensus adopted by the International Conference on Financing for Development. In the true spirit of Monterrey, that effort involved the United Nations system, the World Bank and International Monetary Fund, the microfinance community, academia, civil society and the private sector.

Inclusive financial sectors can go a long way toward breaking the vicious circle of poverty. But an unremitting effort by the international community will be needed. Let us all do our utmost to empower the poor and to ensure that poor people around the world have access to a wider range of financial services. With more opportunities to build on their ideas, energies and visions, they will lead the way in working their way out of poverty with dignity.



Kofi Annan
Secretary-General of the United Nations

PREFACE

Why are so many people and firms in developing countries excluded from full participation in the financial sector? That is the fundamental question that claims the attention of this book and the consultative process that led to it.

The United Nations General Assembly adopted 2005 as the International Year of Microcredit to “address the constraints that exclude people from full participation in the financial sector.” At the World Summit at the United Nations in September 2005, Heads of State and Government recognized “the need for access to financial services, in particular for the poor, including through microfinance and microcredit.” The Monterrey Consensus that Heads of State and Government adopted at the International Conference on Financing for Development in 2002 explicitly recognized that “microfinance and credit for micro-, small and medium enterprises...as well as national savings schemes are important for enhancing the social and economic impact of the financial sector.” They further recommended that “development banks, commercial banks and other financial institutions, whether independently or in cooperation, can be effective instruments for facilitating access to finance, including equity financing, for such enterprises....”

Drawing on this mandate, the UN Department of Economic and Social Affairs (DESA) and the UN Capital Development Fund (UNCDF) undertook a project to analyse the obstacles to financial inclusion and to report on efforts to overcome those obstacles in a variety of countries. DESA and UNCDF also undertook to bring the results of this investigation to the attention of the international community.

As a major part of this process, a series of regional “multi-stakeholder consultations” was organized in the Middle East, Africa, Asia and Latin America. Views of governments, international organizations, financial institutions, the private sector and civil society were gathered in informal roundtable discussions at these meetings. In addition, UNCDF, the Financing for Development (FfD) office of DESA and the World Bank Institute held a global e-conference in the spring of 2005 in which over 800 people participated. Material was also gathered from an on-line questionnaire and in-depth interviews with experts in the field. As an example of other significant inputs, Women’s World Banking convoked a major global meeting of experts who produced a report as input to this process, *Building Domestic Financial Systems that Work for the Majority*. The consultation process culminated in a May 2005 Global Meeting on Building Inclusive Financial Sectors, a final multi-stakeholder discussion hosted by the International Labour Organization in Geneva.

The result is this book, *Building Inclusive Financial Sectors for Development*. The book offers a vision of what inclusive finance could be. It does not dictate policy prescriptions to realize that vision. Even before publication, the book has gained some notoriety in the microfinance industry where it has become known as the “Blue Book” after the colour of the United Nations flag. It is indeed a blue book, but it is not a “blueprint.”

While there are areas of consensus, there are also many issues on which there are diverging views and different solutions in different countries. Individual countries need to design their own national

strategies for financial inclusion. The Blue Book is intended to be a companion to national dialogues among relevant stakeholders that individual countries may wish to convoke to develop their national strategies.

A multilateral agency group representing the World Bank, the International Monetary Fund, the International Fund for Agricultural Development and the International Labour Organization supported the DESA and UNCDF staff team for the Blue Book. This team was further supported by the Consultative Group to Assist the Poor, the Advisors Group of the International Year of Microcredit, the Group of Friends of the Year of Microcredit, colleagues at the African Development Bank, the African Microfinance Network, the Asian Development Bank, the Economic Commission for Latin America and the Caribbean, the Inter-American Development Bank, the Microcredit Summit Campaign, the United Nations Development Programme Santiago Office, Women's World Banking and the World Savings Banks Institute. Several prominent experts were pressed into service to read and comment on successive drafts of the Blue Book. Finally, we would like to acknowledge financial support to this project from UNCDF and from the Swiss Agency for Development and Cooperation.

To all of our friends and partners in this project, who are too numerous to mention individually, we owe a deep debt of gratitude. In particular, however, we would like to thank Kathryn Imboden and Heather Clark of UNCDF and Barry Herman of DESA for their long, patient, and excellent efforts and collaboration in bringing this book to fruition.



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Chapter I

SETTING THE STAGE FOR BUILDING INCLUSIVE FINANCIAL SECTORS

“The stark reality is that most poor people in the world still lack access to sustainable financial services, whether it is savings, credit or insurance. The great challenge before us is to address the constraints that exclude people from full participation in the financial sector... Together, we can and must build inclusive financial sectors that help people improve their lives.”

UN Secretary-General Kofi Annan, 29 December 2003,
following the adoption of 2005 as the International Year of Microcredit

In most developing economies, financial services are only available to a minority of the population, frequently to only a very small minority. Although financial sectors are expanding as these economies grow, financial assets usually remain highly concentrated in the hands of a few. The majority of the people in developing countries have no savings accounts, do not receive credit from a formal financial institution, and have no insurance policies. They seldom make or receive payments through financial institutions. Indeed, the majority in most countries rarely enter their premises. The use of financial services in developed countries could not be more different (see box I.1).

Such limited use of financial services in developing countries has become an international policy concern. Indeed, the Heads of State and Government meeting at the September 2005 World Summit at the United Nations stated that: “We recognize the need for access to financial services, in particular for the poor, including through microfinance and microcredit” (United Nations, 2005, paragraph 23i). This reflects what must be — and increasingly is — a concern of development and poverty eradication policy at national and local levels: the recognition of the important contribution a broad-based financial sector makes to economic development and poverty alleviation.

The basic question is: “Why are so many bankable people unbanked?” But who are the “bankable unbanked?” Who are the people and firms who are excluded from full participation in the financial sector — those who should be but are not using formal financial services? They are creditworthy people and firms who would be able to generate income to repay what they borrow, but who do not have access to credit. They are insurable people and firms who have the income to pay for group or individual insurance premiums on a regular basis, but who do not have access to insurance. The largest group of “unbanked” people are those who want a safe place to save and build assets and a reliable way to transfer and receive money, but who do not have access to savings or payments services.

A financial sector that provides “access” to everyone in each of these main customer groups would be called an “inclusive” financial sector. It would provide access to credit for all “bankable” people and firms, to insurance for all insurable people and firms and to savings and payments services for everyone.

Box I.1.**Access to financial services in developed and developing countries**

Nobody knows the proportion of people in developing countries that use the services of financial institutions. Too often, that information is not collected by financial institutions or by financial regulators. The latter focus on data pertaining to potential instability in the financial sector and have not been mandated to monitor access of different population groups to financial services. The small deposits and loans of low-income households and small firms are unlikely to cause a financial crisis. Some larger financial institutions might occasionally undertake usage surveys for marketing purposes, but they would not likely make the results public or share results with competitors. When comprehensive data are collected, it is usually by survey research entities gathering them for a public policy reason (World Bank, 2005).

The data that is available points to dramatic differences with respect to access to financial services between industrialized and developing countries.

For example, one recent review of national surveys reported that 89.6 per cent of the population of 15 countries in the European Union had a bank account (or comparable account, such as a giro account in a postal financial institution), with country proportions ranging from 99.1 per cent in Denmark to 70.4 per cent in Italy. The comparable figure for the United States was 91.0 per cent (Peachey and Roe, 2004, p. 13). The most recent comparable compilation of available data for developing countries found the following:

Country/location	Percentage with an account
Botswana	47.0
Brazil (urban)	43.0
Colombia (Bogotá)	39.0
Djibouti	24.8
Lesotho	17.0
Mexico City	21.3
Namibia	28.4
South Africa	31.7
Swaziland	35.3
Tanzania	6.4

Source: Emerging Market Economics, Ltd. (2005), p. 20.

Note: In Botswana, Lesotho, Namibia and Swaziland, this is the percentage who says that they have a savings/transaction account from a bank.

Inclusive finance does not require that everyone who is eligible use each of the services, but they should be able to choose to use them if desired.

The objective of this book is to assist policymakers and other stakeholders in developing countries as they seek to build inclusive financial sectors.

Policy must be designed at the country level

The vision of inclusive financial sectors that will be outlined below is very general. It does not provide a blueprint for policy making. The variety of financial institutions is broad and the experiences of countries differ. Institutions, policies and practices that work well in one country may not work at all in another. Strategies for building inclusive financial sectors have to be creative, flexible, appropriate to the national situation and nationally owned. While necessarily designed at the national level, such strategies should nevertheless build on the lessons learned in other Country contexts and the resulting considerations of good practices.

This book is thus intended to serve as a companion to a domestic dialogue that countries may undertake to develop strategies for building financial inclusion. These strategies should result from open and transparent discussion based on a thorough assessment of the sector, informed by international experience and including all financial sector stakeholders. While it is frequently the role of the government to establish the policy framework, it is in the interest of all stakeholders to work together to develop feasible strategies and then to monitor progress in achieving results.

Based on extensive consultations around the world, this book seeks to identify the issues of most concern to stakeholders in developing countries and, on this basis, to provide information that may help them to formulate policy frameworks. The book illustrates the kinds of options that stakeholders may wish to consider based on evidence and illustrative examples of what has proven to be sound practice in numerous country settings. This is not prescriptive or proscriptive and the book does not make specific recommendations. Stakeholders are encouraged to examine policy options on the basis of their vision of an inclusive financial sector, the state of financial sector development in the country in which they are working and the range of constraints that confront them.

In calling for national dialogues to develop strategies for building inclusive financial sectors, emphasis is placed on the full examination of constraints and opportunities as perceived domestically. In many countries, the resulting strategies may take shape as formal documents of the government, or as parts of other documents, such as poverty reduction strategy papers or national development plans. However, the formal status of the strategy is less important than the political commitment of the government and other stakeholders including donors, and the “ownership” of all the other actors that lead them to closely take part in the strategy’s development and monitor its implementation. In this regard, the importance of multi-stakeholder dialogue at the country level is not only to address the constraints, opportunities and policy options with regard to building inclusive financial sectors, but also to develop a political consensus around a concrete programme of action.

The objective of financial inclusion should also be integrated into national thinking about financial sector development. Financial sector development strategies have often focused on strengthening overall financial stability and increasing the availability of financial services to major economic actors which

are generally large firms, the government itself and wealthy households. The innovation advocated here, which some countries already have adopted, is to build into that strategy access to financial services for the poor and low-income population.

In the context of building inclusive financial sectors, this volume frames some of the most common issues and debates, drawing on an extensive series of consultations and related research. It highlights international experiences pertaining to financial inclusion and presents an overview of the main issues. A specific country context may have other more pressing issues than those noted here.

The remainder of this chapter examines why inclusive financial sector development matters and describes the state of financial access today. It centres on developing a vision for inclusive finance. Chapters II to VI attempt to synthesize much of the material gathered through consultations and surveys of research, outlining the issues on which there seems to be consensus and also where there is none. Chapter VII explicitly addresses a number of matters on which there is ongoing debate, and suggests alternatives for policymakers to consider. Finally, Chapter VIII presents suggestions on how to organize a national dialogue on building an inclusive financial sector.

As a prelude to the chapters in this book, a set of terms and definitions used throughout the Blue Book is presented in box I.2.

Why inclusive financial sector development matters

The reason for concern about widespread financial “exclusion” in developing countries is straightforward: we know that access to a well-functioning financial system can economically and socially empower individuals, in particular poor people, allowing them to better integrate into the economy of their countries, actively contribute to their development and protect themselves against economic shocks. Creation and expansion of financial services targeted to poor and low-income populations can play a vital role in enhancing financial access. Inclusive financial sectors — those in which no segment of the population is excluded from accessing financial services — can contribute to attaining the goals contained in the United Nations Millennium Declaration, such as halving the proportion of people in the world who live in extreme poverty by 2015.

It may be useful to recall that a financial sector provides critical services not only to households and enterprises, but to the economy as a whole. Broad availability of such services should be part of national development strategies for the following reasons:

- First, the financial sector facilitates payments between different parties and makes them safer than cash transactions, both in the sense of documenting proof of payment and protection from theft. This is essential for most enterprise-to-enterprise transactions, and it is valuable for households.
- Second, the financial sector facilitates a special category of payments, namely the transfer of funds from entities with a surplus to those willing and able to pay for filling a shortage of funds. In this regard, the financial sector allocates resources, facilitates the intermediation of savings into investment, and allows households to smooth consumption over time.

Box I.2.**The paradigm shift and terminology:
Microfinance and inclusive finance — how are they different?**

Many development practitioners and financial institutions believe that we are in the midst of a paradigm shift from microfinance to inclusive finance — from supporting discrete microfinance institutions (MFIs) and initiatives to building inclusive financial sectors. Inclusive finance recognizes that a continuum of financial services providers work within their comparative advantages to serve poor and low-income people and micro and small enterprises. Building inclusive financial sectors includes but is not limited to strengthening microfinance and MFIs.

Existing terminology that developed over many years to describe microfinance initiatives no longer serves well when we shift to discussing inclusive financial sectors. Microfinance has been defined as the provision of diverse financial services (credit, savings, insurance, remittances, money transfers, leasing) to poor and low-income people. Retail financial service providers that serve this market segment are increasingly more difficult to define with one common term. They include NGOs, private commercial banks, state-owned and postal banks, non-bank financial institutions (such as finance companies and insurance companies) credit unions and credit and savings cooperatives. Many of these institutions are quite large; many are quite old; and many have large numbers of clients and highly diverse products and services. As a result, the term MFI is often not descriptive or adequate to refer to this diverse group of financial institutions. While each of them plays an important role in inclusive finance, many of them could not be considered MFIs in the technical sense.

As a general guide, the Blue Book refers to the range of institutions mentioned above as financial service providers and to those that serve poor and low-income people as financial service providers that serve the lower segment of the market. This book often makes the distinction between retail and wholesale financial institutions. It also specifically distinguishes financial institutions that provide payments, clearance and settlement services as important participants in inclusive financial sectors. When references are made to organizations that provide credit only, the term microcredit is used. When we discuss financial institutions that provide financial services to poor and low-income people through special windows or mechanisms, we refer to these as microfinance operations, or if they are credit only, microcredit operations.

Thus, MFIs represent only one type of financial sector organization. They receive a large amount of attention here and in the consultations undertaken in preparing this book because they have been studied and discussed extensively over the past 25 years. As a result, the reader may note a tension between the effort to present a broader treatment of inclusive finance and a narrower treatment of microfinance, and particularly microcredit. As the paradigm shift mentioned above is only recent, we point out the tension for the discerning reader and expect that greater clarity and precision in terminology will evolve gradually.

- Third, the financial sector provides safe savings facilities and a range of risk/return tradeoffs for savers. In so doing, it mobilizes savings into a formalized system. It helps households accumulate financial assets, which can provide a cushion against untoward events (“shocks”), and provides resources to respond to economic opportunities.
- Fourth, the financial sector provides additional means beyond privately accumulated savings to help absorb shocks through insurance and credit. When people have these products and services to draw upon they are better able to undertake a modicum of risk in their activities. Risk-taking is a prerequisite for being entrepreneurial and thus for economic dynamism.

There needs to be a continuum of financial services available to households as they increase their standards of living and for enterprises as they grow into the business mainstream. This is a critical issue for the development of financial sectors. It involves adequate financial services for small and medium-sized enterprises (SMEs), often called the “missing middle,” as well as the smallest microentrepreneurs. It involves financial infrastructure, such as credit bureaux and property registries, and financial institutions that serve poor and low-income households and their enterprises. Working to extend financial services on adequate terms to all population groups should be a central focus of financial sector development.

Too often, financial services for poor people have been treated exclusively as part of social policy, distinct from the rest of the financial sector. Extending financial services to poor people is also part of policy for economic growth and financial sector development. Expanding and deepening financial services for poor people should simultaneously be a concern of poverty reduction and financial sector strategies. Indeed, these should come together in comprehensive national development strategies to achieve the Millennium Development Goals, as the world’s Heads of State and Government pledged at the 2005 World Summit (United Nations, 2005, paragraph 22a). They should equally inform the poverty reduction strategies that countries discuss with the Bretton Woods institutions and donor governments.

In many countries, a change in attitudes of government and other stakeholders may be required, along with a greater appreciation of what inclusive financial sectors can deliver for development. The views of Fouad Abdelmoumni, Executive Director of Association Al Amana, a leading microfinance institution (MFI) in Morocco, are instructive on this point. To him, inclusive financial sector development means nothing less than reversing the current state of exclusion, turning minority access to finance into majority access in a limited time period. As he said:

“The evidence is clear. Financial sectors today exclude the vast majority of the population. We have learned, however, that the financial exclusion is not congenital, but rather attributable to cultural factors, the stigmatization of the poor, along with the lack of capacity to deliver sustainable financial services to them. Today, we operate from a different mindset, tools in hand, whereby it is considered reasonable to achieve a massive expansion of banking services over the medium term, or at least something closer to the medium term than to the long term.”

There is, in short, a compelling case and pressing need in developing countries to look at financial sector development inclusively, placing greater emphasis on access by poor households and enterprises to financial services. In this regard, policymakers can take important steps towards achieving global

development goals by adopting policies that promote access to financial services for poor and low-income people and assuring that these policies are integrated into overall financial sector development strategies.

The central question asked by this book is how to bring access to these fundamental services to all people in developing countries, and thus to accelerate their economic development and that of their countries. Inclusive finance — safe savings, appropriately designed loans for poor and low-income households and for micro, small and medium-sized enterprises, and appropriate insurance and payments services — can help people help themselves to increase incomes, acquire capital, manage risk, and work their way out of poverty. Access to the financial system facilitates making and receiving financial payments and reduces their cost. This is increasingly important in the globalized labour market and in view of the homeward foreign remittances that result. Moreover, access to financial services serves to increase production and social protection, as the financial sector — through stored savings, credit and insurance — serves as a cushion in times of crisis. Increasing the inclusiveness of financial sectors, fuelled by domestic savings to the greatest extent possible, will, over time, bolster the poorer segments of the population as well as those segments of the economy that most affect the lives of poor people.

The emergence of outreach considerations

The starting point for discussion regarding building inclusive financial sectors is the recognition that mainstream for-profit financial institutions have largely ignored the lower segment of the market. This includes SMEs, microentrepreneurs and the poorest households. Instead, these mainstream institutions have sought mainly high-value clients. This is primarily because the administrative cost of a financial transaction of a given type is similar whether the amount transacted is large or small; thus, large-value transactions are more profitable. Moreover, assuring the creditworthiness of a potential small-scale borrower with no effective collateral can be (or is perceived to be) more difficult than for a large borrower. In addition, as the frequency of formal financial transactions is higher for higher-income people (e.g., salary deposits, cheques written, financial instruments purchased and sold), the fixed cost of bank operations can be spread over the greater volume of transactions.

Finance is an essential ingredient of most economic activity for all households. Poor households have largely had to rely upon informal financial providers, such as pawn shops and moneylenders, or informal groups, such as *tontines* and other rotating savings and credit associations. Religious and other civil society organizations and governments in both developed and developing countries have long sought to broaden access to formal financial services for poor and low-income people. As early as the 15th century, Italian monks set up operations to counter moneylender rates of lending. By the 19th century, a strategy emerged to overcome cost disadvantages of serving poorer customers through scale economies available to national operators. Postal systems and postal financial services have been major providers of savings and payments services since the 19th century in Europe, in Japan and elsewhere. Government-owned banks in Asia, Africa and Latin America also extended financial services to underserved populations, and government-run credit programmes, such as agricultural finance for farmers, were created as part of sector development programmes. As has been the case with many government-run economic operations, these were more effective in some countries and for some periods of time

than others. Important initiatives also took place outside the government sector, as in community-based savings and credit societies and mutual savings banks in Europe and America, which in some ways can be seen as precursors of the modern microfinance movement (see box I.3).

Box I.3.
Extending access to financial services: European antecedents

The economic history of Europe contains numerous examples of efforts to extend financial services to underserved populations. Two that emerged in Central Europe were municipal savings banks, beginning in the 18th century, and savings and credit cooperatives based on the self-help principle, as first organized by Herman Schulze-Delitzsch and Friedrich Raiffeisen in the middle of the 19th century. Both demonstrate that access to finance for the poor can be perfectly compatible with cost-covering, sustainable operations.

As local public financial intermediaries, municipal savings banks have been committed to the welfare of the local population by allowing poor people to save and accumulate financial assets. Probably the oldest local *caisse* in Germany, founded in 1743, was a funeral thrift society. Savings banks offered an alternative to the usurer: in poorer areas in Germany in the 1860s and 1870s, daily interest rates of 2 per cent or yearly interest rates of 700 per cent were not uncommon.

Raiffeisen's credit unions were member-owned unit banks. They initially imposed unlimited joint liability on all members, and only members could undertake transactions. Members were expected to devote some of their time to the credit union, without payment.

There are some interesting parallels between the Raiffeisen credit associations and present-day microfinance:

- middle-class individuals took the initiative to create the savings banks and credit associations, a bit like civil society microfinance organizers nowadays;
- the group-based lending techniques of many present-day microcredit institutions have a historical analogy in Raiffeisen credit associations, where eight individuals had to come together as promoters;
- savings and credit cooperatives in 19th century Central Europe grew from the bottom up, forming district unions, regional and national federations and central inter-union payment clearing facilities;
- economic and social objectives went hand in hand in both types of financial intermediaries, echoing the twin goals of modern age MFIs: poverty outreach and financial sustainability.

One may also draw some lessons from this experience. In both types of the early financial institutions, public authorities refrained on the whole from direct intervention in day-to-day management and did not provide them with financial resources on a large scale. They were driven by individual commitment, enjoyed limited external financing, and managed their growth in a controlled way. Finally, the scope for "scaling up" the volume of services was vital to their success (Engelhardt, 1993; Müller, 1986; Stockhausen, 1995).

The emergence of microcredit, microsavings, and microinsurance industries in various developing countries over the past quarter century indicate that poor clients can be served despite the higher cost of small-scale transactions. In addition, the cost differential of serving poor customers may have fallen as advances in information and communications technology have pushed down the costs of many of the transactions. In some cases, commercial financial providers have begun to offer certain services to this market and some banks have opened full-service microfinance operations. And, while many microfinance providers are, or have been, subsidized in one form or another, it is recognized that a growing number of them can operate independent of subsidy and become self-sustaining.

Today, most developing countries already have a range of retail financial service providers and financial infrastructure services with different ownership structures and legal charters. These institutions provide financial services to a portion of the low-income population, although outreach is uneven, notably with regard to rural areas. As box I.4 indicates, the institutions include some private commercial banks that have special microfinance operations, but primarily they comprise public or non-governmental institutions that pursue a social purpose. They include state-owned commercial banks and savings banks, post banks, private and state-owned rural banks, and banks that specialize in providing services to poor and low-income people or SMEs of varying degrees of quality. In some cases, government ministries manage credit operations outside the formal financial sector. Among such operations are integrated multi-dimensional development projects that offer credit to small farmers and community groups that are established and linked to local and municipal government departments.

There is also a wide variety of non-bank financial intermediaries, including organizations that offer some but not all the services of a bank, such as the *fondos financieros privados* in Bolivia (microcredit lenders that accept savings deposits), microfinance deposit-taking institutions in Uganda, and licensed MFIs in Cambodia. Credit unions, cooperatives and member-owned mutual banks, generally established under distinct regulatory and supervisory frameworks, provide financial services to poor and low-income households in rural and urban areas. These institutions are the predominate providers of financial services in West Africa and have a significant market share in the Americas, Europe and Asia.

In addition to these formal institutions, there are a number of financial service providers, such as non-governmental organizations (NGOs) that are not regulated by the banking or other financial authorities. NGOs are the most prevalent retail establishments in countries such as Bangladesh. They provide significant financial services to rural and urban populations in all regions of the world. Other examples in this category are self-help groups that stand alone or are linked to banking establishments. There are also donor-funded microfinance projects with no legal status and projects of international NGOs that channel donor funds directly to local operations. Finally, moneylenders continue to play an important role in many societies.

In this regard, the main question facing financial sector policy strategists is how to expand and deepen access to financial services until the financial sector can be called “inclusive.” Other questions follow: which institutions have the capacity to provide sustainable access to financial services that respond to a broad range of customers’ requirements? How many institutions should be encouraged, by what means and with what supportive infrastructure?

Box I.4.**The providers of financial services to poor and low-income people**

Various retail financial institutions have provided access to financial services for lower income clients over the last 25 years and in some cases for more than 100 years. They include a diverse mix of public, private and not-for-profit organizations. Most of the providers have social as well as financial goals and are sometimes referred to as organizations with a “double bottom line” or “alternative financial institutions.” MFIs are generally considered to be a sub-set of financial service providers and they include NGOs, microfinance banks, and non-bank financial intermediaries.

Governments and donors have played a catalytic role when supporting the innovative approaches of alternative financial institutions, with mixed results. These institutions operate in rapidly changing environments. They try to meet the social, economic and political challenges in their economies while serving the needs of those traditionally denied access to financial services. Most countries have a number of these institutions and in some cases all of them are present. They are the focus of the discussions in this book. More precisely, they include:

Commercial banks

In some circumstances, providing certain financial services to low and middle income households can be a profitable business for a commercial bank (e.g., simplified savings accounts allowing a limited number of transactions per month; fee-for-service activities, such as international money transfers, even microcredit in some circumstances). Services include savings accounts, fee-for-service activities, such as international and local money transfers; and credit. Some banks find themselves in this market segment owing to government-mandated lending targets, some due to increasing competitive pressures at the high end of the market and some because it makes business sense to position there for future growth.

State development and agricultural banks

Governments have established state-owned banks to foster the development of priority sectors (e.g., agriculture, handicraft industry), to promote policy initiatives and to reach clients neglected by conventional commercial banks. These banks also act as a channel for government transfers, payments, or receivables. They have had a mixed history and many have closed while some successfully fulfil their mandate.

Postal savings banks

These institutions capitalize on the infrastructure of the world’s largest distribution network to provide financial services. In some countries they are the leading financial service provider, particularly in rural areas, and can manage small account balances. Generally, they offer mostly savings and payment/transfer services. Sixty of the 190 members of the Universal Postal Union provide postal financial services and savings bank services.

Non-postal savings banks

The World Savings Bank Institute (WSBI) lists 101 member organizations from 85 countries including both private and public institutions. They seek to be “proximity banks” in communities, offering a range of financial services to generally underserved populations and operate under a “double bottom line.”

MFI banks

These MFIs operate independently or as the subsidiaries of larger banks. They operate under prudential, regulatory, legal and institutional frameworks adapted to serving a clientele traditionally perceived as too risky or unprofitable by commercial banks. While the MFI banks include a social dimension in their *modus operandi*, they treat microfinance as a profitable core business activity. In contrast to traditional commercial banking, they tailor their banking services to reach people with a wide range of incomes up to the higher end of the low to medium income segment of the market and SMEs. Shareholders of these institutions value the social dimension of the bank’s activity and are likely to expect lower returns compared to purely private investors.

Licensed non-bank financial intermediaries

This group includes former microcredit NGOs that have transformed under special legislation, as well as finance companies. Offering predominantly non-collateralized credit products and services, some are authorized to take deposits under certain conditions and the supervision of designated government authorities. Their capital funding can be from public or private sources. Typically they serve the low end of the market and small enterprises.

Financial cooperatives and credit unions

This group includes municipally-owned savings and loan institutions as well as member-owned financial cooperatives like credit unions. They are not-for-profit organizations, generally controlled and operated by their members, and they redistribute any earnings in excess of operational costs to their members in the form of dividends on share capital, increased interest on savings, or decreased rates on loans or other new and improved services such as remittances and insurance.

Rural banks and community banks

These are generally small financial intermediaries, locally-owned by individuals or by local or regional governments. They may also be organized as cooperatives. They can operate with subsidized or commercial funding sources. Some are fulfilling a government mandate to provide sustainable financial services to individuals and enterprises that otherwise would not have had access to savings, pawn, personal, entrepreneurial, or agricultural loans. Others are privately owned banks that serve the community. They are generally licensed institutions with smaller amounts of paid-in capital than is required of commercial banks.

Non-governmental organizations

This group includes NGOs that provide financial services (primarily credit), as well as others that offer basic financial services in conjunction with other services (e.g., health and literacy). They are subject to a variety of civil and commercial laws. NGOs are funded largely by donors. Their primary purpose is to improve the welfare of the poor and poorest populations. Since they are not subject to bank regulation and supervision, they are not authorized to mobilize deposits from the public.

Insurance companies

A wide variety of insurance providers operate in developing countries, albeit with modest sales to poor and low-income customers. They include for-profit or not-for-profit institutions, government providers, and mutual and cooperative insurers. Few of the institutions work directly with poor people, although they may act as reinsurance providers to organizations that provide a variety of microinsurance services, such as property, life, disability, loan redemption assurance, health and agricultural risk insurance. They may sell to low-income customers through agency relationships with retail institutions.

Transfer payment companies

Specialized money transfer companies have dominated the formal provision of quick and safe transfers of funds within and between countries for low and middle-income clients. Other main providers of this service are commercial banks and postal systems. Increasingly, credit unions, MFIs and NGOs are also offering these services. In all, their services may be grouped under three headings: remittances, credit lines on bank cards of relatives abroad, and account-to-account deposit transfers. Because these services are fee based and profitable, they can offer an effective opportunity to attract new customers to saving and loan services. Partnerships between money transfer companies and other financial service providers are on the rise for domestic and international payments.

Additional providers of financial services are often considered "informal" ones, outside the scope of the formal financial sector. Some of these institutions may be regulated by commercial law and special regulations outside the banking law. They are, however, often the major providers of financial services to poor and low-income populations. The major categories are:

Non-bank private retailers

There is great diversity, size and number of non-bank private retailers engaged in providing financial services to poor and low-income people. These private commercial retailers include individuals who engage exclusively in financial services (such as moneylenders, who often also provide deposit services), pawn shops, private retailers predominately engaged in other lines of business (such as small grocery stores, agricultural input providers and agro-businesses, and large retailers of consumer goods with vast national networks).

Informal mutual assistance groups

Rotating savings and credit associations (ROSCAs), *tontines*, self-help groups and mutual assistance groups, such as burial societies, fall under this heading. They can be quite small, organized among a group of friends, NGOs, or local community members. ROSCAs and mutual assistance societies can also be quite large, involving an entire community, employees of larger businesses and government departments, or extensive and well-organized informal social capital networks among businesses that support their enterprises with surprisingly large amounts of money.

The state of financial access today

Taking all the financial institutions together, there is evidence that financial services are being offered to a large number of people, albeit a fraction of the potential customer base that can be considered the primary target of inclusive finance. While comprehensive information does not exist, estimates from available data on usage of formal financial services suggest that several hundred million people have savings accounts in the developing world and that over 100 million people are borrowers from an “alternative financial institution” of some sort.¹ As shown in the figure within box I.5, state-owned institutions have a dominant role in providing financial services to poor and low-income people. This reflects the fact that over half the accounts and loans in the figure are for customers in two countries with large state activities in financial services, China and India. These two countries also account for over half the world’s poor people.

Another striking feature that can be seen in this box is the rapid growth and current significance of MFIs. Unlike the state financial institutions, MFIs hardly existed as significant organizations 10 or 20 years ago.

The Microcredit Summit Campaign reported that at the end of 2004, there were 3,044 MFIs in developing countries making microloans to over 92 million clients. Of these, 66.5 million were classified as among the “poorest” people and 55.6 million of the poorest were women.² In terms of people served, the MFI phenomenon, like that for access in general, is dominated by the Asian experience, as that region accounted for 88 per cent of all reported loan clients in developing countries and 92 per cent of the poorest female loan clients. This notwithstanding, significant numbers of MFIs operate elsewhere: in 2004 the Campaign reported there were 994 in Africa, 388 in Latin America and the Caribbean and 34 in the Middle East (Daley-Harris, 2005, p. 26).

While MFIs may lend very small amounts, they can be very large organizations. The Microcredit Summit Campaign reported that eight individual institutions and three networks each served one

¹ The term alternative financial institution is used here consistent with the study quoted. As this volume was going to press, a new study for the World Savings Banks Institute raised the estimated number of accounts in savings banks from 450 million to 1.05 billion (see Peachey and Roe, 2005). The estimates in the text above should thus be interpreted as quite conservative.

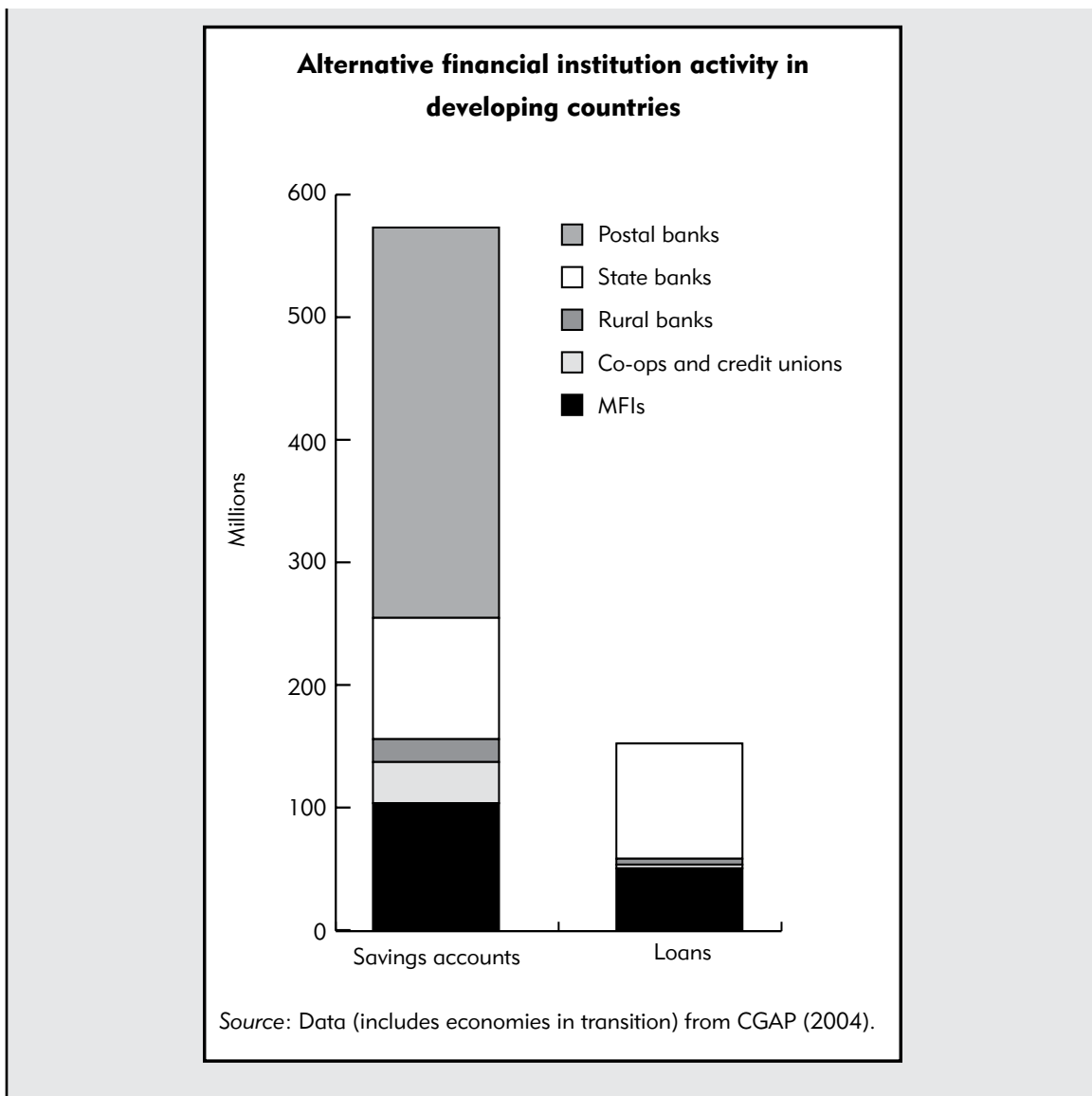
² “Poorest” was defined as either the bottom half of the people classified as below their national poverty line or people living on the equivalent of less than US\$1 per day (Daley-Harris, 2005, p. 22).

Box I.5.
“Alternative financial institutions” in developing countries

There are no data on the basis of which to directly estimate the overall extent to which financial institutions in developing countries are used by poor people or by micro, small or medium-sized enterprises. Such information would have to be collected from survey research undertaken in comparable ways in a significant sample of countries. So far this has not been done. However, financial institutions generally maintain data on the number and value of accounts or loans they have outstanding. The Consultative Group to Assist the Poor (CGAP) has attempted to bring together all the data of this type that could be located. The idea was to use those data, which were from over 3,000 institutions for years around 2000, to roughly estimate access to financial services by the population that is usually excluded from the mainstream financial sector.

The study notes several cautions in interpreting the data. First, alternative financial institutions that were set up to serve clients who did not have access to commercial banks and finance companies and for whom account data was available, do not serve the poor exclusively. Second, the number of accounts does not reflect the number of users: households may have more than one savings account or loan. Also, large numbers of dormant savings accounts, especially in postal financial systems, would lead the data to overestimate the number of active accounts. On the other hand, important savings institutions (in particular, non-postal savings banks) that do not publish data on number of accounts, as well as many small institutions, were not captured in the exercise, which would tend toward an underestimate of total usage.

With these caveats, the result is that there were over 500 million savings accounts and over 150 million loans in alternative financial institutions around the year 2000 (see figure). Savings accounts assuredly are the dominant financial service, however incomplete the data, underlining the widespread importance households give to having access to safe savings services. Postal banks accounted for over half the total savings accounts, reflecting their position as the most widespread institution having a financial function in many of these countries. State banks and MFIs each accounted for almost a fifth of the total number of savings accounts. On the lending side, state banks (including agricultural and development banks) accounted for 62 per cent of the total, and MFIs for 33 per cent (the latter includes microfinance departments of full-service banks). The other categories of institutions accounted for small shares.



million or more of the “poorest” clients.³ Adding the 41 individual institutions that served between 100,000 and one million clients would account for almost 84 per cent of all poor clients served. The rest were serviced by the remaining 3,112 MFIs, the overwhelming majority of which served fewer than 2,500 clients each.

Not only do financial service providers differ in size, the extent of their focus on poor customers also differs. While small MFIs, typically NGOs, may focus most of their activities on serving poor customers, large commercial banks may have microfinance operations as a relatively small part of their activities. MFIs that are regulated (required, for example, when allowed to take deposits), NGOs that convert

³ The networks are organized under the National Bank for Agriculture and Rural Development in India, the Association of Asian Confederation of Credit Unions (Thailand) and the Bangladesh Rural Development Board. They are comprised of MFIs of varying size that have varying relationships with banks and draw on various common services (Daley-Harris, 2005, p. 25).

fully into commercial banks, and savings banks with microfinance operations generally fall somewhere in between. This phenomenon is important because there are large economies of scale in retail financial services and small firms will thus be relatively high-cost suppliers of what is in any event a relatively high-cost activity (see Chapter III).

One should not conclude, however, that institutions serving a mixed group of customers are necessarily less interested in serving poor customers. As a recent survey of microcredit providers in Latin America showed, 17 commercial banks with microcredit operations that issued only 38 per cent of their loans for under US\$800 still reached almost as many customers as 56 NGOs that devoted 60 per cent of their lending to loans in the same size category (see table I.1).⁴

Table I.1.
Microcredit in Latin America, 2004

Type of microcredit institution	Number	Microloans outstanding (US\$000)	Number of clients	Average loan (US\$)	Percentage of loans below US\$800
Commercial banks	17	1,175,232	847,498	1,387	38
Regulated MFIs	47	1,790,373	1,540,920	1,162	52
NGOs	56	384,045	868,544	442	60
Total	120	3,349,650	3,256,962	1,028	---

Source: Marulanda and Otero, 2005, pp. 6 and 29.

Despite the large numbers served by MFIs or the broader category of financial institutions, it needs to be appreciated that the number of people who are not served is far greater still. While data on *access* to financial services is extremely sparse, some recent data on *usage* can illustrate the gap in access to financial services by a large percentage of the population in many countries. Referencing the study on usage of financial services from the “alternative financial institutions,” cited in box I.5,⁵ Patrick Honohan estimated that 6 per cent or more of the population accessed credit from one of the alternative institutions in only 5 of the 119 countries on which data were collected; over 70 countries had less than 1 per

⁴ As may also be seen in the table, the average loan size of the Latin American NGOs was less than half that of the larger microcredit providers. This suggests that one should be wary in interpreting statistics that show the average loan size of an institution rising over time, as the institution could be significantly increasing its outreach to poor people at the same time as its average loan size rises. There are also questions of different credit methodologies, loan terms and payment intervals that make using average loan size a problematic indicator of outreach to poor people. By the same token, there is a common practice of measuring average microcredit loan size in a country relative to its per capita income. This can give misleading indications in cross-country comparisons. The idea of the indicator is that a smaller average loan size relative to income per person would indicate relatively more lending to poor people, as they would borrow smaller amounts. However, imagine that the institutions of two countries lent the same amount to the same number of people of the same absolute poverty level, but as the countries had different per capita incomes, the one with the higher per capita income will appear to “better” serve poor borrowers as its average loan size relative to per capita income will be lower.

⁵ See box I.4 for general categories of financial service providers. For a definition of alternative financial institutions and a detailed reference of financial institutions included in the study see CGAP (2004, p. 2).

cent coverage (Honohan, 2004, p. 6). The situation was somewhat better on the savings side. Deposits in alternative institutions were held by over 8 per cent of the population in one third of the countries. This is still not satisfactory coverage in those countries, let alone in the other two thirds of countries. Honohan notes, moreover, that none of the data sets even attempted to deal comprehensively with the coverage of either insurance or payments services.

Clearly, much work has to be undertaken before financial sectors in developing countries become inclusive.

A vision of inclusive finance

While appreciating the variety of approaches, the richness of diverse experiences, and the differing policies among countries, one may discern a vision of inclusive finance that can be widely shared. The ensuing chapters will elaborate on that vision. But it may also help orient the reader to try to describe it at this point.

The vision begins with a goal: supported by a sound policy, legal and regulatory framework, each developing country should have a continuum of financial institutions that, together, offer appropriate products and services to all segments of the population. This would be characterized by:

- (a) access at a reasonable cost of all households and enterprises to the range of financial services for which they are “bankable,” including savings, short and long-term credit, leasing and factoring, mortgages, insurance, pensions, payments, local money transfers and international remittances;
- (b) sound institutions, guided by appropriate internal management systems, industry performance standards, and performance monitoring by the market, as well as by sound prudential regulation where required;
- (c) financial and institutional sustainability as a means of providing access to financial services over time;
- (d) multiple providers of financial services, wherever feasible, so as to bring cost-effective and a wide variety of alternatives to customers (which could include any number of combinations of sound private, non-profit and public providers).

To achieve this goal, financial services for poor and low-income people should be seen as an important and integral component of the financial sector and various types of financial institutions, based on their own comparative advantages, should see it as an emerging business opportunity. Inclusive finance should be part of any financial sector development strategy.

A number of other important considerations need to be taken into account to accomplish this vision.

First, the individual in his or her society must enjoy the right to fair treatment. This requires financial policies and practices that do not tolerate discrimination by gender, ethnicity, or other characteristics that should be seen as irrelevant to financial services availability. It requires protection of customers’

rights and enforcement of that protection, recognizing that financial market abuses of customers have been common.

Second, the vision also recognizes that the ability of customers to do business with financial institutions depends on their degree of financial literacy. Especially in communities in which people are not used to handling debt, education about the dangers as well as opportunities of borrowing are essential, not to mention counselling for the over-indebted and appropriate personal bankruptcy legislation. Promoting financial literacy increases access as well as the ability of customers to get the financial services they need on appropriate terms.

Third, the vision must be cognizant that historically some civic or government intervention has typically been required to open access to appropriate financial services for poor and low-income people on sustainable terms, in particular by setting in place the systems of incentives for a broad range of financial services providers to step in. Policymakers have accommodated a variety of legal models for financial institutions and allow different sizes, forms and methods for institutions that seek to provide financial services to poor people. Multiple types of financial service providers (private, non-profit, and public) may very well coexist in competitive economies. Public/private partnerships are also possible.

Fourth, while some financial policy interventions may be necessary, they should not be prisoner to short-run exigencies. Policy should take a long-run view on access. This means that financial services should be provided on a sustainable basis. In this regard, governments can decide to give subsidies or special tax benefits, but they should take into account the lessons of many countries over many years, and they should be sure to aspire to sound practice. Whether in the form of providing incentives or removing disincentives, these measures can be adopted as conscious policy. Incentives should find transparent expression in annual government budgets, where they may be judged against alternative uses of public funds. Choices will differ from country to country, but they should all be aimed at efficient, effective and sustained access to the most services by the widest share of the population. The goal should be that no one is excluded from accessing appropriate financial services.

Finally, the vision is dynamic and eclectic. It sees the possibility of new forms of service provision arising through technological and financial innovation. Indeed, it welcomes them, especially when they hold out the promise of further breaking down the impediments to access to financial services of underserved populations. It follows that regulation and supervision of financial institutions should make room for financial service providers to innovate to enhance access, as long as this does not impede the fundamental imperatives of financial institution soundness and financial sector stability. Some individual countries will find greater interest than others in different institutional forms and regulatory interventions, but they should all be alert to changing opportunities and constraints. What the vision requires, in other words, is being open to progress.

Overall policy context for enabling inclusive finance

Much of the discussion in this book examines how the financial sectors of developing countries support or impede financial inclusion. There are also a number of overall policies that are complementary requirements for building inclusive financial sectors. Those policies are warranted for reasons that go

beyond consideration of financial inclusion per se. They pertain to creating and then assuring an enabling economic environment for development. As the nations of the world agreed in the Monterrey Consensus in 2002, governments of developing countries have a crucial role to play in creating an enabling domestic environment for development, just as the international community has a parallel responsibility to provide an enabling international economic environment. The crucial importance to financial inclusion of seven of these policy areas needs to be acknowledged before entering into detailed discussion of financial sector issues in the following chapters.

Growth with equity. Policymakers seek to foster economic growth and strengthen opportunities for poor and low-income people to raise their incomes and build assets. This is frequently done through “pro-poor” public expenditure and appropriate land tenure policies. Public expenditure programmes that strengthen physical and communications infrastructure, boost human development through investments in education, health and nutrition, and assure adequate social protection and personal security should complement policies for inclusive financial sector development.

Macroeconomic balance. Macroeconomic balance must be an essential target of policy. A macroeconomic policy framework with excessive government deficits will crowd out credit to the private sector to the degree that they draw from the general private credit pool. But an excessively tight macroeconomic policy chokes off economic growth and private demand for credit. Financial volatility due to “hot money” rushing into and out of an economy can also destabilize the financial environment. Macroeconomic policy requires paying close attention to the balance sheets of the financial sector, the non-financial private sector and the government, in particular regarding its short-term foreign liabilities and assets. The art of making macroeconomic policy is in finding the balanced policy package that holds inflation down to tolerable levels while facilitating adequate and sustained growth of output and employment. In this package, interest rates should reflect the real cost of credit in an environment favourable to increased financial intermediation and the development of capital markets.

Robust institutions. General institutional weaknesses in a country impede its development. These weaknesses can include poor public sector governance, including limited effectiveness of the courts (particularly in the areas of contract enforcement, collateral and bankruptcy), as well as excessive and corrupt bureaucratic procedures. Other weaknesses include traditions of obscurity in business accounting and reporting, inadequate ancillary services for credit-risk management (inefficient and incomplete property registers, absence of credit bureaux or rating agencies), and the cash-based nature of the economy. Inherent information asymmetries are hard to overcome in such an environment. This leads to high transaction costs for financial institutions and clients, an inability to manage risk, and biases against certain segments of the market. This problem is notably worse in poorer developing countries and disproportionately affects SMEs and poor households in all countries. It raises the overall cost of doing business.

Healthy financial sector. Appropriate policy, legislation and regulations are essential to enable the banking system to withstand financial shocks, serve a growing economy, develop markets for financial securities, and promote long-term as well as short-term financial intermediation. With regard to expanding financial access, as will be discussed in more detail in subsequent chapters, governments need to foster an appropriate oversight infrastructure to increase the flow of information, allow the broad

range of financial institutions to offer financial products suited to the needs of poor and low-income people, and promote prudential regulation. The successes and failures of direct government provision of a range of financial services, and under what conditions they advance access, are also covered in subsequent chapters.

Protection of the public. On some occasions, governments need to intervene directly in the economy to protect the public. At other times, they can be most effective in protecting the public by promoting competition among private entities. Adam Smith's warning remains as germane today as it was almost 230 years ago: when enterprises can get away with it, they will collude against the public purpose and for their own private gain. It is the responsibility of government to protect the interests of the people when they cannot reasonably be expected to be able to adequately protect themselves. This may require, for example, legislating consumer protection that forces financial institutions to reveal the full costs of their loans and other financial products. This is also a focus of discussion later in this book.

Competition, diversity, level playing fields and transparency. Policies to assure that the buyer has options from which to choose are necessary in market economies as a general proposition. Traditionally, this means promoting competition by facilitating entry of new competitors. In the case of finance and in a world of consolidating global financial institutions, it means maintaining a diversity of types of financial service providers. Overall, countries differ in how they respond when firms have excessive and lasting market power. In some cases, the firms have been broken up. In other cases, they have been regulated. In yet other cases, they have been tolerated as long as they do not engage in prohibited anti-competitive practices. In general, governments should promote a level playing field (as through design and even-handed implementation of fiscal, regulatory and supervisory tools) and judiciously define their own roles in financial markets. Finally, assuring consumer choice means fostering an information infrastructure to provide transparency and deliver appropriate and full information to market participants.

The dynamics of political economy. Underlying political and economic dynamics are important for policy reform. The difficulties of policy reform are less about economic engineering than moving "the art of the possible" in a positive developmental direction. In countries in which relatively small and well-connected elites control the major levers of power, as when family conglomerates control the main financial institutions, poor and low-income people are unlikely to have high priority. Reforms in such cases will be part and parcel of a broader political struggle. We also do not lose sight of the deleterious forces of sexism, racism, xenophobia, homophobia and ethnic and class discrimination that operate in the world today, undermining the basic principle of fair treatment of all people.

Like everything else, government intervention can be of better and worse quality. Policymakers need to learn from "government failure" and "market failure," and policies need to be determined by dialogue among all the relevant stakeholders, including the private sector and civil society. Finding the best policy interventions in any situation is usually most effective when it is an iterative learning process.

In conclusion, increasing access to financial services by all segments of the population requires that strategies be turned into effective policy measures. This requires that adequate attention is focused on financial inclusion today, tomorrow and the next day. We believe the payoff to doing so is very high. First, it will enrich overall financial sector development. Second, by increasing the economic opportu-

nities of poor and low-income people, it will help make economic development itself more inclusive. Third, more inclusive development will be more rapid development, as more widespread and sustained growth of the incomes of lower-income households will translate into additional growth of national markets and economies. Fourth, balanced and sustained economic growth helps support political sustainability as well as social progress.

The Heads of State and Government who gathered in Mexico in March 2002 and adopted the Monterrey Consensus began their declaration stating that their goal is “to eradicate poverty, achieve sustained economic growth and promote sustainable development as we advance to a fully inclusive and equitable global economic system” (United Nations, 2002, para. 1). This requires strong international economic cooperation in many areas. In our view, it will require policies aimed to fully include poor and low-income households in development and that provide for inclusive financial sectors.

Chapter II

WHAT LIMITS ACCESS TO FORMAL FINANCIAL SERVICES?

“Poor women and men have shown the world that they are bankable, attractive customers of financial services.”

Women’s World Banking, 2005, p. 6

There is no question that poor and low-income people use basic services from financial institutions when they are available, accessible and appealing. They become customers, in some cases for life. But they will stop using a financial service when they decide it does not meet their needs. There is also ample evidence that poor and low-income people simultaneously use both informal and formal sources of finance when the latter are available. However, the majority of people who use informal financial services do not have the option to choose between the two.

People also make judgements about what they expect from financial services providers. They know how much they are willing to pay for those services in time and money, although they can be fooled. What people “demand” is very much shaped by what the market offers to them, and the market is often not very friendly to potential poor and low-income customers.

In investigating demand, one needs to compare the more encouraging experiences in usage of financial services by poor people with the less encouraging ones. One needs to ask why, for example, the Equity Bank in Kenya was able to increase the number of savings accounts from 39,380 in 1998 to over 430,000 in 2005. Or why Al Amana of Morocco increased the number of borrowers from 7,885 in 1998 to 160,600 by the end of 2004.⁶ One needs to ask as well why only one third of the Brazilian population has a bank account, when one half of the population is considered “bankable” (Kumar, 2005, p. 3). Or why a quarter of those who are unbanked in South Africa were previously banked (Porteous, 2004, p. 25).

Research initiatives that gather new forms of data from customers provide important lessons. For example, financial diaries of 42 Bangladeshi households indicated that financial amounts (i.e., sums of all financial transactions) were formed by informal means in 9 out of 10 cases, when 26 MFIs provided services to these households (Rutherford, 2004, p. 67). Household financial diaries prepared in rural and urban India reveal the use of over 48 types of financial services and devices, with an average of one transaction every 2 ½ weeks, accounting in aggregate for roughly 130 per cent of household annual income. Yet only 10 per cent of diary keepers borrowed from banks (IDPM, 2002, p. 2). Financial diaries in South Africa revealed that rural and urban households used 17 different financial instruments over the course of the year, with an average of four savings instruments, two insurance instruments and 11 credit instruments. About 70 per cent of the instruments were informal ones (CSSR and FinMark, 2005, p. 4).

⁶ Statistics for Al Amana are from the MIX Market, accessed June 2005. Available at www.mixmarket.org. Statistics for EBS from the EBS website, accessed July 2005. Available at www.ebsafrica.com.

Clearly, poor people use a variety of financial services all the time, although the formal financial sector does not appear to figure predominately in their financial lives. A central question about the use of financial services from the perspective of the customer is how much it results from customer reluctance to seek services and how much from negative perceptions about, or other factors related to, potential customers on the part of financial institutions.

This chapter asks what the main factors are that shape the market for financial services used by poor and low-income people. Are there excessive constraints that limit customer demand for financial services? What accounts for how suppliers perceive potential customers and sell to them? The answers given here should be understood as a distillation of experiences and hypotheses that may be considered by stakeholders when examining their own national situation.

Issue 1.

Who you are and where you live matters

Personal and cultural characteristics of potential customers appear to have a large role in shaping — and often discouraging — use of financial services by poor and low-income people, as do education and location.

Cultural norms matter

Cultural factors are routinely mentioned in surveys and interviews as constraints on usage of financial services. Some serve as barriers to access and others discourage potential customers from seeking access. While some cultural barriers are reinforced by the legal system, others are based on deeply rooted social traditions that influence how people treat each other in society. Several of the most prominent constraints on demand include:

- rigid economic class and caste systems that determine social standing and occupation;
- historical exclusion of ethnic minorities and language barriers that are tied to how the dominant society perceives minorities and discriminates against them;
- religious beliefs and practices which follow accepted social norms and expectations as well as advice of local religious leaders; and,
- the stigma of poverty, which results in discrimination and self-exclusion.

Gender matters

A major cultural issue in many countries that deserves special attention is gender bias. Access to credit is limited for women who do not have or cannot hold title to assets such as land and property or must seek male guarantees to borrow. There are often legal requirements that enterprises be registered in a man's name, whether he is present or not, effectively limiting a woman's access to credit from formal financial institutions. These limitations often extend to a woman's ability to open a savings account and accumulate assets under her own name. Women often do not control cash flows from economic

activities, their own ability to work, or their own mobility. Women's literacy rates are generally lower, compounding the other constraints on their demand for financial services. Indeed, most loans from agricultural development banks go to men even when women own agricultural and agricultural-related enterprises.

Many microcredit operations have sought to counter gender bias by focusing on serving women. But targeting women customers is both praised and criticized. On the one hand, targeting women strengthens access and can help to achieve social justice and development goals. Also, managers of financial services often favour women borrowers owing to their high diligence and trustworthiness in repayment, making them desirable clients. On the other hand, there is evidence that targeting women may lead to family, social, or cultural tensions and sometimes leads to the rather deceptive practice of men sending women to borrow, a practice labelled "loan diversion." A survey of bank managers in Madhya Pradesh in India notes:

"While many managers believed women clients compared well to men, being superior in trustworthiness (73 per cent), repayment (80 per cent), and skills in enterprise development (62 per cent), more (87 per cent) thought that allocating credit to women resulted in men using women to obtain loans" (Jones, et al., 2003, p. 152).

However, gender bias does weaken in some circumstances. The condition in post-conflict situations is an unfortunate example, as many women become the sole support for their families after years of war lead to displacement and the social and economic breakdown of society. Gender bias also weakens when there is high rural-urban or international migration, where the traditional male breadwinner works overseas or in urban industrial areas. Women increasingly open home-based or village-based economic activities or become the end users of remittances and domestic money transfers.

Age matters

There is an age bias in the financial industry that also extends to financial services for poor and low-income people. Financial service providers usually target the middle of the economically active population, often overlooking the design of appropriate products for older or younger potential customers. To some degree, this is a response of the institutions to cultural or economic factors that make younger and older clients less likely customers.

Another constraint on demand for financial savings among older populations in rural areas can be a preference for non-institutional means of savings, such as livestock investments, which they have traditionally made or have used to protect the value of their wealth in inflationary times. Competing placements for savings, such as investing in the businesses of other family members, also appear to limit demand for financial instruments by the older population. Insurers, especially life insurers, routinely exclude older populations from their policies, or provide reduced benefits once people reach a certain age. This is true worldwide, for actuarial reasons.

On the other side of the spectrum are youth who have little experience in business and no credit record. Such young people are effectively blocked from borrowing. Youth are not seen as good prospects

for classic group guarantee lending methodologies. Their most likely guarantor is a family member who already participates in a group credit arrangement. Youth may also be effectively prevented from opening savings accounts in financial institutions because of legal age limitations or limited income to save. Another factor is low financial literacy, from which comes low interest in such services. Many financial institutions with a social mandate, credit unions, and private commercial banks that have a far-sighted view of their customer base, consider this a problem they should address. For example, the Government Savings Bank of Thailand has developed a programme to involve students in banking at an early age (see box II.1).

Box II.1.

The “school-based banking scheme” in Thailand

The “school-based bank” is a model bank operated by students, with their teachers and the staff of The Government Savings Bank (GSB) of Thailand playing an advisory role. Students who behave well and have a sense of responsibility and thoughtfulness are selected to serve as the manager, finance officer, counter-service officer, and teller. Deposit and withdrawal services are provided before the morning class or during the lunch hour. The GSB branch that plays an advisory role performs audits and collects savings after the banking hours of the school-based bank.

Support from GSB for the school-based bank includes training on banking operations and the provision of equipment. Passbooks and printed forms are specially designed for the purpose. It is important that the administrators of the participating schools are aware of the value of the scheme and give their full cooperation. GSB also provides the students who participate in the scheme with scholarships, educational material, and it organises study tours for them (WSBI, 2004, p. 17).

Legal identity matters

Lack of legal identity is a significant barrier to accessing financial services. This often affects women and ethnic minorities most directly. Many people do not have identity cards, birth certificates, or written records that are often needed to prove who they are or to prove ownership of assets. In areas affected by civil strife and conflict, records are often lost, destroyed or left behind, and recording facilities are inactive or no longer accessible. Economic and political refugees, migrant workers, and ethnic minorities who have no national legal identity are also often excluded from accessing financial services.

Lack of land title and unclear or absent laws on the ownership of assets serve as significant barriers to accessing formal institutional finance, particularly credit. In countries where the overall legal system is weak, including areas of property rights and collateral law, local authorities often have great discretion in deciding who can access credit. To borrow, many people must legally register their enterprises no matter how small. The steps may be cumbersome, lengthy and expensive. In such cases, licensing requirements for would-be entrepreneurs (time, number of permits, and expense) create barriers to demand for credit. Hernando de Soto, Chair of the United Nations High Commission on Legal Empowerment for the Poor, stated the problem dramatically:

“There are three questions that are always asked: ‘What’s your name — identify yourself?’ Most people in the world cannot identify themselves, at least not legally. Second: ‘What is your address? Most people don’t have an official address.’ And third: ‘What company do you work with?’ Most people don’t have an official company. That’s the world of microenterprise. That’s the world of the informal sector, the informal economy or the shadow economy” (Interview with Opportunity International, February 2005).

This notwithstanding, some financial institutions seek to cope with this constraint. Stuart Rutherford, Chairman of SafeSave in Dhaka, Bangladesh, recognizes the importance of this issue for access to financial services:

“It is very common for MFIs that work in many developing countries to offer savings and loan accounts, and even insurance, to people who do not have identity documentation of the sort that is enjoyed in developed countries...[We] have considered providing our own clients with a plastic identity card (preferably a smart card with some embedded information) that our clients could use not only to make secure transactions with us but to help them with identity recognition when dealing with other private and public entities that they come in contact with.”

What you have learned matters

Limited literacy, particularly financial literacy, is often cited as a significant constraint on demand. Limited literacy includes lack of basic mathematics and business finance skills, as well as lack of understanding of what a bank does. People with limited literacy skills are also often unaware of their rights and can be taken advantage of. “Financial illiteracy can certainly lead to the self-exclusion of some people from access to some products. In other cases it can result in consumers making wrong and irrational decisions about their choice of products and in their greater exposure to increased risks of fraud and theft” (Peachy and Roe, 2004, p. 14).

Without literacy skills, potential clients feel intimidated by banking systems and procedures that include complex contracts and documentation they cannot read and do not understand. They are reluctant to trust an institution with its documents and forms and hidden decision-making powers. A personal relationship is more appealing. This type of relationship is based on face-to-face contact, pledging their word on simple agreements, and allowing the affixture of thumb prints and marks rather than signing complex contracts replete with detailed legal provisions.

Limited literacy also reduces a potential customer’s ability to seek out services that may otherwise be available. There are self-imposed limits on demand in the nature of: “I cannot read. I do not understand this. There’s nothing out there for me.” However, as customers gain experience with financial services, financial literacy increases. When appropriate services are available, experienced customers become adept at understanding loan contracts, requirements of financial service providers, the value of savings accounts, the technology of transferring funds through formal arrangements and working models of insurance.

Some financial institutions are adept at innovating and adapting technology to provide quality services to customers who would otherwise remain excluded due to their limited education. Their customers begin to access a broader range of services when these institutions purposely seek to design product and service delivery methods tailored to customer circumstances and preferences. In this regard, PRODEM's experience in Bolivia using technology to overcome language and literacy barriers is instructive (see box II.2).

Box II.2.

Smart technology and customer illiteracy

PRODEM FFP is a Bolivian MFI that is authorized to take savings deposits (a *fondo financiero privado, FFP*). Many of the rural areas where its branch offices are located lack communications infrastructure. As a result, developing an automatic teller machine (ATM) network with a real-time, always-on connection was economically infeasible, at least until volumes adequate for economies of scales were reached. About 27 per cent of PRODEM FFP's customers cannot read or write and many do not know how to sign their names. In addition, a significant number of rural villagers speak only the indigenous languages of Quechua and Aymara. A traditional ATM that uses on-screen text as its primary communication mechanism was not a realistic approach. Many people in rural Bolivia are unfamiliar not only with the concept of an ATM but also with the concept of a Personal Identification Number (PIN) or other type of identification code. In many cases, they have never had to memorize an identification number. A system that required a PIN seemed unlikely to succeed and likely to require significant customer support to explain the approach and deal with forgotten PINs.

PRODEM's smart card solution allows customers to withdraw funds from any PRODEM FFP Smart ATM and to withdraw or deposit funds at any PRODEM FFP branch without filling out a deposit slip or withdrawal form — an obvious advantage for customers who cannot read or write. Further, since digital images of a customer's fingerprints are stored in PRODEM FFP's customer service system, customers can "sign their name" by making an ink impression with their finger. Moreover, a voice-driven ATM that uses indigenous languages and colour-coded symbols is obviously much easier for many of PRODEM FFP's customers, as well as more respectful of their cultural differences. The result is a system that is more secure, provides superior customer service, and broadens PRODEM FFP's appeal and reach to new customers (Hernandes and Mugica, 2003).

Where you live matters

It matters whether potential customers are located near or far from a branch outlet of a formal financial institution, although effective distance is as much about transportation infrastructure as physical distance. Large urban neighbourhoods and densely populated areas have more access (as in Bangladesh, Brazil, and South Africa), which appears to be related to the mobility of the population in and out of their neighbourhoods rather than true proximity of branches, service posts or mobile outlets. In this regard, a household survey in Brazil found that the wide regional disparities in bank service provision could be significantly ascribed to differences in population density and income. But it also found that disparities in financial access could be at least as significant between neighbourhoods within a city as

between regions of the country. Factors such as hours of operation or distance, which suggest physical inconvenience, were not important in an urban-based survey (Kumar, 2005, p. xxiii).

Rural populations generally have a harder time accessing financial services by being distant from central places and thinly dispersed. Remote areas, as distinguished from rural areas, are least well served. The lack or poor condition of road networks blocks access, especially during rainy seasons when many rural areas are inaccessible. However, as roads and telecommunications begin to link previously isolated areas to the national economy, opportunity, goods and services, including financial services, follow. Nevertheless, high costs of obtaining basic infrastructure services, such as energy, appear to impose significant constraints to enterprise development and thus limit demand for financial services.

In addition, highly mobile populations that have no fixed or formal address find legal and service delivery constraints on accessing financial services. Highly mobile populations have no track record within local communities or with local authorities and institutions. There is no one to vouch for them as part of a group lending methodology or to serve as a guarantor.

Finally, insurgency in a location can significantly constrain demand for financial services, although demand is often high in areas affected by conflict or neighbourhoods affected by violence. There would be high demand for a safe place to save and obtain credit for commercial businesses that operate on the fringes of areas affected by violence or conflict. When mainstream financial institutions cease working in the area, demand for alternative providers is pushed to a higher level. The risks involved from both the customer perspective and the supplier perspective — in moving money or in building assets in businesses that can be destroyed overnight or raided by marauding troops of different factions — are considerable and also present considerable constraints on demand. As an individual from the Democratic Republic of Congo stated in the UN/World Bank Institute e-conference on building inclusive financial sectors in March-April 2005: "...the minimum standard for a financial structure is absent, and the informal sector is growing in order not to die from the burden of life."

Issue 2.

How you make your living matters

The interest of potential customers in accessing financial services depends on what services they perceive as valuable to support their economic activities and social obligations, their financial status, and what services are available to them from mainstream or alternative financial institutions.

Level of income matters

People who are not economically active express limited demand for formal financial services. Conversely, growth of economic opportunities can increase demand for these services. For example, a discussant in the Asia regional meeting held in preparation for this book said that in Papua-New Guinea, 80 per cent of the population is rural; people save, but do not use banks for saving or credit. However, when some groups (coffee growers, for example) organized cooperatives and found export markets, they began to demand banking services.

Even if lack of economic opportunity limits demand for formal financial services, it does not eliminate it. While destitute people are a less likely market for microcredit, they may wish to draw on micro-savings services. Formal sector savings accounts that require high minimum balances are out of reach for this group. Having to save in small quantities generally affects whether savings are brought to formal or informal institutions (Peachy and Roe, 2004, p. 18). Some institutions have introduced flexible savings accounts that allow balances small enough for even the lowest income group to maintain. The following statement in this regard was offered by a customer of SafeSave in Bangladesh:

“So I’m a beggar — that doesn’t mean I don’t need to look after my money. Don’t I have a future too? Don’t I have a daughter I need to marry off? So let me save a few *paisha* a day — it soon builds up in my account” (Rutherford, 2003, p. 9).

In fact, financial status of customers is always important in gaining access to financial services. Extremely poor people find difficulty in accessing financial services even when the services are tailored for them, for example, when collateral requirements for loans are removed. Perception barriers and income discrimination among potential members in group-lending programmes may exclude the poorer members of the community. A participant in the e-conference mentioned above related the following experience:

“My organization is a pro-poor microcredit provider in Limpopo Province, South Africa — The Small Enterprise Foundation or SEF. One of the constraints on demand that we encountered about ten years ago was socioeconomic. SEF originally started with the Micro Finance Credit Programme under the assumption that small initial loan sizes and Grameen-type groups would ensure that most clients came from the poor. After some analysis SEF discovered that due to the dearth of available credit, non-poor and less poor membership was the norm and that the very poor were not accessing our product....

“The primary reason was [low] confidence [in very poor people within the group]. SEF then created a second programme that specifically targets the poorest one third of members of a community via [the] Participatory Wealth Ranking (no one above a certain score is eligible for a loan). We use active marketing to this population and have provided them with more support mechanisms, especially for our newer centres (where groups meet fortnightly). The programme is now actually larger than the original and serves as the model for our expansion. The demand was there, we just needed to meet it via another route than we were using.”

Type of occupation matters

Many commercial banks have not developed the capacity to evaluate loan applications from SMEs, especially for smaller scale, new enterprises. Prospective entrepreneurs have to mobilize financial resources elsewhere. In Jordan, for example:

“The availability of funding for starting up and expanding businesses has always been a major concern for entrepreneurs, especially when their professional track record is limited. The structure of available traditional banking services in Jordan was never developed to cater to the needs of ‘potentially successful’ SMEs, and therefore most banks did not develop risk assessment capabilities to evaluate applications for funding from smaller businesses. Therefore, entrepreneurs still depend mainly on personal and family support to obtain funding for their ventures” (ILO 2004, n. II.d.3).

Formal financial institutions and microcredit lenders face similar difficulties in extending credit to newly established enterprises which are higher risk for the creditor and the borrower. New micro, small or medium enterprises do not often qualify for loans from microcredit organizations or mainstream financial institutions. Applications from new enterprises are rejected more frequently than from enterprises that have been operating for one year or more. Knowing this, the new entrepreneur is reluctant to submit an application.

This also seems to be how one might characterize financial service opportunities in general for the “missing middle” of firms that are between microenterprises and large ones. This complements an observed reluctance among many microenterprises to try to go to scale. Many such firms are risk averse and unwilling for many good reasons to expand the business. They may diversify activities as a risk-coping mechanism, preferring to manage diverse portfolios of many small activities rather than to grow one. As a participant in the e-conference noted, output and/or employment tends to reach a “steady state;” the enterprise does not grow and average size of the loan stagnates, as well as demand for other services. There is limited “graduation” from microentrepreneurship to SMEs.

The demand for credit gets more of a market supply response in some economic activities than others. Credit for traditional crop agriculturists who rely on rain-fed agriculture has largely been the province of state-owned agricultural development banks in many countries, following the agricultural sector development policies of those countries. Other financial service providers that invest heavily in agriculture limit the percentages of their portfolios invested in traditional agriculture to certain levels, or seek diverse income streams within the rural household as prudent risk management measures.

“Where rural microfinance providers do exist, they are mostly limited to diversified rural economies and to clients with a number of income sources. Rural areas that are not densely populated, or that are dependent on a few principal crops and livestock activities, have generally been avoided by MFIs because of higher transaction costs, price and yield risks, seasonal client incomes, and collateral limitations inherent to the agricultural sector. Conventional microcredit methodologies rely heavily on short-term loans with frequent, regular repayments, which do not fit well with seasonal crop or livestock production (except for poultry)...Flexibility in loan disbursement and repayment is needed, so that finance is available when farmers need it, and repayments match income from produce sales” (CGAP, 2004, p. 1).

Issue 3.

Compromised confidence in financial institutions

A customer's prior experience with financial services from institutions and informal sources will have important effects on willingness to utilize such institutions again. On the one hand, previous exposure to institutional financial services appears to have a positive influence on demand for additional services. With greater exposure, the individual's financial literacy increases. Savvy customers are able to make decisions to access financial services based on features such as the quality of the service and the price. On the other hand, previous exposure to formal (and informal) sources of finance can also have a negative impact on demand. The reasons fall roughly into two broad areas — behaviours of the providers of financial services and the economic environment in which they operate.

Personal relationships with customers

Customers will limit their use of formal financial institutions for a variety of reasons that include knowledge of corruption, theft and mismanagement in the institution, how their staffs treat clients, and the clarity of rules and procedures customers are asked to follow. They also limit their use when they anticipate political influence in decision making by the financial institution, or when they are wary of the organization's attitude toward confidentiality.

In many cases, customers have personally lost savings or know of others who have lost savings in financial institutions as well as in community-based savings and loan funds. Others have witnessed the capture of credit funds by the local elite or experienced the failure of member-based financial associations due to mismanagement by poorly trained staff or by volunteer managers drawn from the membership pool. Poor and low-income people have been vulnerable to fraudulent schemes, outright theft by “fly-by-night” operators and scams, such as pyramid schemes. The experience is not easily forgotten and forms a significant constraint on demand for formal financial services.

In this regard, two surveys in Africa point to positive perceptions of formal financial institutions as places to keep one's savings. A Micro-Save Africa survey revealed that 99 per cent of clients saving in the informal sector report that they have lost some of their savings, while 15 per cent of those saving in the formal sector report that they have lost some savings. The formal sector, for those lucky enough to have access to it, has been safer both in terms of likelihood of losing any savings and in terms of the relative loss (amount lost to amount saved). Those with no option but to save in the informal sector are almost bound to lose some money, probably around one quarter of what they save there (Wright and Mutesasira, 2002, p. 14). In the second survey, FinScope in South Africa noted that customers' attitudes towards banks are generally positive, with safety perceptions a major feature. The survey notes that 73 per cent of respondents (including 77 per cent of the “never banked”) would put a “fairly large sum” in a bank, compared to only 2 per cent in a *stokvel*, an informal community savings and credit club (FinScope, 2004, p. 11).

However, banks are not always regarded as operating transparently. Low-level corruption, where bank tellers ask depositors for “extra fees” and loan officers require kick backs from loan proceeds, is not uncommon in many countries. This does not appear to be a major constraint on demand: customers pay these fees to retain access to services, but they do not like it.

Nor do customers like other types of poor treatment by bank staff. Often bank staffs are not friendly. They may be openly disrespectful or they may discriminate against people of lower socio-economic status or different cultural origin or those who make small deposits or loan repayments in worn notes in small amounts. Poor customers then limit how much they use the institution, as illustrated by a “near-poor farmer, Hasan” from Bangladesh:

“...At first [he] told us that he keeps cash in the bank...Later, when we got to know him better, he told us that in fact the cash was stored with a money guard — a friend with a shop in the market place. Not only was it more convenient to bank with this merchant than with the highly bureaucratic bank, Hasan also confessed that he thought it wise to keep his savings away from an institution from which he had taken a loan, in case the manager confiscates the savings” (Rutherford, 2004, p. 58).

Other practices that limit customer demand may operate at the level of institutional policy, such as changing rules without notice, keeping them ambiguous or ignoring them. “Bookkeeping can be sloppy; clients can lose a proportion of their savings when they close accounts. MFIs often fail to keep their word, promising loans to keep clients happy and then making excuses” (Rutherford, 2004, p. 74).

Interacting with the government is yet another factor that inhibits potential customers from accessing institutional sources of finance. Many potential customers feel safer outside the oversight of the authorities by avoiding formal institutions. Their business may not be registered or have the appropriate permits. An individual or business may not be paying tax. Approaching a formal institution implies entering the formal system which potential customers may prefer to avoid, or may not be prepared to join. On the other hand, there is a sense that the law and the government do not operate fairly. As an African e-conference participant put it: “The rich always have access to the facilities of their choice, while laws and policies are made which scare the poor.”

Finally, some potential customers are unhappy with some of the conventions followed. These may be fair and above board, but nevertheless cause some potential customers to pause before borrowing or investing. This is particularly the case for debt collection practices when they entail rigorous enforcement of a fixed weekly repayment schedule, or those which can bring about community embarrassment or peer group revenge on the occasion of non-payment in a group loan. Often borrowers are discouraged by well-meaning but invasive means testing and community-based group lending techniques that openly rank personal wealth in villages, or reveal loan amounts to others, exposing potential customers to the scrutiny of their neighbours and possibly to exploitative relationships with local authorities.

Impact of national financial developments

Customers’ central fear with saving in a financial institution is losing their funds. This could result from a crisis in the individual financial institution, within the broader financial sector, or in the economy as a whole. Examples of the latter case include inflation that erodes the purchasing power of the funds on deposit. Another example is blocking withdrawal of funds from the banks in crisis or reducing the

value of the funds when withdrawal is allowed. Whether through administrative or inflationary means, it should be considered a major crisis when the financial savings of households are confiscated.

This has happened, however, on a number of occasions, particularly in Latin America. As a result, depositors there are said to be less confident about their deposits than depositors in industrialized countries or in emerging Asian economies where depositors believe the real value of their deposits will be preserved. In other words, depositors are likely to react when a crisis threatens in Latin America by withdrawing funds en masse and creating a run on the banks out of fear that they will suffer a personal loss when the crisis erupts, which is in fact what has been the case historically. It is also said to reflect a lack of confidence in the capacity of the authorities to manage financial crises effectively, fairly and in a timely manner (Inter-American Development Bank, 2004, p. 71).

The central concern of borrowers is not having continued access to credit and having to face the consequences. One experience in South Africa illustrates how borrowers will postpone the day of reckoning as long as possible, falling deeper into debt for as long as the lenders permit it. In that case, a burgeoning flood of borrowing among middle to low-level salary earners that began in 1993 came to a sudden halt in 2000 when the Government revoked permission for certain practices, including automatic payroll deduction for loan servicing for civil servants, on which the microlenders had relied. Borrowers who had no trouble getting loans, including for servicing other loans, suddenly found themselves without access to credit. Banks found themselves with sizable portfolios in default that had been backed by the seemingly secure and now unavailable payroll deduction method of guarantee. In the end, two major banks with large microlending portfolios failed, the small bank sector shrunk, competition at retail banking level decreased, and average bank margins on lending rose (Porteous, 2004, pp. 50-51). It would appear that borrowers were also chastened. Perhaps this was also the result for borrowers in Bolivia, where the crisis included a debtors' revolt, a protracted debt relief negotiation, as well as a shake out of consumer lenders who had jumped into the microlending market without understanding it (see box II.3).

Issue 4.

The attractiveness of the product matters

When we speak of "demand" for financial services, we are in reality discussing what kinds of financial products and services customers would like to buy and in what quantity. Both the financial services themselves and how their availability is marketed are crucial in this regard. To expand access to those who are excluded, providers of financial services have to overcome difficulties in reaching the market with information about their products and services. They may need to target particular messages to particular market segments. Providing better information to the customer helps to improve understanding of the product's features, benefits and obligations. The ultimate requirement is to provide the products that customers need, want and value enough to pay for. While it is not feasible to introduce an extensive discussion of product varieties, some observations may be made on aspects of the general product categories of savings, credit, payment services and insurance.

Box II.3. The microcredit upheaval in Bolivia

After the hyperinflation crisis of the mid-1980s and the strong structural adjustment policies that followed, Bolivia saw a dramatic growth of small-scale enterprise, especially in commerce, as traditional employment in mining and state enterprises fell away. The economic shift provided a golden opportunity for microfinance to serve this emerging market (Marconi and Mosley, 2005, p. 3). The early microcredit organizations worked with banking authorities and donors to transform into banks and non-bank financial intermediaries.

Problems arose when Bolivian consumer credit companies began to crowd into the microcredit market in the late 1990s. Since these credit companies did not have the know-how to analyze a client's ability to pay, they used the fact that an applicant for credit had borrowed or had a current loan from an MFI as proof of creditworthiness (Von Stauffenberg, 2001, p. 3). "Clients capitalized on the increased competition, often maintaining two or more loans at a time, borrowing more than they could handle. Some let repayments slip, or worse, they began bicycling loans — using the proceeds of one loan to pay off another" (Rhyne, 2001, p. 2).

The over lending coincided with the onset of a major recession and borrowers found themselves trapped in debts that spiralled into crisis proportions. Bolivia began to experience heightened social unrest, with mass protests about the prices of basic utilities like water and electricity. "Microfinance, too, felt the anger of the powerless. Interactions with clients started to sour, as loan officers spent more time wheedling collections from customers faced with too much debt and shrunken demand" (Rhyne, 2001, p. 2).

In this politically charged atmosphere, two "borrower associations" formed that tapped into people's growing desperation. Both associations worked on the same principle: for a fixed membership fee of Bs. 50 (roughly US\$8.50), they promised debt relief through borrower revolts. Their appeal was powerful and their membership swelled to huge numbers. Not surprisingly, with municipal elections looming, political parties were attracted to a cause that enjoyed such obvious popular support (Rhyne, 2001, p. 2).

Shortly thereafter, the debtors' associations threw their own leaders in jail. In one association, leaders illegally collected debt service payments due to the microlenders and used them to make new loans. Another association's leaders mishandled membership dues, a less spectacular crime, but it was enough to bring them down. After a few months' hiatus, the associations resurfaced with new leaders. In addition to debt forgiveness, their demands included prohibitions against certain collection practices, extended grace periods, longer loan terms, and annual interest rates of 2 per cent. Tactics escalated. In the most extreme example, in July 2001, demonstrators carrying dynamite took over the Superintendency of Banks, holding employees hostage and threatening to blow up the building (Rhyne, 2001, p. 2).

The major consequence has been to politicize microfinance, as microloans were rescheduled in response to the demands of “debtors’ cartels.” The experience also points to important lessons about the risk management techniques of all credit providers that work in the same market and the importance of information sharing infrastructure, such as credit bureaus, in mature markets where a number of organizations actively compete. The Bolivia experience also points to lessons about the relationship between the financial service providers and their customers. While the established microfinance banks weathered the crisis and continued to expand, albeit with historically high arrears, the consumer credit microlenders held little customer loyalty, experienced high default rates, and all but one closed. Microcredit NGOs had diverse experiences, although those that fared best appear to have been organized by women on a “village banking” model of community responsibility for loan repayment, which includes an emergency loan facility for members as a limited kind of insurance (Marconi and Mosley, 2005, pp. 7-12).

Savings accounts

As noted in Chapter I, the financial service in broadest demand globally is safe savings. When financial institutions are not available (and often even when they are) individuals frequently save through informal means, as in rotating savings and credit associations (ROSCAs). They also save by hiding cash or in some places by giving cash to a “money keeper” who may be a local merchant, moneylender or neighbour. People often pay a fee for the service, in essence a negative interest rate, to keep their savings safe. People save in non-financial forms as well, including jewellery and livestock. In most cases, saving is not a matter of being frugal, but of being able to survive through difficult periods, as well as to meet a variety of social obligations.

The question from the perspective of the prospective customer is whether safe, appropriate institutional savings services are on offer and accessible. In a recent survey of urban adults in Brazil, for example, 64 per cent of the people who did not have bank accounts reported interest in having one. Among the voluntary reasons for not opening an account, the dominant answer was high fees (Kumar, 2005, p. xxiii). The problem continues to be a general one across countries, even through some banks and licensed financial institutions have responded by designing products meant to be attractive and affordable. In South Africa, the private banking sector has developed a special “Basic Bank Account” or *Mzansi* account that has no general fee and carries a fixed charge for transactions above the monthly transactions cap. The account is limited to small balances to discourage regular customers from switching to it (Porteous, 2004, p. 34).

On a larger scale and with a longer experience, Bank Rakyat Indonesia has built a customer base of over 25 million people not only by reducing the minimum opening amounts and required balances, but also by providing 3,900 small sub-offices at which to bank (Armendáriz de Aghion and Morduch, 2005, p. 147). In India, one way the disincentive to formal saving owing to distance and time to make deposits has been addressed is through dispatching savings agents that collect small savings on a commission basis under various government-supervised programmes (Swarup and Bhattacharya, 2004, pp. 150-152). In another approach, ANZ Bank teamed up with the United Nations Development Programme in Fiji to deliver small-scale banking services to over 150 rural communities and 100 schools on six trucks that are independent of electricity, phone lines or buildings (Blacklock, 2005).

Customers do not like savings accounts that are not under their control. This has been a feature of the savings products of a number of organizations where funds in compulsory savings accounts cannot be withdrawn until the individual leaves the programme. Compulsory savings are widely intended to “promote the savings habit” as well as to provide a way for the lending operation to introduce a collateral substitute. They also serve to mobilize funds for on-lending, if the institution is permitted to intermediate them. Grameen Bank, the pioneer of the methodology of lending to groups of clients, required complementary compulsory savings but began to change its approach in 2000 by introducing more flexible savings accounts and loans under “Grameen Bank II” (Armendáriz de Aghion and Mor-duch, 2005, pp. 149-150; Rutherford, 2004, p. 5; Yunus, 2002, pp. 4-5).

Credit products

The central innovation in the last quarter century in increasing access to credit of poor people is, of course, microcredit, whose principles and product features are well known.⁷ Small, short-term, repeat loans, often building to larger amounts and allowing for relatively unrestricted use, were compatible with the outlay and income patterns of poor households and enterprises. Motivation for repayment, as well as risk assessment, was built into the product and delivery technology through joint liability groups, character-based collateral substitutes and repayment incentives that relied on repeat access to services.

As crucial as the microcredit revolution has been, it has not provided the full range of credit products needed by poor people. The one-size-fits-all working capital loan entails inflexible terms, rigid loan cycles and amounts that are only suitable for microbusinesses with high turnover or those that produce regular weekly or monthly cash flows. The inflexibility of the product limits its usefulness to people who operate businesses with irregular cash flows, or require higher (or lower) amounts to support their businesses. Customers may use the inappropriate credit product, may not qualify for it, or may simply decide not to borrow. As noted earlier, it is not an accident that organizations offering microcredit largely eschew agricultural lending.

The narrow range of products usually offered by microcredit lenders also does not meet major household life cycle needs for credit, particularly for long-term investments such as housing. While emergency loans are often found in some large group credit methodologies, such as village banking and in credit unions, they are hard to come by in many formal financial institutions. Credit offerings are also limited for the diverse requirements of growing microenterprises or SMEs.

Microcredit operations offer loans that carry higher interest rates than commercial bank lending to prime customers. This reflects the higher costs of administering a portfolio made up of many small loans of small amounts. In addition, microcredit customers often pay a number of hidden transaction costs. For example, attending a series of regular meetings or group training sessions that are conditions for accessing credit often requires borrowers to close their businesses during these times, forgoing income and often permanently losing customers to competitors. When documentation requirements are excessive, additional transaction costs are imposed on borrowers, especially those who do not un-

⁷ For a review of the principles and practices of microcredit lending and why it works, see Rhyne and Holt (1995). For a more in-depth review, access UNCDF's *Microfinance Distance Learning Course*, available at www.uncdf.org/mfdl.

derstand forms and cannot read the fine print of loan contracts. Borrowers take it upon themselves to consult local literate scribes to “translate” these documents. Such hidden transaction costs, as well as fees paid to local officials to sign off on loan applications, can be higher than the interest paid on the loans (Morduch and Rutherford, 2003, p.15; Robinson, 2001, pp. 210-213; Srivastava and Basu, 2004, pp. 13-14).⁸

Microcredit operators have long argued that access to credit is far more important to borrowers than receiving a subsidy to alleviate the full cost of the service. As long as interest rates are lower than those on offer from the sources of credit poor people could otherwise access, principally moneylenders, and credit can be accessed with clear terms and free of hidden obligations, experience has shown that there will be a strong demand.

Many microcredit providers nevertheless seek to reduce the borrower’s transaction costs by opening branches in convenient locations and requiring simple standard procedures that fit the characteristics of their borrowers. Costs also tend to decrease as physical and human infrastructure is built — the two most costly factors in a microcredit operation. In fact, reduced transaction costs are among the most important factors enhancing customer demand for microcredit.

While the social goals of microcredit providers lead many of them to seek to reduce costs while expanding access, many observers consider competition to be a more reliable way to reach these goals. As competition increases for increasingly savvy customers, interest rates tend to drop owing to market pressures to decrease costs through improved efficiency, increased scale and new technologies. “The most powerful mechanism for lowering interest rates in microfinance is competition. In competitive markets, efficiency has improved and microcredit interest rates have declined” (Helms and Reille, 2004, p. 11).

Competition, however, may be a long time coming in any given market or work only slowly to reduce customer costs. High interest rates for microcredit thus can and have become an irresistible political target in some countries, particularly during an economic downturn when borrowers find their earnings expectations disappointed while their repayment obligations remain unchanged. The outcome is often a legislated interest rate ceiling which constrains microcredit operations and their expansion into higher cost areas and markets (see Chapter V for a discussion on interest rates). Offering a broad range of credit products may not be economical or within the current capacity of some financial institutions (see Chapter III). For example, long-term loans generally require collateral, which requires appropriate appraisals of its value within a reasonable period of time and confidence of the financial institution that it can take possession should default occur. In addition, many small microcredit operations have not been able on the whole to manage diverse credit products or to meet the needs for larger working capital and fixed asset loans. There is thus good reason that a variety of financial institutions in addition to microcredit organizations — including credit unions, savings banks, postal banks and commercial banks — are required to offer a full range of financial services to poor people.

⁸ While the extent of bribe paying is not well-documented, several studies have noted that bribes can range from 10-40 per cent of the loan amount (Srivastava and Basu, 2004, p. 14) and out of pocket transaction costs, unrelated to bribes, can be 20 per cent of the loan amount, whether the loan is approved or not (Robinson, 2001, p. 211).

Payment services

One service valued by customers everywhere is safe, quick and low-cost payments service. Higher income customers find a greater need to make financial payments, as for taxes, utilities or other goods and services. While low-income customers are unlikely to have current accounts at banks and make most of their payments in cash, they seem poised to increase use of financial payments instruments, such as local and international transfers. This is in part because the financial sector is being rapidly changed by technological advances that increasingly make transfers financially feasible and safer. In part, the response is also due to increased official scrutiny of payments services, especially internationally, owing to heightened concerns about money laundering and the financing of terrorism. As more transactions have been pushed into the formal financial sector, their high cost has increasingly received political attention, leading to political pressure to bring down the fees charged.

In fact, the competition among many financial firms that have been attracted to newly appreciated profit opportunities in international worker remittances has pushed down the charges. The cost for transferring US\$200 from the United States to major Latin American destinations had been on the order of US\$40 in the late 1990s and was comparably expensive elsewhere. Overseas residents preferred sending money home through informal money transfer systems. Not only were the latter cheaper than formal transfers, they were also confidential, if less safe. By 2002, however, the cost of such transfers had halved, at least in the main corridors, which were witnessing rapid growth. Donald Terry, Manager of the Multilateral Investment Fund at the Inter-American Development Bank, which has launched a number of innovative projects to channel remittances into community-level financial institutions in the region, told the May 2005 consultation gathering views for this book that: “The total aggregate of remittances to Latin America and the Caribbean through formal channels during this decade is conservatively projected to reach more than US\$450 billion, even taking half the current growth rate. The numbers are staggering under any scenario.”

One example of the technical innovations that are driving the change in the industry is the use of refillable stored-value plastic cards. This modality is beginning to gather momentum for making and receiving payments, for purchases from merchants, and as a way to serve the lower-income “unbanked” populations. Cards can be made available to individuals without bank accounts because other parties may transfer funds into the cards, including employers and relatives in other countries in which a partner programme exists through which to initiate the transfer (Jacob et al., 2005).

In many countries, old technologies nevertheless retain a role in making financial payments, including those of the postal system, which is the institution with the most widespread physical presence in most countries. Of course, usage of different payment systems differs in different countries. In countries in which residents would hesitate to use the postal system to mail anything of value, it is unlikely they would use it to transfer money. In other countries, the postal system is widely considered safe, even if often bureaucratic, and where they exist the postal banks provide a range of directly affiliated financial services (see Scher and Yoshino, 2004, on a number of Asian experiences).

Changes are nevertheless occurring in the postal-based systems. The traditional way to make a payment or transfer funds within the postal system, the postal money order, is increasingly being overtaken by other postal financial transfers, such as electronic “giro” accounts in countries that maintain that

system. The Universal Postal Union facilitates both traditional and new transfers among member countries, and Eurogiro, an international network mainly of postal financial systems, has been developing an alternative standard instrument for international transfers.

In addition, the World Council of Credit Unions (WOCCU) has developed a cross-border payment system for its members, called *IRnet*, which allows migrants to make remittances at low cost. Also, a global partnership with MoneyGram has added credit unions as senders. Partnerships of financial institutions like La Caixa in Spain or large banks in the United States (including Citibank, Bank of America, and Wells Fargo) with banks in Latin America are also important initiatives. Other developments have taken place in Singapore, Malaysia and the Philippines, aimed at streamlining the remittances process. Initiatives of card-companies, like VISA, offer new options for remittances as well (IMF, 2005, p. 33).

Market dynamism can be seen in Asia as well as Latin America, as the experience of the Philippines indicates. In addition to traditional money transfer companies, new entrants to the Philippine market include a number of Philippine and foreign-based banks, Internet-based remittance service companies, a large international money transfer agency, and telecommunications and mobile phone-based money transfer systems. The new players bring into the industry more alliances among card companies, banks, insurance, and telecommunication companies. Some go beyond simply offering remittance services for migrant workers by linking their families to livelihood and franchising programmes — as one Philippine thrift bank did — or linking seafarers to an investment and savings product — as a large Philippine insurance company did (Asian Development Bank, 2004, p. 44).

While the new electronic payment services are primarily an urban phenomenon, making payments to residents in rural areas — “going the last mile” — has remained a challenge. As the cases of Cambodia and Ghana illustrate, however, finance can quickly follow physical infrastructure development and serve rural areas with new technology:

“ACLEDA Bank tapped into a latent demand for local money transfers by increasing branch and service post presence. They followed the development of roads and telecommunications infrastructure to Cambodia’s isolated provinces. On-line networks in less isolated areas enabled urban customers to send money to relatives in villages, and small and microenterprises to send payments to suppliers and receive transfers from buyers. This system replaced the informal system of using friends and taxis to transport cash — a system that was often unreliable and unsafe. Product usage grew from 1,000 transactions in 2000, appealing to development projects and institutions sending funds to their offices in rural towns, to over 50,000 in 2004. The average size of the transaction decreased by almost 260 per cent, showing a higher penetration in the market of smaller transactions particularly urban factory workers sending portions of their salaries home to the village” (Clark, 2005, pp. 194, 224-225).

“Apex Bank is a central treasury for the rural banks of Ghana, a network of more than 100 banks representing over 400 points of service, some in villages as small as 500 people. Market studies in the rural areas served by these banks revealed that

clients were having difficulty accessing transfers from urban areas in Ghana. Crime made it especially difficult for traders, who carried large sums of cash on their person for business...Apex Bank developed the 'Apex Link' domestic money-transfer system. The service uses proprietary software to manage money transfers between rural banks using coded messages sent by phone, fax, or express mail. Turnaround time is between 15 minutes and 24 hours, and transfers can be made from an account or in cash, making the service accessible to customers and non-customers alike" (Isern et al., 2005, p. 5).

Insurance

Insurance is a traditional non-bank financial service, but one that has thus far found a smaller market among poor and low-income populations than credit and savings. Insurance is a fundamentally different type of financial service than savings and credit, requiring different sets of skills, financing delivery and institutional expertise.

Over centuries, people in poor and low-income communities have pooled resources to help each other out in difficult times. Through burial societies, ROSCAs and strong community and social networks, such as "the friend in need" system in Uganda, and the "pulling together" culture in Kenya, people create mechanisms that help them to manage the financial risks in their lives (McCord and Osinde, 2003, p. 1). Yet these important community social systems generally offer very specific services and do not mobilize large enough resources to protect people against loss from a variety of frequent events, such as sicknesses, crop failure, drought, accident and loss of property and income-producing assets.

If the population covered by insurance were visualized as a pyramid of workers and entrepreneurs who can make regular premium payments or on whose behalf such payments can be made, then it might look like the figure in box II.4. The population group with the greatest vulnerability is generally found outside the formal economy and outside the pyramid. Over two billion people worldwide are not covered by any type of formal social security protection. Workers in the informal economy usually do not have access to any insurance services. The most pressing need is usually for health insurance (CGAP, 2003, p. 29).

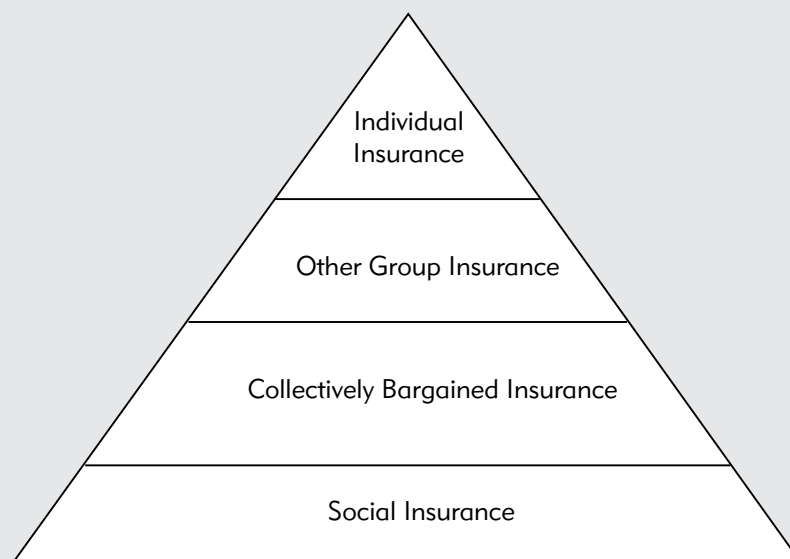
One response is microinsurance, a relatively recent product line:

"Microinsurance is the protection of low-income people against specific perils in exchange for regular premium payments proportionate to the likelihood and cost of the risk involved. Low-income people can use microinsurance, where it is available, as one of several tools to manage risks. Other tools include community-based mutual support systems; risk avoidance and reduction; access to other risk-managing financial services such as savings and emergency loans; and social protection options available through the state. Together, these tools form a complex matrix through which low-income people manage their risks" (CGAP, 2003, p. 1).

Microinsurance is not simply downsizing commercial insurance products; it requires new and different products that specifically respond to the low-income market. The risks faced by poor people are much the same as those for most individuals but often with greater frequency, and with a relatively greater financial impact. Because low-income people often reside and work in higher-risk areas, they

Box II.4. The insurance pyramid

The Working Group on Microinsurance of CGAP has illustrated the range of modalities for insurance provision in what it called the “insurance pyramid.” It comprises:



Social insurance is at the bottom of the pyramid and provides the broadest coverage. Definitions of social insurance vary greatly, but they generally have two necessary elements: they have been established through a political process, and they are compulsory for all concerned. They may be financed by general tax revenues, by special taxes, levies or charges, and run by government institutions, special-purpose institutions or the private sector. They commonly provide a degree of income replacement in case of work-place accidents, sickness, disability, retirement, unemployment, maternity (and paternity) leave, as well as income support for rehabilitation.

Collectively bargained insurance is offered to many employee groups and covers various insurances — for life, health, supplementary accident and sickness, retirement benefits, and others — agreed on through collective bargaining between trade unions and employer associations, firms or government (civil service).

Other group insurance is offered through various types of affinity groups — trade unions, professional associations, cooperatives, church groups and others. Insurance coverage can range from traditional group life schemes through a variety of products, up to and including special insurance needed uniquely by members of certain trade associations (for example, commercial fish farmers). These schemes can vary greatly in their structures, from compulsory schemes for everyone in a particular group and with one premium paid centrally for everyone, to schemes where joining up is voluntary and where each individual covered pays the relevant premium.

Individual insurance is offered by public and private insurance companies. Individual insurance generally covers life, health, auto, and other individual needs. Insurance companies collect premiums directly from the individual.

At the bottom of the pyramid, compulsory schemes covering large segments of the population are the least expensive to administer and do not require traditional underwriting. The further one climbs up the pyramid, the more marketing and sales costs are incurred, the more underwriting is required, the greater the transaction costs involved, and the more costly the scheme is to operate (CGAP, 2003, p. 27-29).

are endemically subject to relatively greater risk. As they have little, if any, money to respond to a risk, their vulnerability is even further exacerbated (CGAP, 2003, p. 30).

In East Africa, as elsewhere, several models of microinsurance delivery are being utilized for health insurance. These models include hospitals and clinics that create prepaid or risk pooling coverage for people at their facilities. For example, BRAC and Grameen Bank in Bangladesh use similar models, but manage their own clinics, or offer health care and insurance separately (Ahmed, et al., 2005). Other approaches include community-based models owned and managed by members who absorb all risk, retail financial institutions or health management organizations that absorb risk, or a partnership where the insurer retains the risk (McCord and Osinde, 2003). Health insurers that intend to provide services for poor people are still grappling to find a balance between offering a broad coverage to meet clients' needs and charging affordable premiums. In general, these services are not yet provided on a sustainable basis.

A number of financial service providers and regulated insurers are also beginning to offer insurance products to the low-income market. For example, AIG, a global insurer, works with almost every MFI in Uganda, covering 2.9 million people with microinsurance for accidental death. Regulated insurers like Delta Life (Bangladesh) have downsized insurance services and offer a long-term savings product (annuity) with life insurance at a premium affordable by poor people (Cohen and McCord, 2003, p. 2). The Delta endowment product is versatile, marrying the advantages of savings in small amounts, ability to borrow against the surrender value of the contract, and insurance (McCord and Churchill, 2005, pp. 55-56). Over half a million Guatemalans have access to life insurance and 54,000 have a microinsurance policy for funeral services and accident coverage through COLUMNA, an insurance company created by Guatemalan credit unions. Nearly 90 per cent of COLUMNA's clients are members of the 35 credit unions affiliated with the Guatemalan National Federation of Credit Unions; most live in rural areas and work in agriculture and the informal economy (Herrera and Miranda, 2004, p. iii).

The most common type of microinsurance offered through lending institutions is loan life insurance which serves to protect the lender more than reduce vulnerability of the borrower. It is often compulsory. These insurance policies pay the outstanding amounts due on a loan should the borrower die or become incapacitated. The cost of the insurance is usually built into the fees for the loan and the lender may itself manage the insurance programme through a special reserve fund generated from the fees or it may out-source this risk to specialized insurance agents or companies. In recognition of the complexity of the busi-

ness, savings banks tend to outsource the design and administration of such policies to a separate entity, which could be an insurance company owned by the savings bank (WSBI, 2004, pp. 27-28).

Like the Delta Life product offered in Bangladesh, other insurance products are linked to savings, most commonly life insurance policies that build “cash value” on which the insured can borrow or withdraw cash. These policies include contractual savings plans with an insurance component, so that if the saver dies before reaching the savings goal, the policy pays the shortfall (as for a house or a child’s education). These policies are offered by regulated insurers, such as Delta Life, and a number of savings banks including BancoEstado in Chile, Banco Caja Social in Colombia, the Government Savings Bank in Thailand, and the postal savings banks of Benin and Burkina Faso. Other types of insurance are less common, although Banco Caja Social offers a policy called *poliza del hogar* which covers damage to property and civil liability towards third parties (WSBI, 2004, p. 29).

In some markets, introducing microinsurance has not gone smoothly. Several pilot microinsurance plans have found that people often prefer credit and savings to insurance as ways to reduce vulnerabilities to unexpected events (McCord and Osinde, 2003, p. 6).

“...The risk-pooling concept is not clear to many poor households or subscribers of microinsurance policies. They do not differentiate between prepayment and insurance. Fundamentally, premiums are perceived as payment for services one is entitled to access within a year rather than a long-term payment schedule to permit the access to services when needed. Clarification of this and other insurance concepts is fundamental to the success of any microinsurance initiative” (Cohen and Sebstad, 2004, p. 51).

In other words, lack of clarity about how insurance works, what it covers and claim procedures constrain demand of clients and potential clients. Confusion is well illustrated by examples from Kenya and India:

“One of the ladies in *Tusaidiane sisi kwa sisi* in Nairobi’s South B had insured her business against fire, paid premiums of Sh. 600 per month for two years and then ‘All that money! I stopped.’ Many people are not sure they are getting value for money if ‘the risk does not happen’ (Cohen and Sebstad, 2004, p. 52).

“One borrower had deducted 500 Rs. for an insurance plan. She however does not know what it is for; only that it is a *vima* (insurance). She had been severely ill last year and had spent a few thousand Rupees for hospitalization and treatment. She did not file for claims. She did not know she could. No one told her. [Other clients think] the insurance covered health problems only. She had her house burnt down in a riot in 1995–96. She did not make any claims. She did not think she had insurance coverage. [Others find] the paperwork was difficult since doctors often did not provide receipts” (McCord et al., 2001, pp. 25-26).

Customer confusion about insurance products, what they are willing to pay for them and how to file claim extends to many microinsurance efforts. From the supplier side, microinsurers are finding

that the most promising avenue for providing these services is through partnerships with insurance companies that already possess the skills and the expertise. There is still a large difference between what financial institutions think is important, for example loan life insurance, and what potential clients think is important: health, life, property and livestock insurance. In short, the insurance sector is at an early stage in providing services that poor and low-income populations find attractive in reducing their vulnerability.

Conclusion

There is a large number, diversity, and complexity of reasons why poor and low-income customers do not seek — or are not offered — more access to formal financial services. In some cases there is a latent demand that innovative financial services providers can bring out. In some cases the demand cannot be satisfied by the financial products or delivery methodologies currently being offered. In all cases, poor and low-income people want financial services that match their needs to better manage their households and businesses. These needs are not surprising: convenient, affordable, flexible, permanently available, reliable and safe financial services. In all cases, financial institutions have been more successful in unlocking demand or stimulating it when they “look through the eyes of the customers.”

In the next chapter, we turn our attention to the supply side of the issue and ask: what are the main constraints retail financial institutions find in providing services to poor and low-income people?

Chapter III

WHY RETAIL FINANCIAL INSTITUTIONS CAN SERVE POOR AND LOW-INCOME PEOPLE BETTER

*“The ultimate proof that poor people are bankable
is that their banks are bankable as well.”*

Multilateral institution interviewee

Financial services offered to poor and low-income customers in developing countries have grown rapidly in recent decades. Evidence is that demand grows when financial service providers understand what customers use and value and then offer products and services customers want to buy. When these operations function with appropriate pricing and efficient, streamlined institutional structures, they can become profitable business ventures that reach a scale necessary to be increasingly significant players within a vast market. And yet, most of the bankable poor people of the world are still unbanked.

The crucial question for inclusive finance is: why, despite the diversity of institutions and over two centuries of institutional experience, are poor people still so poorly served? The operators of these financial service providers are governments, independent civic organizations, social entrepreneurs, and for-profit enterprises. Why do they not reach more poor people?

It is widely recognized that an enabling policy environment is an *important* condition for increasing access, but it is not a *sufficient* condition. Furthermore, the overall business environment affects the willingness of financial institutions to extend credit beyond short-term secured loans. Beyond these considerations, increasing access to financial services for unbanked and underbanked people involves innovation in products and the means of reaching customers, improved capacity in retail organizations, adequate financing, skilled management and building supportive infrastructure.

This chapter looks at constraints to supply at the level of retail financial institutions. An examination of why supply does not grow faster or in more places can be approached in different ways. Constraints include those internal to the financial institution and those constraints found in the supporting infrastructure, regulatory frameworks and policy agendas. Chapters IV to VI focus on the factors external to the financial institution, including those in financial markets, the regulatory framework and the policy environment. While in some senses this division is artificial, the issues discussed in this chapter are those that are to a greater extent within the control of the institutions.

A review of why retail financial institutions have been slow to expand in the market segment of poor and low-income households and firms serves two purposes within the national dialogue. First, it may help stakeholders understand which parts of their own market different organizations might decide to enter and under what conditions. Second, the review may be helpful in assessing priorities for investment.

This chapter is organized around three main issues:

- The first issue addresses general constraints to increasing supply, such as perceptions of the market, business strategies and reasons retail financial institutions may or may not decide to serve the market or expand services in favour of poor people and firms. It involves a discussion of the diversity of legal and organizational forms.
- The second issue focuses on the more detailed constraints suppliers face. Factors such as pricing policies, managing risk, selecting products to offer, achieving economies of scale and scope, and increasing efficiency are addressed.
- The third issue is a forward-looking one. It addresses the question of innovation, and why some institutions are more dynamic than others. The issue of governance is considered.

Issue 1. Profitability, risk and incentive structures

The historical starting point for the involvement of “alternative financial institutions”⁹ in financial services for poor and low-income people was that commercial banks, the standard source of retail financial services, did not serve this clientele. Alternative financial institutions grew in response, including state-owned agricultural, development, savings and postal banks, member-owned savings and loan institutions, and low-capital local and/or rural banks, and the range of specialized banks and finance companies that offer microfinance (CGAP, 2004, p. 2). Many were chartered to offer only limited services, were restricted to use only by members, or were directed by governments to serve only priority sectors of the economy, such as agriculture. This left the vast majority of poor people, including urban entrepreneurs and households, bereft of financial services, particularly credit.

In the past two decades, financial liberalization and other policy reforms in many developing countries opened spaces for innovation in financial technologies (Westley, 1999; Gonzalez-Vega, 2003, p. 20). In other countries, early pioneers started microcredit as part of poverty alleviation strategies, not with the specific aim of linking to the financial system. In both cases, perhaps for different reasons under different conditions, many organizations grasped the opportunity to expand the boundaries of the supply of finance to unbanked populations. They did so by innovating in the marketplace. These early innovators included NGOs and NGOs that have since transformed into commercial enterprises, credit unions, retail banks and national networks of state-owned retail banks.¹⁰ Yet, because the market segment of poor and low-income households and firms is so large and is growing, the supply of retail financial services continues to fall behind. In fact, there is a general perception that alternative financial institutions, despite their outreach and infrastructure, probably serve only a minority of the clientele they were created for, and many suffer significant limitations (CGAP, 2004, p. 3).

⁹ The term “alternative financial institutions” is used consistently with the study cited.

¹⁰ Early innovators in the market include Bank Rakyat Indonesia, a state-owned bank; PRODEM, an NGO in Bolivia that later transformed into BancoSol, a private bank, and developed PRODEM FFP, a specialized finance company dedicated to microfinance; Grameen Bank, Association for Social Advancement (ASA), Bangladesh Rural Advancement Committee (BRAC) and Proshika in Bangladesh, which hailed from NGO origins; and credit unions, in particular, a significant early movement of Guatemalan credit unions and their national Federation (FENACOAC).

Profitability

The profitability of serving poor households and firms is a main concern for many retail financial institutions — those with a “double bottom line” as well as those which seek to maximize profits. Many financial service providers are not “profit-maximizing,” although they are “profit-seeking.” For example, credit unions seek to provide a positive return to their members through savings accounts and dividends and to build capital reserves to facilitate growth and ensure safety. Microcredit NGOs seek to use retained earnings to expand their portfolios. Commercially chartered financial institutions, including those that have transformed from NGO origins into commercial or specialized financial institutions, seek profits for all of these reasons and also seek to provide a return to shareholders. Commercially oriented state-owned banks seek profits so as not to drain the national treasury, but also to provide a positive return to savers, who often make up the greatest number of their customers.

Commercial retail banks, on the other hand, seek to maximize profits. Motivations, however, may be starkly different between a small, local, privately owned commercial retail bank and one that focuses on serving national corporate clients. By contrast, some NGOs, government institutions, donor- and government-supported projects do not seek to become profitable; their primary aim is to serve as a channel for disbursing funds. Organizations and projects of this latter type are frequently designed with a limited life span or are established to be financed with a designated budget allocation.

There are two ways to assess the profitability of serving the low-income end of the retail market. The first is whether serving poor customers can be a profitable business enterprise, and the second is whether it is relatively profitable when compared to other possible lines of the business. The main questions retail financial institutions ask when assessing the profitability of entering or expanding in this market are: Are poor and low-income people more risky? Is the business profitable enough? Are the incentives within the corporate culture, core business model and growth strategy compatible with serving this market?

Risk

The profitability of serving poor clients depends on the product or service in question. Historically, the central service offered in microfinance has been microcredit. In addition to the questions of cost, revenue and volume, the lender needs to know how high the risk is that clients will default, which would represent a significant drain on income and a reduction of income-generating assets.

It is not uncommon for microcredit operations to report risk levels and loan losses in their portfolios well under those of conventional bank lenders in the same countries. One of the earliest lessons of microcredit was that poor people repay their loans and are creditworthy customers (Christen, 1997, pp. 16-17). Risk mitigation strategies adopted by microlenders demonstrated that repayment depends fundamentally on factors within the control of the lending institution. In contrast, many early development finance organizations gave a high-risk image to poor and low-income people by failing to implement their own institutional risk management measures. The image, unfortunately, still lingers.

Some international surveys of private and state-owned bank managements have found relatively modest concern about high risk in lending to poor clients or a decreasing concern as the market be-

comes more familiar with this type of lending.¹¹ Acción International found in a recent survey that banks regarded microlending as a way to reduce overall risk:

“Interviewees mentioned two types of diversification that occur when commercial institutions enter into microfinance: 1) microenterprises are thought to have little correlation with traditional business cycles and to be more resilient during economic downturns; and 2) a portfolio of microenterprise loans spreads the risk over thousands of businesses, at least theoretically unrelated, throughout the economy, so called ‘atomization.’ These aspects of diversification may appeal to larger downscaling institutions already operating in parts of the economy with different risk profiles” (Chowdri, 2004, p. 13).

In addition, the risk of lending can be mitigated with better information on borrowers. Solidarity groups mitigate risk through information that is common knowledge among members of the group. When credit bureaux begin to include information on microentrepreneurs, the lender has more information on which to base the loan decision for individual borrowers. In that respect, experience of the Peruvian Superintendent’s support for including information on loans below US\$5,000 in the public credit bureau and fostering privately managed credit bureaux has led to increased bank lending to the micro and small enterprise market:

“Credit professionals in Peru report that [credit bureaux] have improved the quality and lowered the cost of the credit decision. They have also reduced the waiting time of applicants. There has been an impressive expansion of credit access for microentrepreneurs. Banks have begun to compete with each other to lend to this sector. If the results of this case study are verified by similar results in other countries, risk-mitigation strategies may prove to be a powerful and cost-effective strategy for expanding microfinance access” (Guillamon, et al., 2000, pp. 6-8).

Comparing the profitability with other lines of business

Clients who require small loan amounts and maintain small savings balances are relatively more expensive to serve than customers who borrow for larger amounts or maintain savings accounts with larger balances. We return to this question in more detail under Issue 2. Yet, microfinance can be a profitable business venture. For the more than 500 MFIs reporting to the Microfinance Information eXchange (MIX), return on assets usually averages higher — often much higher — than the return of commercial banks in the same country.¹²

¹¹ Only 17 per cent of 72 banks sampled in one study cited risk as a disincentive in micro and small enterprise lending, compared to 40 per cent citing high administrative costs and 32 per cent citing lack of personnel and a network geared to the market; 29 per cent cited interest rate controls as a detrimental factor (Jenkins, 2000, p. 6). This can be compared to an earlier survey that found risk a greater concern about lending to micro enterprises (Baydas et al, 1997).

¹² MIX/CGAP analysis (publication forthcoming), using MFI data from www.themix.org and commercial bank returns as reported in Bankscope.

The high costs of serving small-scale borrowers and savers are offset by charging higher prices and designing products that limit other costs for the institution. Retail institutions engaged in this market also design products that reduce non-financial transaction costs for customers, thereby reducing the total cost for customers to access the service. The question then becomes: is providing financial services to poor and low-income people profitable enough to attract more retail financial institutions into the market?

What services are profitable enough?

The concept of “inclusive finance” is one for special consideration because serving the low-income end of the market is often not perceived as a major profit opportunity when compared to other lines of business. In discussing why more commercial banks are not more involved, a senior manager of a credit union association suggested that:

“Ample experience demonstrates that microfinance services can be profitable if appropriate rates are charged, but there is the perception and possible truth is that they are not as profitable as other ways that capital can be deployed.”

A wide variety of retail financial institutions have found that micro and small scale lending is profitable enough. They have also found that microsavings combined with broader savings mobilization initiatives decreases the blended cost of funds. Credit unions have been particularly adept at intermediating members’ savings, including very small account balances, to support loan products for their members. “By serving a diverse group of people from different social and economic strata, credit unions can help more poor people than if they only focused on the poorest of the poor” (Lennon and Richardson, 2002, p. 98).

“The Guatemalan credit union movement was one of the first to discover this important principle. In 1987, the entire movement of more than 20 credit unions had mobilized only US\$ 2.8 million of savings deposits and member share accounts. By offering convenient service, market returns and institutional security, 11 credit unions with a user base of 199,332 people, were servicing more than US\$80 million in 345,000 accounts at year end 2000, resulting in an average savings account balance of US\$233. Of that amount almost 302,000 accounts had an average balance of US\$37. It is interesting to note that while the credit unions provided a very valuable service to the poorest...they also provided a valuable service to other groups of poor and low-middle class people. Even though lower middle class accounted for only 16,064 accounts, they provided more than US\$55 million, or 69 per cent of the total volume of savings and share accounts. Were it not for this group of people, the Guatemalan credit unions would never have had the necessary liquidity for onlending purposes” (ibid., pp. 98-99).

By 2004, 26 Guatemalan credit unions had 550,000 members, US\$279 million in savings deposits, and a combined portfolio of US\$207 million (WOCCU, 2005, p. 3).

While some savings banks, such as postal savings banks, are restricted to providing savings and fee-based services, many also have loan portfolios that serve poor and low-income people. The weight of microloans in their portfolios ranges from modest to significant. Savings banks are often the major providers of small savings accounts in countries where they operate (WSBI, 2004, p. 19). Savings banks, because of their “proximity services,” often dominate the payments market, including combining social welfare benefits with savings accounts (*ibid.*, p. 16).¹³

Commercial banks have traditionally discouraged small-scale savers by setting high minimum balances or transaction fees. This is often cited as a major challenge for commercial banks to provide savings services to poor and low-income people. Yet innovation in product design, such as South Africa’s *Mzansi* accounts, limit cost by restricting the number of transactions per month. Savings banks within the WSBI network also offer a range of products that limit administrative costs for the institution and offer savings services to the lower segment of the market.

Increasingly banks that extend microcredit to poor clients — regardless of ownership or mandate — have sought to raise net income from their client relationship by providing additional services on which they earn fees. These services include bill-paying, debit and stored-value cards, and money transfer services. As noted in Chapter II, this can take the shape of specially designed product offerings or partnering with other financial services providers, as for insurance and remittances, or forming alliances with NGOs and community-based entrepreneurs, such as the ICICI experience in India (see box III.1).

Incentives and disincentives to serve the market

Retail financial institutions can make a profit providing financial services to the low end of the market. However, they still may choose not to provide them. If this new line of business competed for managerial talent and investments from other profitable lines of business, financial institutions may opt not to allocate these scarce resources. “If banks enjoy higher margins on traditional business and are not pressured by competition to search out new markets, it is unlikely that they would seriously consider the microfinance market” (DfID, 2005, p. 5). Factors internal to the firm also influence its decisions on market entry and staying power to expand and succeed. These factors include corporate culture, core business models and growth strategies.

Corporate culture: The role image plays

For many retail financial institutions, corporate image is not a constraint. “While other financial institutions have a profit-driven focus, credit unions understand that their first responsibility is their members and their communities. Credit unions have long understood that doing well by doing good is not just a wish, but an achievable goal” (WOCCU, 2005, p. 1). Socially-oriented financial NGOs, including those that have transformed into commercial banks, continue to expand in the microlending market and offer a number of banking services to poor and low-income customers, such as savings and transfers that a banking license permits (Fernando, 2004, p. 17-22). Other NGOs seek to reach the

¹³ The World Savings Banks Institute (WSBI) describes savings banks and socially responsible retail banks as “proximity banks” — those close to their customers that serve the best interest of the community they operate in. The four main characteristics of proximity banks are geographic proximity, accessibility, sustainability and social commitment.

“poorest of the poor” and complement their financial services with education, health care and business development services.

But some private commercial banks as well as some development-oriented financial institutions have a different self-image. Will bank management and staff welcome poor and low-income people into their establishments? Will there be negative publicity if the bank follows convention and charges higher interest rates on smaller loans to poorer customers while richer customers with larger savings account balances earn higher interest rates and borrow larger loans with lower rates?

Different questions regarding image can be asked of microcredit providers who seek to serve the poorest members of the community. Would an organization that lends to “the poorest of the poor” view approving a loan for a small enterprise or a medium-sized one as compromising its image? Would seeking larger deposits from middle class and wealthy individuals be interpreted as a drift away from serving poor clients? Does the retail institution consider poor people victims or hard-working entrepreneurs and astute managers of money?

Financial institutions weigh these factors before seeking to serve a market segment that may challenge their prevailing image.

Consistency with core business strategies

As in any business, diverse retail finance institutions have business strategies that address how to best penetrate, expand and diversify their business. Strategies develop from what top management believes are the organization’s core competencies — those things that the business does particularly well and competitive advantages. For some banking establishments, the strategy does not even include retail banking. For others, retail banking is the institution’s only business.

Motivation. Serving unbanked customers may be challenged as part of a commercial bank’s business strategy because the historical view is one that is “socially motivated” or “charity-oriented.” This removes consideration of financial services for poor people to the public relations or philanthropic departments of the commercial bank. Such banks might then enter into providing some services to poor clients, but it is unrealistic to expect philanthropy to take precedence over commercial motivations.

Some governments have sought to overcome this reluctance on the part of private banks to serve poor people. One approach has been to require that a certain amount of a commercial bank’s lending portfolio be allocated to priority sectors. Priority sector lending programmes have been a primary motivation for some commercial banks to lend to the low-income segment of the market as they follow the government mandate. But the growth in financial services for the unbanked truly comes when retail finance organizations independently approach the market as a business opportunity, as demonstrated by ICICI Bank in India (see box III.1).

Institutions that benefit from these government mandates have found that they can increase access to financial services when these mandates disappear. This is demonstrated by the experience of the Thai state-owned Bank for Agriculture and Agricultural Cooperatives (BAAC). BAAC formerly operated with funds that commercial banks were required to place with it as part of a priority sector lending programme for agriculture. The experience also points to the power a combined policy reform agenda

and strong institutional management can have on increasing access to financial services for rural people while enhancing the performance of the financial institution.

“Interest-rate controls were relaxed and the requirement that commercial banks hold deposits with BAAC was removed. As one of their responses to these reforms, BAAC made deposit mobilization a major focus of its banking operations. Deposits from rural areas evolved into the single most important source of funds for BAAC...BAAC was a sound financial institution with adequate capital to withstand external shocks, such as inflation and devaluation. It also had robust internal controls supported by a detailed and reliable management information system. BAAC was demonstrably well-managed with good oversight of credit, liquidity, and interest-rate risk. Proper supervision was undertaken by the Ministry of Finance” (Goodwin-Groen, 2003, p. 1).

“By 2003, 5.2 million farm households were registered as BAAC’s clients...the number of savings accounts of almost 10 million provide significant proof that rural clients have high demand for the financial services of BAAC...The pro-active rural savings mobilization of the BAAC led to an almost revolutionary change in the financial resource base. The BAAC has become financially self-reliant and was able to significantly reduce its dependence [on] loans from domestic and foreign sources” (Watchananawat, 2004, pp. 5-6).

Competition and demonstration effect. When competition increases in a bank’s traditional markets, it may seek to diversify its customer base. While competition may be the main driver to expand services, the demonstration effect provided by organizations that already serve poor and low-income people makes this market segment more visible. In countries where there are a greater number of financial service providers serving the poor and low-income market, and long and successful experience, banks can take note of financial performance, observe service delivery models and hire an experienced human resource pool. The point here is that competition alone may not be enough to encourage new market entrants. But when the effects of competition combine with successful demonstration effects, a greater number of formal sector retail institutions frequently venture into the market.

Corporate growth strategies

Some banks have “downscaled” their retail operations to serve the low-income end of the market. Others have already abandoned the effort. In others, performance is sluggish (Valenzuela, 2002, p. 72). That some banks took the initiative indicates that they found the concept attractive enough to overcome the costs and obstacles of market diversification. Reaching new markets with new products is always risky and a costly market growth strategy.

Market research, creating or adopting a new branch network, developing new products, hiring and training staff to handle a new business line and melding this with the existing corporate culture

are some of the main obstacles and costs of market diversification. That some commercial banks have already abandoned the effort suggests that their core competencies and competitive advantage might indeed lie elsewhere. As noted above, it could also mean that the most effective way for some commercial banks to participate in the market might be through partnerships with others, through other forms of linkage, or through mergers with and acquisitions of institutions whose core competency lies precisely in serving the poor and low-income population. Many commercial banks and credit unions already possess many of the essential ingredients, such as sizable branch networks, the means to manage liquidity, access to financial resources, information technology and human capital to serve the poor and low-income market. In this respect, box III.1 illustrates three different approaches from different regions to commercial bank engagement in microfinance.

Box III.1.

Three different approaches to commercial bank engagement with microfinance

Stanbic Uganda: Acquisition, not organic growth

In February 2002, Stanbic Bank, which had only one branch in Uganda, bought a 90 per cent stake in Uganda Commercial Bank Limited (UCBL), a largely retail government-owned bank that operated a 66-branch countrywide network. As part of the acquisition, the Government of Uganda required Stanbic to maintain UCBL's branch network to provide financial services including payments, savings, and rural or microfinance services. The acquisition of UCBL introduced microfinance to Stanbic's operations, which would not likely have been part of an organic growth strategy.

Stanbic's commitment to serving the low-income market shows growth in lending operations and broader access to deposit services. Profitability through lending, a deepened deposit base and additional fee income has allowed Stanbic to maintain and grow its microfinance operations and other activities, particularly in rural areas. In turn, UCBL's clientele, as well as the low-income market segment in general, are benefiting from Stanbic's better management, technology, and competitive market presence. Since acquisition, Stanbic has added a net increase of 150,000 new deposit accounts with lower minimum balances than UCBL while reducing the number of dormant accounts, which had averaged as high as 50 per cent of total accounts at some branches. As of 2004, Stanbic had 29 per cent of the small lending and deposit market in Uganda (amounts up to US\$1,750 per account or loan) and was particularly strong in the rural areas (DfID, 2005, p. 34-38).

ICICI Bank: Innovation and business opportunity

ICICI Bank Group is India's second largest bank and largest private sector bank, with a balance sheet of over US\$30.2 billion, a network of over 560 branches and offices, over 1,900 ATMs and over 10 million retail customer accounts. ICICI Bank offers a wide range of banking products and financial services to corporate and retail customers through a variety of delivery channels and through its specialized subsidiaries and affiliates in the areas of investment banking, life and non-life insurance, venture capital, asset management and information technology.

ICICI Bank has actively sought involvement in microfinance and began pursuing innovative approaches as a business opportunity, positioning for future market growth, rather than simply following government mandates. Their innovations include:

Portfolio Re-discounting. In the world's largest microcredit deal of this type prior to 2004, ICICI Bank issued securities backed by a portfolio of 42,500 loans worth US\$4.3 million that it purchased from Share Microfin Limited in 2004. ICICI continues to work on developing a secondary market for microfinance.

Self-Help Groups (SHG). Encouraged by early results of the Government's SHG-Bank Linkage model, but finding the model too slow, costly and constrained to reach efficient scale, ICICI partnered with NGOs, MFIs, traders, and local brokers as intermediaries and 'service providers' for loans to groups of small and marginal farmers. The tasks of loan appraisal, processing, management and collection are delegated to the intermediary but ICICI funds the borrower directly and the loan does not pass through the NGO/MFI. The bank provides an initial loan to the NGO/MFI to develop SHGs, but then requires that the NGO/MFI repay the loan in a few years and become a viable unit through charging service fees to the groups directly. ICICI has piloted the ICICI Bank Farmer Service Centre operating model (Mahindra Shubhlabh model) with successful results. Preliminary evidence suggests that this model reaches small farmers (Srivastava and Basu, 2004, p. 30).

Internet kiosks. These kiosks link rural villages by providing a range of financial and non-financial services. Each kiosk, which is equipped with a low-cost ATM, has the potential to become an ICICI Bank franchise in the village. Over 2,700 kiosks have been supported, and plans are on the drawing board to expand the number and the range of products offered, including remittance-linked credit (ICICI, 2005, pp. 58-64).

Although a relatively new entrant in the microcredit market, ICICI has a microcredit portfolio outstanding of US\$138.8 million. It has 1 million microcredit customers and 42 partners (ibid, pp. 31-32).

In Chile: The subsidy auction

"...Microcredit was first established by small NGOs. But none grew to the scale and importance of their Bolivian counterparts. Instead, the Chilean Government directly subsidized the entry of commercial banks into the microcredit market. The Government auctioned off a relatively small lump-sum subsidy for each loan a bank made, with the bank assuming all credit funding and risk. This programme was quite successful. Today, three large banks offer microcredit to about 70,000 microentrepreneurs. The NGOs essentially abandoned the credit market, though many of their former employees now staff the commercial banks' microlending operations..." (CGAP, 2001, p. 6).

It seems clear that a range of institutions can serve the market. There are many different options which rely on different internal institutional strengths. State-owned banks, financial institutions with NGO origins, savings banks, privately owned commercial banks, and credit unions all could serve the market, whether their aim is commercial or social or a combination of both. In fact, the main conclusion that emerges from a review of international experience is a positive one: that increasing supply to

the lower end of the market does not depend on organizational form or ownership structure. Instead, it depends on how well the customer is understood, how well the service is delivered, how consistent serving the market is with core business activities and growth strategies of the potential suppliers, and how much product and service innovation retail financial institutions can devise.

We now turn to a more detailed discussion of scale, costs, efficiency and the models retail organizations have adopted to reach poor and low-income customers.

Issue 2. **“Small is beautiful, but large is necessary”¹⁴**

Certain financial and business considerations must be taken into account if one is to understand how financial services might expand to poor and low-income people, especially if these services are to be provided on a sustainable basis. First, historically microfinance has been a high cost proposition. Cost is the single most common constraint retail financial institutions cite for not serving this market. Second, achieving economies of scale in this high-volume business of small-sized transactions is important from the business perspective, as well as from economic and social development perspectives. There are also economies of scope so that offering more than one product or service can lower average costs, improve income streams for the institution and provide a wider variety of choice to the customer. Third, there are advances in information technology and new innovations that build on past experiences and alliances. Successful models of operation emphasize multiple sales points, standard yet accessible products, and technological and operational innovations that increase efficiency and lower costs.

The high costs of small transactions

The cost of providing financial services to poor and low-income clients has been the subject of extensive analysis over the past two decades. Clients who require small loan amounts and maintain small savings balances with frequent transactions are a less profitable clientele to serve than customers who borrow larger amounts or maintain term deposits with larger balances.

In reality, the cost disadvantage for microlending is higher than a simple mathematical calculation would indicate. Reaching poor and low-income customers that have never used a formal banking service requires more staff time and personal interaction. This translates into additional costs for the financial institution. There are also literacy barriers that must be overcome, orientation to the financial product or service, discussions about borrower and lender responsibilities and obligations, and often distances to travel or communicate over poor infrastructure. The cost of disbursing, managing and collecting instalment payments on many tiny loans, often at more frequent intervals, is significantly more costly than for fewer loans of larger amounts.¹⁵ The dilemma is illustrated by the following:

“A sustainable Indian MFI incurs a cost of only US\$0.25 per customer interaction (i.e., per visit or per transaction). However, due to the high number of interactions, this low

¹⁴ Quote by Fazle Abed, BRAC.

¹⁵ For an analysis of costs and revenues of microfinance, see CGAP (2004).

cost per transaction translates into 25 per cent of operating costs relative to the average loan portfolio. In contrast, commercial banks in India typically have operating expenses in the range of 5–7 per cent of outstanding loans” (CGAP, 2004, p. 3).

By the same token, the cost of mobilizing savings from many small account holders is higher than the cost of servicing a similar large account. In addition, issuing a large fixed-term deposit that is illiquid until the end of the period would be less costly to the financial institution than a large demand deposit. Not only do withdrawal restrictions on small balance accounts reduce operating costs, but there are also prudential regulations with respect to liquidity ratios that must be maintained, and asset and liability management requires institutions to match maturity terms as a prudent practice. On the other hand, costs can be reduced if institutions pay less interest on small balance accounts or restrict the frequency of transactions.

Fee-based services, such as local money transfers, remittances, money orders and bill paying services are considered off-balance sheet financial services, unlike savings and lending. These services generate income without incurring the risk of lending or exposing the institution to risk from withdrawal of deposits. Yet extending these services is not risk free and there are costs in obtaining and managing systems and training and placing staff. Even when these services are provided by a partner, these costs can be significant. Processing remittances and other money transfers can expose the payor institution to increased credit risk. Credit risk occurs when the money transmitter settles transactions with the payor organization with a time lag, such as over the weekend. The payor organization distributes the funds as soon as it gets the transaction information and thus often extends significant amounts of overnight or multi-day credit until the money transmitter organizations reimburse them. Depending on the value of transactions and settlement periods, credit risk for the payor institution can be considerable.

Due to the inescapably higher costs of serving customers who borrow in small amounts, maintain small savings accounts, purchase small insurance policies, and transfer or receive small payments, successful retail finance institutions that serve this market have focused on appropriate pricing strategies, achieving economies of scale and scope, and controlling costs and increasing efficiencies. They have sought models of business operation that promote all of these elements. They also pay attention to customer service because higher costs are associated with first-time customers, especially borrowers.

Pricing strategies

Until recently, microcredit critics and advocates alike focused attention on the pricing side of cost recovery without adequate attention paid to cost reduction strategies and efficiency. But as the discussion above indicates, there are higher costs that must be taken into account regardless of how efficient the models that may be followed are. The importance of cost-recovery interest rates for sustainability and outreach underscores the principle that customers should pay the necessary cost of providing the service. Historically, however, there has been broad public concern to prevent the creditor from exploiting the borrower. Whether presided over by religious institutions or government, most societies have notions of “usury” that sets upper limits to how much interest a creditor can charge. In virtually all societies there is some level of interest rate that is considered immoral and/or illegal.

The problem for microcredit is that while the higher cost of providing a loan justifies a higher

charge than for a more conventional loan, interest rates charged on microcredit are politically sensitive (see discussion in Chapter V). Higher prices for small-scale financial services transactions are thus a concern for policymakers. They are also a concern for retail financial institutions that decide to enter this market. And while a banking establishment may be enticed by the higher interest rates charged by microcredit NGOs, they often find that the costs of serving this clientele and designing business models to reach them greatly outweigh the income generated before economies of scale are achieved. As one study of commercial bank entry into the microcredit market noted:

“Banks must be willing to differentiate their pricing strategy and to withstand and respond to external and internal criticism of these high rates. While the microfinance industry has largely overcome the stigma of high interest rates, it is still an important consideration for banks. A bank may charge the same rate as an NGO, but be perceived by the public as gouging” (DfID, 2005, pp. 6-7).

Economies of scale and scope

Scale of operations was and continues to be a concern of policymakers, in part because the numbers of people without access to financial services is so great that serving a small customer base appears to be an insignificant activity and an ineffective use of national and international subsidies. From the business perspective, reaching scale is also a concern. The basic ability to spread fixed costs over more transactions is a crucial reason for the scale economies. Large retail branch networks find economies of scale in mass marketing their products. Without determining the direction of causality, one recent econometric study confirmed that larger firms tend to be more profitable:

“The pattern of results is rather clear on the question of institutional scale. Larger firms, whether measured in terms of total assets or number of clients, are more likely to be profitable” (Honohan, 2004, pp. 53-58).

Early on, microcredit organizations sought economies of scale and appealed to the mass market as they focused on reaching large groups of people, operating in urban centres, and developing the loyalty and repeat transactions that membership in an organization engendered. Generally, they pursued “horizontal” growth strategies for expansion by offering one standard product, keeping their staff and administrative costs low and their research and development costs down. But there were limits to this type of expansion, especially in less densely populated areas. “Vertical” growth strategies — those that relied on selling a variety of products and services to different customers — allowed institutions to increase the volume of transactions of a single branch unit or of the branch network system, thereby capturing diversity in their product and customer base or “economies of scope.”

Product diversity includes mobilizing savings, as well as developing and offering more diversified loan products, including larger loans for individual microentrepreneurs and SMEs. From the business perspective, the move to diversify products is a healthy one when it contributes to lowering average costs and diversifying income streams. Product diversity also draws new customers to the institutions, as the credit union experience with processing remittance for members and non-members in Caja Popular Mexicana (CPM) illustrates:

“Fifty-six per cent of the non-member receivers joined CPM to access other financial services as a result of receiving remittances there, one of the key goals of remittance distribution through credit unions” (WOCCU, 2004, p. 3).

Diversification can also be a strategy to extend the services of a microlender to the “missing middle” of underserved small and medium sized firms, including former microenterprises. This allows them to access credit to grow, employ more people, facilitate trade, provide inputs to micro firms and purchase their outputs. There is, however, a debate around the desirability of broadening the MFI customer base. The debate hinges on whether the microcredit organization somehow abandons its social *raison d'être* by seeking to serve larger and more prosperous customers to whom it could make larger loans.

Critics of commercially oriented microcredit who claim there has been “mission drift” often base their concern on data showing higher average loan balances of regulated institutions compared to their NGO counterparts. In fact, average loan size of the institution is not a very good indicator of whether the institution serves poor clients well or poorly. The usual statistics show average outstanding loan balance relative to per capita income on the presumption that poor people will borrow amounts that are small relative to average income. That may be, but the *average* loan balance reflects the loans to the middle income groups as well as to customers whose incomes are below the poverty line.

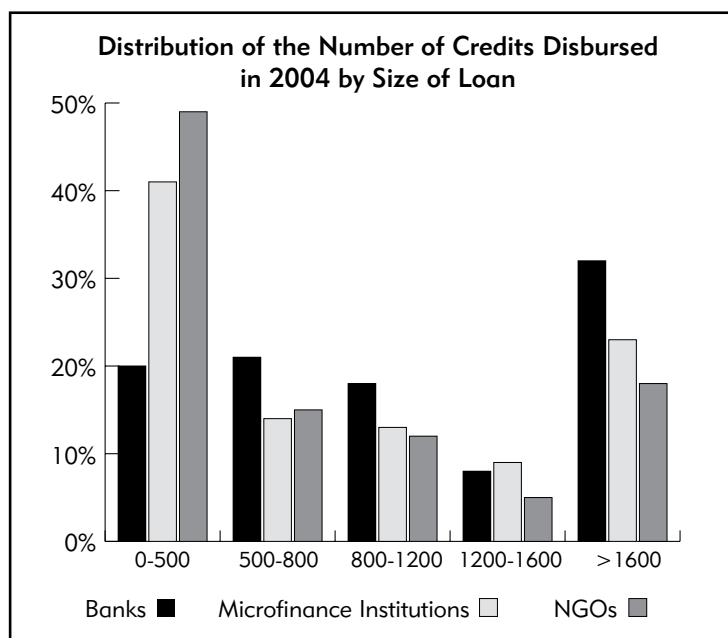
One reason for the calculation of these indicators, however imperfect, is that donors are concerned that their policies to encourage microcredit NGOs to become sustainable and act more like commercial lenders result in their focusing on more wealthy clients. There is, however, no evidence that regulated institutions have specifically limited the number or volume of small loans as a percentage of their total disbursements. In that regard, a recent survey by Acción Internacional noted that disbursed loan size and the number of accounts are more telling indicators of how many small borrowers an institution reaches. A survey of 47 retail credit operations in Latin America found that while NGOs continue to disburse the largest percentage of their loans below US\$500, there is more similarity in the portfolio composition of NGOs, regulated MFIs and commercial bank microfinance operations than might have been thought (see figure III.1).

The survey also reminds us that poverty measurement is much more complex than tying average loan size to whether a financial service provider serves poor people. One striking example is the case of BancoSol in Bolivia. “Forty-nine per cent [of its] clients are below the National Poverty Line, compared to 58% of the total population. This is a MFI that in 2004 had an average loan size of US\$2,088”¹⁶ (Marulanda and Otero, 2005, p. 31).

Similarly, in Asia, the preponderance of evidence suggests that after microcredit operations transform into commercial entities, outreach is greater in absolute numbers, reaches new customers with diverse products and services, and reaches areas and people previously excluded from any financial service. The evidence suggests that the majority of microcredit NGOs have not left their original market behind once they transform to commercial organizations; they greatly expand traditional product sales to their existing customer base and continue to lend to their original markets at an increased pace and breadth (Fernando, 2003, p. 10 and 2004, pp. 22-27). Analysis of pre- and post-transformation per-

¹⁶ The US\$2,088 average loan size for Banco Sol in 2004 was equivalent to 267 per cent of GDP per capita. This would tend to indicate a better off borrower customer base if the common measurement for depth of outreach — average loan size/GDP per capita — were used. Figures cited in Marulanda and Otero, 2005, Table 16, p. 32.

Figure III.1.
A survey of banks, MFIs and NGOs in Latin America and the Caribbean by ACCIÓN International, 2004



Source: Data of Marulanda and Otero, 2005, p. 28

formance of microcredit operations in the region also indicates that depth of poverty outreach appears to increase (Fernando, 2004, p. 6 and pp. 23-27; Gibbons and Meehan, 2000, p. 6).

In summary, the evidence suggests that profitability allows firms to grow, take advantage of economies of scale and expand outreach. Growth strategies incorporate both economies of scale and economies of scope. One can also find examples of large (and small) institutions that have the potential to take advantage of scope and scale economies but continue to make losses that are covered by subsidies. The key question in such cases is what incentives are given to management and whether they might be changed. What is clear is that among financial service providers that do serve the market, the large regulated institutions around the world serve the majority of poor and low-income clients who are served, and often do so by providing a variety of products and services to people who are less poor as well.

Cost control and increasing efficiency

While pricing strategies in microcredit have gained considerable attention, particularly with respect to interest rates, cost reduction is the main driver of sustainability. Sustainable organizations frequently pass on increasing efficiencies to their customers. A recent study of performance trends of MFIs that became sustainable over the period 1999–2002 did so primarily through cost reduction.¹⁷ While revenues as a per cent of total assets of newly sustainable MFIs increased 5 percentage points over the period, this gain would not have been enough to cover costs at the 1999 level as is shown in figure III.2a. “Rather tight cost management at all

¹⁷ The study analysed trends based on the data of 60 institutions world-wide that submit data to the *MicroBanking Bulletin*. During the trend period, there were 11 institutions that were not sustainable, 17 that became sustainable, and 32 that were already sustainable.

levels led to the breakthrough in sustainability. Better portfolio management has lowered expenses for loan loss. These institutions have also leveraged economies of scale in service provision and better process efficiencies to dramatically reduce costs” (Stephens, 2005, p. 28).

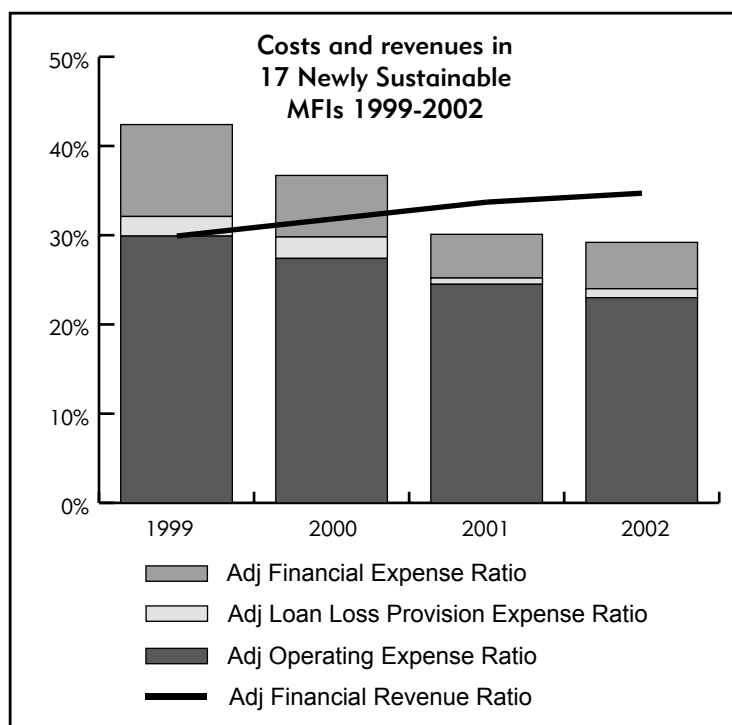
The study also presents data that shows that while non-sustainable MFIs improved operating expense ratios over the period by 4 percentage points (as a percentage of total assets), loan loss provision expense ratios worsened, making up for half the gain in these improved operating expense ratios. In addition, by 2002, non-sustainable MFIs had loan write-off ratios 15 times higher than the MFIs that became sustainable during the period, clearly demonstrating the important role risk management plays in advancing the sustainability of an MFI (see figure III. 2b).

As microfinance is a high cost business, reducing costs, particularly through enhancing risk management, improving efficiency, controlling salary expenses and increasing the productivity of staff throughout the organization are cornerstones of successful performance.

The heart of inclusive finance: multiple sales points and products

It is now well accepted that poor and low-income people need, want and use a variety of financial products. They do not have to obtain these services from the same provider but “one-stop-shopping” is more desirable and convenient for the customer. It can also be cost effective and a revenue opportunity for the financial service provider.

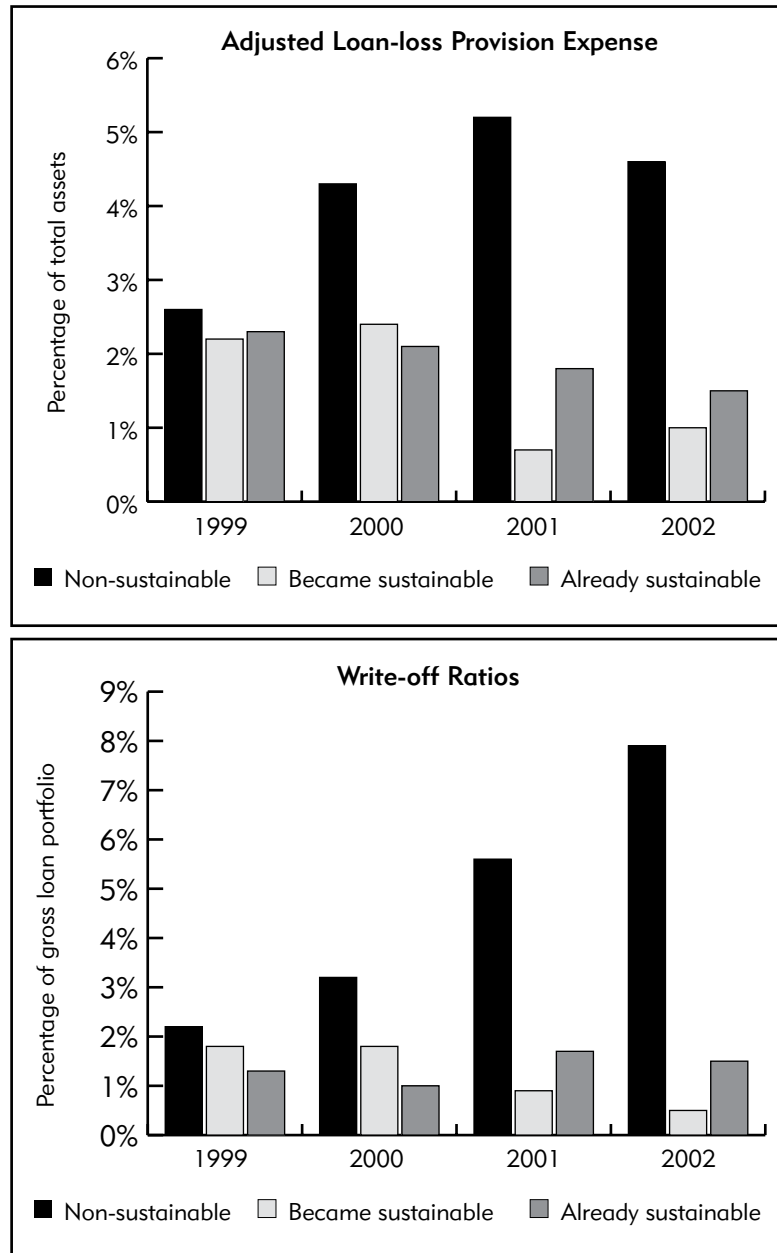
Figure III.2a.
Cost reduction and efficiency: Trends from the MicroBanking Bulletin



Source: Data of Microbanking Bulletin, No. 10 (Stephens, 2005, p. 28)

Note: Graph presents data for 17 microfinance institutions that became sustainable during 1999-2002. Ratios are shown as percentage of MFI assets.

Figure III.2b.
Provision expense ratios as a percentage of total assets and write-off ratios for non-sustainable and sustainable MFIs: Trends from the MicroBanking Bulletin



Source: Data of Microbanking Bulletin, No. 10 (Stephens, 2005, p. 28)

Standard but modern products

As discussed above, the keys to the financial success of a retail enterprise selling a standard product are sales volume and cost control. A standard product opens opportunities to sell quickly with a technically less sophisticated workforce following standardized procedures. Standardization also opens opportunities for automation, which increases speed and may reduce costs.

A relevant example of standardized but competitive products can be found in what a number of postal systems discovered in offering products to low and middle-income customers, as well as poor people. The postal systems found that all customers at all social and economic strata want products that are simple, easy to use and understand, convenient, transparent in conditions of use and pricing, fast, reliable and secure (Boon, 2004, p. 58). In Tunisia, for example, La Poste Tunisienne:

“...has succeeded in both developing its traditional postal financial services and in launching new account-based postal financial services on a large scale. More than 500,000 postal giro accounts are in operation, providing modern cashless payment instruments for payroll services, bill payments and transfers. The payment instruments also include electronic money orders, payment via the Internet and online account information, electronic wallets, and ATMs at which clients can withdraw with ‘Dinarpost’ cards. Moreover, Tunisia Post is preparing for the introduction of insurance products, consumer credit (in partnership with a bank) and savings and deposit products” (Boon, 2004, p. 45).

For savers, the key words are security, convenience, liquidity, confidentiality, access to credit, good service and returns (Robinson, 2001, p. 28). In essence, they are no different than the type of financial products anyone wants to use. It is, however, possible to offer standard products that build in these features, as shown by the Grameen II experience (noted in Chapter II) and by the experience of Bank Rakyat Indonesia (see box III.2).

Product diversity and the importance of alliances

There are limits to the number of products and services an institution can provide efficiently. Figure III.3 compares the range of products provided to customers by a sample of commercial banks that serve low-income and poor clients, regulated MFIs and unregulated NGOs in Latin America and the Caribbean. It is clear that banks offer the most comprehensive products and services and show up more strongly in offering savings, payment and insurance services. Almost all the MFIs offer consumer credit as well as microcredit and almost half offer mortgages, but fewer offer savings accounts or payments. The NGOs offer fewer financial services, as may be expected since they are the smallest and are prohibited from offering savings accounts. More than half of them, however, offer training in one form or another. The differences, in short, may be explained both by the principle business of the institutions, regulatory prescriptions, and the size of their capital base and operations.

Alliances with specialized providers present an opportunity to overcome the limit on the products and services that an institution can offer on its own. If smaller organizations would be hard pressed to develop a business line outside their core expertise, figure III.3 shows that doing so is not necessary. NGOs or MFIs offering remittance services and insurance usually provide the products and services in alliance with more specialized providers. On the opposite end of the spectrum, large organizations, such as ICICI Bank in India (see box III.1) seek to form alliances with MFIs, small community-based NGOs and local entrepreneurs, such as kiosk-based services.

Alliances also provide opportunities to expand core products and services that complement the new service. For example, the relationship that Equity Bank Limited (EBL) of Kenya built with Western

Box III.2.**Standardized products at high volume: The case of BRI-Units**

In 1984, Bank Rakyat Indonesia (BRI) created a special set of microfinance banking operations, the BRI-Units, out of a system of offices it had previously operated to channel subsidized credits. A departure from the past, the new BRI-Units aimed to be self-sustaining and locally autonomous operations, whose managers would be responsible for the profit of the Units and the quality of their loan portfolios (Rudjito and Nazirwan, 2004, pp. 12-18).

BRI set up a single loan product for the Units, the *Kupedes* (General Rural Credit), which carries a market-based interest rate for generally small loans (88 per cent are less than US\$300). Loans are short-term for working capital, but can also be up to five years for investment (available only to borrowers with good records of prompt repayments). The loan programme uses simple procedures that are processed quickly. Co-signers (usually a spouse) and collateral (usually a land title certificate) are part of loan agreements, although the latter is said to be mainly “for the purpose of establishing the borrower’s serious intent to repay rather than to provide a basis for legal action” (ibid., p. 15). The long-term loss ratio is reported to remain constant at 1.67 per cent. As at end-2003, BRI had 3.1 million active borrowers in the programme who access it through 4,049 BRI-Units spread out across the country.

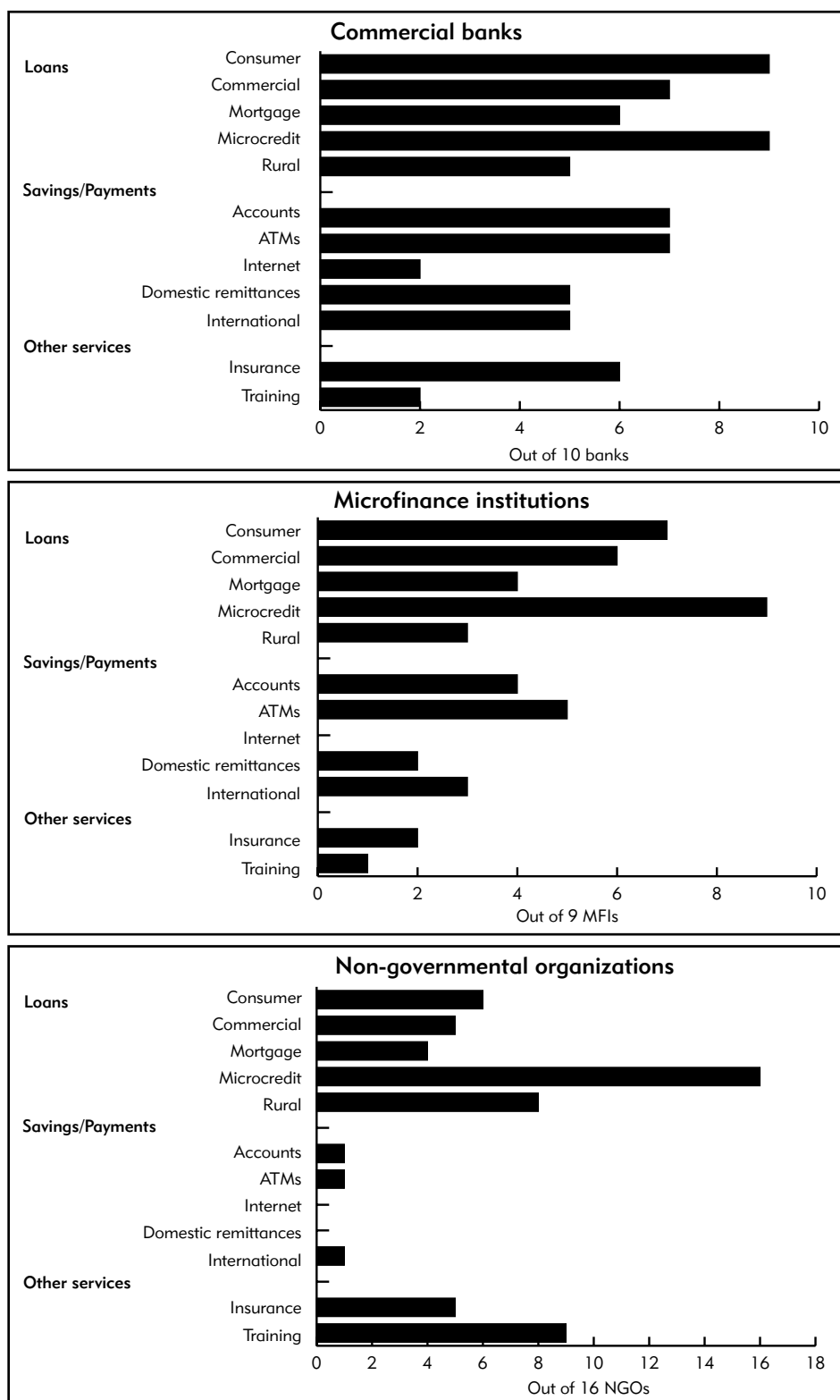
BRI itself offers a variety of loan products to customers in its branches and regional offices, but only the single lending vehicle, the *Kupedes*, is available at the Units. The Bank also offers a variety of savings products, but a limited variety is sold through the Units (passbook savings, time deposits and checking accounts for businesses). The BRI Units achieve volume: at the end of 2003, the Units had 30 million account holders. In short: “The approach of BRI-Unit is mass-market oriented and standardized in order to serve huge [numbers of] clients and to minimize transaction cost per units” (ibid., p. 14).

As BRI senior management attests, the Units’ success in expanding lending is tied to their success in mobilizing savings. This is considered a major advance over the pre-reform era when government and donor flows into the Units determined the volume of lending and the below-market interest rates on loans limited their ability to offer savings to the public. Moreover, the credit on commercial terms that the Units now provide to micro and small enterprises addressed the problem in Indonesia that creditworthy small borrowers could not access the formal banks, even though they were fully capable of repaying commercial loans, as the BRI-Unit experience demonstrates.

Union enables customers to receive remittance transfers directly into their savings accounts. The bank was also planning to tie a housing loan product to regular repayments from monthly remittances, thus linking both credit and savings products with remittances (Women’s World Banking, 2004).

Alliances can also be used to expand coverage, as the credit union experience in Nicaragua demonstrates. The *Central de Cooperativas de Ahorro y Crédito Financieras de Nicaragua* (CCACN) entered into an agreement with FAMA, an affiliate of Acción Internacional, to provide greater coverage to remittance receivers through *IRnet*[®], the international credit-union transfer payment network. The credit unions are located primarily in rural areas and do not have a large presence in urban areas as FAMA

Figure III.3.
Product offerings in Latin American financial institutions, 2004



Source: Data of Marulanda and Otero (2005, p. 21).

Note: The one NGO reporting saving accounts was being acquired by a financial institution.

does. This partnership yields 43 points of service throughout the country, covering all major markets and many smaller ones in 13 of 17 states (WOCCU, 2004, p. 8).

Alliances are best formed from a position of strength of the parties, not weakness. Finding the right partner and developing the necessary trust are essential for establishing working relationships. There is always the concern that the stronger partner will “take over” when the business achieves critical mass. Partners to an alliance should seek to resolve revenue sharing issues prior to entering the partnership. Lack of management control, including quality control, brand confusion and reputation risks are also concerns. There is a need for constant monitoring by all parties to the alliance (Brinsden, 2005, p. 2-3). While alliances are important opportunities to expand scale and scope, they must be nurtured. They work best when both partners see advantage and profitability in continuing the relationship.

Expanding points of sale

Having a broad national distribution with many points of service is especially salient to banks that often are chartered to operate nationally and take “proximity banking” as their primary mandate. This leads them to establish large retail branch networks and a variety of partnerships to further extend services. For example, in Brazil:

“...In addition to 1,693 branches, Caixa Economica operates 291 Bank Service Stations (called PABs), 2,053 banking correspondents, and also provides services through 8,870 lottery shops and simplified lottery units. It is the only bank that is present in all 5,561 municipalities of Brazil” (WSBI, 2004, p. 12).

Outreach of a proximity bank can also involve taking the bank to its clients. One way of doing this is through mobile banking, where the mobile unit circuits through a rural area on a regular basis and the customer can expect to see the mobile bank return on a fixed schedule. Outreach can be also be customized. In Chile, for example, BancoEstado complements its branch network and mobile units by sending agents to “visit people in their businesses or homes to sell them credit and savings services, using Palm Pilots connected to computers in the branch, saving time and increasing efficiency” (WSBI, 2004, p. 12). ICICI Bank in India anticipates dramatic scale-up through a variety of alliances, including locally owned kiosks equipped with low-cost ATMs, partnerships with NGOs and self-help groups and their own growing branch network.

Both traditional and advanced technologies are useful in extending outreach. A new technology does not always trump the old ways of operating. In fact, new, computer-based technology enabled by computer-based transactions can be used recklessly by financial institutions when it substitutes for more measured risk management systems. The experience that different MFIs have had with personal digital assistants (PDAs) is a case in point. While many had difficulties with the interface between PDAs and their management information system (MIS) and discontinued use of the technology, others have found benefits in more efficient operations, cost reduction and client satisfaction. For example, ADOPEM in the Dominican Republic recorded dramatic improvements with its PDA use:

“Client retention improved significantly, and the number of days between [loan] application and disbursement dropped from five days to two days. Expenses for paperwork dropped by 60 per cent and data entry expenses dropped by 50 per cent. Loan officer caseloads and other productivity measures increased by about 35 per cent” (Waterfield, 2004, p. 2).

There are many possible ways, using varying technologies, to scale up the volume of retail financial services for populations that should be served by an inclusive financial sector. Financial service providers seek economies of scale and scope to lower costs and increase revenue streams. Alliances and partnerships make possible new products and allow new types of financial institutions to enter the market, including small, locally based retailers. Costs are a factor in every decision and no simple answer can be given as to which combinations are most appropriate to which financial institutions in which environments at what times. These are the strategic decisions of management.

Issue 3.

Lack of innovation prevents closing the gap between supply and demand

Innovation sparked the “microfinance revolution.” The lack of innovation is a factor that is often noted as the reason there is still a huge gap between supply and demand for financial services at the lower end of the market. The economics of retail financial services points managers of retail financial institutions toward choosing a set of standardized products and services and seeking to expand the volume of sales and lower average costs by capturing economies of scale and increasing efficiencies. As the preceding discussion indicates, a large number of institutions have done exactly that. But an even greater number have not. They start small and remain small; or they start large and stagnate; or they fail and go out of business. Why?

The operating environment

One argument that is sometimes offered is that the less dynamic providers have an especially difficult operating environment with which to contend and that precludes thinking about growth strategies. As a participant in the e-conference organized in preparing this book said:

“Simply put, it just isn’t easy to offer financial services in a sustainable way: one day in the life of a financial provider will often include electricity outages that prevent a portfolio manager from monitoring loan repayments and taking quick action, security concerns that prevent loan officers from accessing new villages, weak human resource capacity that force top management to spend the day, as it has for the past six months, on getting at least one product right instead of developing new products...”

Clearly, there are human resource and economic and social infrastructure constraints that are more difficult in some environments than others. The same retail financial products and services cannot be offered everywhere at every moment with corresponding dynamism.

Internal systems and practices

In many cases, however, there are difficulties in the way the institution operates that make successful performance a challenge whether the environment is enabling or not. Among those difficulties is tolerance of practices that:

- do not provide timely, accurate and meaningful information to decision makers at all levels of the organization. This can include MIS that do not register all transactions or hide information, or reporting systems that require duplicate information or information that is not useful for strengthening the performance of the organization;
- do not support transparency, compromise internal controls, dismiss internal audit functions or do not consider rigorous external audits important;
- do not adequately manage risk, including a focus on disbursements of loans rather than recovery, or not classifying loans according to risk;
- do not support appropriate recruitment or training of staff which is often accompanied by rapid turnover, especially when there are few opportunities for promotion within the organization; and
- do not adequately protect the organization from nepotism, favouritism and corruption.

Retail financial institutions, no matter how small, are businesses. While they may have a social purpose, they best advance that purpose through efficient operation and gaining a full understanding of their customers and markets. Managers need to be alert to customer demand and tailor their products and services with creativity, flexibility, and responsiveness. This is simple basic retail entrepreneurship.

Management

Even when good management practices are present and operations run smoothly and efficiently, some managers of retail financial institutions will be less open to innovation than others. The less entrepreneurial managers may not encourage customer feedback. They may ignore the importance of improving products and services or designing new ones as organizational capacity increases, technology advances, infrastructure improves or the market changes. Management may feel comfortable with the operations it has, the product mix it has, and the revenue that it produces.

This can be described as managerial complacency. If a retail financial institution is providing its products and services and operating within expected margins, why should management wish to take risks in innovating? There are individual and institutional factors making one management team dynamic and inspired, and another static and unimaginative. It does not seem to matter whether the organization is a private or state enterprise, small savings and loan cooperative or national savings bank, foreign-inspired NGO or government bureaucracy. One can find encouraging and discouraging examples of dynamism and complacency in all types of organizations.

There can be various reasons for complacent management. Perhaps the most troubling one sometimes proffered is a “flood” of donor money or government subsidies, under which management feels

little pressure to be entrepreneurial. In some instances, these subsidies come with strings attached: products are designed by donors and governments for political reasons, or reasons that fit more closely with the donor's or the government's mandate than with an assessment of the market. In such a situation, management can survive passively.

Entrepreneurial management teams can forge a vision and bring an intensity of conviction and drive to increase outreach in a sustainable fashion, in many circumstances against heavy odds. The question to which we can give no answer is how to identify those entrepreneurial managers so they may be nurtured by their organizations. The question that we can address is that success recognizes that institutional development takes place in a dynamic environment. Those managers and governing boards who push it forward recognize the importance of continual assessment, adaptation, innovation, and investment. They determine regularly what works and what does not work; they reinforce the former and are willing to correct the latter; they are willing to invest in change and improvement.

Governance matters

Effective governance is an essential element in the safe and sound functioning of a financial institution. The functions of a board of directors and senior management with regard to setting policies, implementing policies and monitoring compliance are key elements in the control function of a financial institution. In addition, governing bodies play a critical role establishing the values and "culture" of an institution, including its ability to innovate, adapt, change and grow.

Governance of financial institutions is arguably of greater importance than for other companies, given the crucial financial intermediation role of financial institutions in the economy, the need to safeguard depositor funds and the high degree of sensitivity to potential difficulties arising from ineffective governance. Financial institutions may lose large sums of money in a short period of time in the case of events such as fraud. Poor governance can also lead to the loss of confidence of customers and funders (BIS, 2005, p. 6).

These principles were underscored during the consultations for the preparation of this book: "Internal management problems within MFIs were a leading cause of failure to expand even where demand and repayment rates are high" (e-conference, participant from Kenya).

Certain elements of governance apply across the full range of financial institutions: establishment of clear strategic objectives, sound corporate values, incentives for ethical behaviour and the practice of high ethical standards, the setting and enforcing of clear lines of responsibility and accountability throughout the organization, ensuring appropriate oversight by senior management and effectively utilizing the work conducted by internal and external auditors; providing structures and incentives for innovation and growth; and promoting transparency at all levels. Sound governance is supported by shareholders (in the case of equity-based financial institutions), auditors, professional associations, governments, supervisors (for regulated financial institutions), donors (for NGOs) and employees (BIS, 2005, pp. 7-19).

The legal form of regulated, licensed financial services providers does not determine whether they can effectively deliver financial services to poor and low-income customers.¹⁸ Governance, however,

¹⁸ The case of NGOs that are not permitted to mobilize savings is discussed below and again in Chapter IV.

does matter. All critical institutional decisions are dependent on governing boards and the system of governance that runs throughout the organization. To the extent that governance is related to ownership, several common constraints found under different ownership structures are discussed below. It is also noted, however, that experience shows each of these constraints has been overcome in particular situations and that broad proscriptive generalizations about ownership and governance need to be considered carefully in light of specific circumstances.

Privately-owned and publicly traded commercial banks. These commercial banks have often been criticized for ignoring poor and low-income customers. The primary responsibility of the boards of directors of these organizations is to maximize shareholder return, and too often serving this market is not seen as profitable enough. A commercial enterprise that has not made significant investments in the low end of the market would have its fixed costs employed elsewhere, serving its existing market with existing products and services. Governing boards with an eye on maximizing shareholder return are unlikely to commit to significant change in prior investments, or to commit top human and physical resources to an activity perceived as public relations or a response to fulfilling government mandates, such as portfolio quotas.

Diversification into the lower segments of the market, however, has its appeal, particularly when there is excess liquidity, significant social pressure and the potential to leverage physical, human and technological infrastructure. When these factors combine, the view may emerge that the market is a profitable and socially important business line, even if it may not be the most profitable one. In this regard, commercial banks have invested in serving the lower segment of the market by incorporating a long-term view of its development. They have used the “service company model,” supported specialized internal units, established financial subsidiaries and formed strategic alliances (see Lopez and Rhyne, 2003 for discussion on the advantages and challenges of each model).

State-owned banks. State-owned banks experience a different type of governance challenge that affects growth. They tend to be vulnerable to political influence and the changing priorities of different administrations. This is reflected, in frequent changes in boards, among other areas, as political priorities and administrations change.

These institutions often have the most potential for stability and growth because of implicit government guarantees and preferential regulatory entry. There are also numerous effective public sector savings banks. At the same time, however, there are frequent cases of disappointing performance with regard to lending operations. This is largely because the core canons of credit management (careful selection of borrowers, vigorous collection, cost-recovery interest rates) often run counter to political incentives. Politically inspired debt moratoria are also common.

As a result of poor lending practices, state banks have sometimes destabilized the financial sector and several of them have required frequent recapitalization, which causes a significant drain on national budgets. There are also, however, many cases of costly financial crises (and thus of poor risk management) in inadequately regulated private financial systems. Major macroeconomic imbalances and shocks can also generate costly financial crises in financial systems where either public or private sector institutions prevail.

These problems indicate that mechanisms for control, risk management and staff and management incentives to improve operations, innovate and grow are often significant challenges for state-owned banks. But some

state-owned banks have clearly and consistently succeeded in overcoming these obstacles. This is usually the case when the confidence of policymakers is vested in technical management, governing boards are selected based primarily on the basis of expertise and are focused on the health of the institution, and when operational decisions on products and services and who can access them are removed from the political process.

In addition, state-owned banks are often exempt from supervision by financial sector regulatory agencies. Because of this, they have often been criticized for non-transparent operations. State-owned financial institutions can, however, and arguably should be, at the forefront of disclosure — a public good that has shown to be of great benefit to the financial system at large.

NGOs. NGOs experience a different type of governance challenge that affects growth. Their governing boards and management have no ownership stake in the capital of the institution. They serve as stewards of the institution's assets, and also safeguard its mission. For this reason, they are often considered by banking authorities to be weaker structures, with no “deep pockets” that could rescue the organization in times of crisis. Their capital base is dependent on donations, retained earnings and at times borrowing from financial institutions. They are generally not subject to banking law and are not supervised by the banking authorities, which prevents them from offering a range of products and services, such as savings, and from attracting capital for growth.

NGOs are also seen as less demanding of management and staff because of their not-for-profit structure than a for-profit entity would be. Nevertheless, in some contexts, NGOs are significant providers of financial services, particularly credit, to poor and low-income households and enterprises. They can also function with excellent management teams, creative incentives, and operate with demanding business targets, in spite of their not-for profit status. They often combine financial services with health, education and business training. Because NGOs are not subjected to restrictions from regulatory authorities that often make innovation difficult, they can play an important role in innovation. That role has often been cited as one that “goes where no other institution dares to tread,” whether that be in product or technology innovation, in serving isolated areas or in helping vast numbers of extremely poor people to develop employment skills and tiny enterprises.

Cooperatives and credit unions. Traditionally, the capital of cooperatives and credit unions was restricted to amounts member-owners could raise in deposits and shares and to the retained earnings generated by their operations. The “one-person one-vote” principle of cooperative governance expresses the cooperative spirit of self-help and care for all members in the cooperative movement. It works well in practice when all members are vigilant of the organization's performance. The one-person one-vote principle of governance can break down, acting as an incentive for borrowers to push for more control of the organization than savers. When powerful borrowers exert influence on governing boards, there is an incentive to reduce interest rates on loans, or to forgive them entirely, both of which sacrifice a return on savings and can lead to substantial losses for the organization and its members. Governing boards are often under pressure to distribute dividends to member shareholders even when the profitability of the organization does not warrant it. Another serious problem has been donor lending to financial cooperatives, which tends to make them even more borrower-dominated. In addition, government institutions have often misused the cooperative movement for political purposes. This has been cited as a major cause of cooperative failure in many countries.

The revitalization of the credit union movement over the past two decades has led to improving the soundness of some credit unions and their regional and national networks. This enables them to better manage excess liquidity and remove one constraint to growth. “Open door” policies have led to increasing membership that is not restricted to the “closed bond” operations on which many credit unions relied in the past. Credit unions continue to show lower costs and higher efficiencies in delivering services than many other institutions and often target rural areas.

Credit unions are registered under cooperative law or as a special category in the banking law but may lack effective external supervision or authorizing legislation. They are often supervised by a federation to which individual cooperatives are members, creating a conflict of interest. They may also be supervised by a ministry that is responsible for non-financial cooperatives as well, and typically lacks the expertise to provide sound financial supervision. Improving the internal governance of cooperatives and credit unions has been of the utmost importance in the dramatic improvements that some of these institutions have made.

Transformed NGOs and specialized microfinance banks. Institutions of this type are thought to have advantages in serving their “double bottom line” mission. They use a governance structure that draws on private sector and public institutions that have gained experience in this area. While they are thought to have the right mix of “ideal capitalists,” they often rely on capital that is still essentially public funding through bilateral and multilateral development banks or specialized equity funds set up for this purpose. As such, their governing boards are often a mix of donor staff (where problems of continuity, expertise and time constraints on board members can become serious constraints to good governance) and representatives of government, other public institutions, and the private sector.

A challenge often cited for these institutions with respect to growth is that they may drift away from their social mission to serve poor and low-income people. However, the management and new governing boards of transformed NGOs present the same argument for continuing to serve their original market as many private banks give for ignoring it. Why leave a profitable market that the institution has taken years to build, abandoning products, services, technologies and staff capacities that have been developed, at significant cost, to serve this market? Thus, experience suggests that these transformed or specialized institutions frequently remember their roots quite well and retain their emphasis on serving poor and low-income customers.

Mass-market retailers. Retailers that are engaged in other lines of business have ventured into financial services and have become an integral part of the provision of financial services to poor and low-income people. For example, telecom companies, whether they are large or community-based firms, are frequently important providers of financial services. And so are convenience stores, gas stations, food stores and a wide range of other retailers. The world of microfinance may look completely different 10 to 15 years from now, just as it did 10 to 15 years ago. Mass-market retailers, especially those operating in large economies, may find their role increasing in providing consumers with financial services that are not directly tied to their current retail relationship.

“Socially responsible” retail financial institutions are often considered best positioned to address the issue of financial inclusion. But experience suggests that good governance may be more important for serving the market than ownership structure. Clearly ownership structures have a major influence on governance, and governance issues are involved in any type of ownership structure. Yet, every type of or-

ganization has proven it can have good governance and serve the market well, even if its legal form limits the range of products it can offer, and even when there are different motivations that range from the purely social to the purely commercial, with the “double bottom line” organizations somewhere in the middle.

What is also clear is that organizations need to have good leadership and strong management teams that do not tolerate corruption, but rather encourage transparency, accountability, innovation and growth at all levels of the organization. Furthermore, governing boards must take seriously their mandate to serve their institutions well by helping them provide the best products and services they can to their customers. After all, it is the customer who ultimately determines whether a market-oriented retail financial institution survives. It is the governing board, however, in both private and public sector institutions that determines how best to structure, manage, and strengthen the institution to compete, serve its customers, and attain its social and business objectives.

Conclusion

A fundamental challenge in building inclusive financial sectors remains adequately expanding retail capacity to serve the unbanked and underbanked. Which institutions will best serve the market? Legal form and ownership structure are not necessarily related to scale of operations or to organizational efficiency, effectiveness, or sustainability. Different types of retail providers have different strengths and weaknesses and challenges and advantages, including the range of products they can offer. The commercial orientation of an organization does not prevent it from serving poor clients with quality financial services; by the same token, an organization’s social mission or mandate does not assure that the organization will serve the poor well or efficiently. In fact, there is a direct relationship between profitability (whether in a commercial or socially motivated institution) and scale of operations: profitable institutions have shown they can reach many more poor clients than unprofitable ones.

Small, locally oriented banks, cooperatives and NGOs can be expected to continue to expand in their markets, seeking alliances with others and through networks to offer a greater range of products and services. The importance of small organizations should not be minimized; they are often the most significant, if not the only, financial service providers in many communities. But one may expect that these financial products and services will increasingly be provided through larger entities, ones that will also more likely offer a broader range of financial products and services to SMEs as well as the smallest entrepreneurs, and to middle and low-income, and poor households.

While expansion of retail financial institutions is dependent upon an array of internal factors, the overall conditions in each country, including the policy environment, are extremely important. The main issue is how policymakers can help establish and strengthen a variety of retail financial institutions without opening the financial system to instability. The design and delivery of financial services to vast numbers of poor and low-income people who do not have access will lie in innovation, investment, reducing costs through improved efficiencies and technology — and appropriate regulation and supervision.

Chapter IV

ACCESS TO FINANCIAL MARKETS: A CHALLENGE FOR MICROFINANCE INSTITUTIONS

“When microfinance institutions are providing credit, at some point there’s a limit. They can’t just keep building up loan portfolios. They’ll run out of financial sourcing possibilities. A true financial intermediary is one who intermediates, not only through transactions with customers, but also within financial markets.”

International fund advisor

The financial system serves to transfer financial resources from savers at home and abroad to borrowers. Though older institutions, such as public sector banks and savings banks, have participated in this process for a long time, the new institutions specialized in micro and SME finance have only begun to participate recently. Financial intermediation that provides vastly increased financial services for poor and low-income people using domestically generated savings and recycling them within the economy is a virtuous circuit. It deserves to be a primary consideration in the context of inclusive financial sector development.

This chapter departs from other chapters of this book because it focuses exclusively on MFIs and their progressive inclusion into domestic and international financial markets. The chapter discusses the challenges MFIs face in the financial sectors in which they operate, the relationships they can foster to access formal financial markets, the instruments they can use to access capital, and the opportunities and risks they find in accessing financial markets. Part of the analysis may be relevant, however, to other institutions providing microfinance, particularly to savings and credit cooperatives.

Broad-based financial development means extending financial services to all segments of the population and the ability of financial service providers to access capital. Just as financial intermediation between individual savers and borrowers benefits accumulation of assets and investment, intermediation across the financial sector benefits retail financial institutions broadly, including those that serve poor and low-income customers. In the words of an international network manager: “By integrating into the domestic financial system, MFIs become players in the financial system, teaching bankers how to bank with low-income entrepreneurs, and helping shape financial sector policies to work for microfinance.”

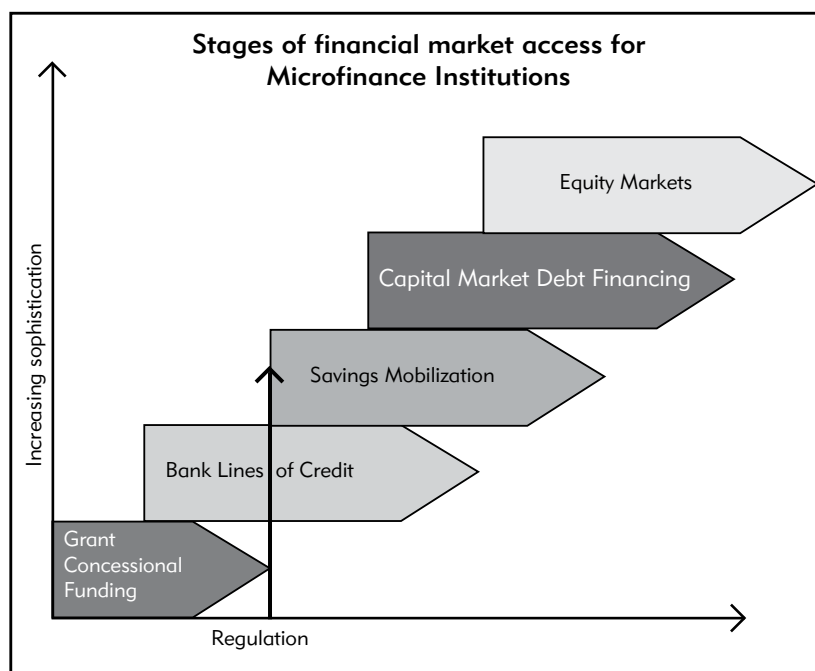
There is, however, fragmentation in financial markets — institutions serving poor households and firms lack access to mainstream financial sources. Inclusion in financial markets takes place differently with regard to different types of institutions: whereas formal banks have access to financial markets and the interbank market, non-bank financial institutions with a limited license and semi-formal institutions have little or no access to funding. Leaving aside the debate on the importance of formalization, it is clear that linkages between market segments are weak in many countries and wide differences exist in risk-adjusted returns. When financial intermediation does exist, it helps institutions to operate more

efficiently and to better serve the target population.

A major concern of MFIs is the ability to fund the growth of their loan portfolios by drawing funds from the mainstream financial sector. The primary impetus to seek financial market access is to fund the growth of loan portfolios. Restructuring the liability side of the balance sheet to include commercial instruments and savings is critical to the growth and sustainability of financial institutions over time.

The progressive inclusion of the range of social finance institutions into domestic and international financial markets occurs through mobilizing savings as a source of funds, accessing debt and short-term funds, operating in clearing and settlement systems, and utilizing capital market instruments such as bond issues, securitization and equity finance. MFIs typically begin as specialized microcredit institutions, lending out resources that were given or loaned to them by public or private donors. As their loan portfolios grow, they face the need to draw in new resources for lending purposes, and they often move through a sequence of stages (see figure IV.1). Typically, they will first seek additional loans and grants from their initial suppliers or other funders in the same category. Thereafter, they often seek resources from commercial lenders, especially when their operations prove profitable and enable them to pay market interest rates on new funds.

Figure IV.1.
Accessing financial markets: Progressive stages for MFIs



Source: WWB, 2004, p.1.

Access to financial markets benefits MFIs in a number of ways: it provides (1) increased access to funding to assure continued growth in outreach and portfolio size; (2) diversified funding sources to reduce funding concentration risks which can also improve risk management; (3) longer maturities to allow greater diversification of product offerings; (4) potentially lower financial costs through sav-

ings mobilization and financial instruments such as bond issues; and (5) improved profitability from increased leverage. Increased access to financial markets may also give rise to a shift from donor or government funding to funding on commercial terms through market-based finance.

There are multiple dimensions of broad-based financial sector development. An important one is the various ways many types of institutions (e.g., banks, savings and loans, investment and insurance companies, pension funds) participate in the financial sector and can intermediate funds across it. Another is the way in which the various actors in the financial sector are linked together from an infrastructure perspective. There has also been extensive discussion of the expansion and integration of financial relationships to better intermediate funds from the broader financial community to institutions that serve poor and low-income people. Discussion points centre on the range of possible alliances and linkages to better intermediate funds from the broader financial community and the role of international funds and international commercial banks in these relationships.

Issue 1.

Impact of weak financial sectors on MFIs

A robust financial sector, with strong performance of financial institutions and growing financial assets, can help strengthen financial services for poor and low-income people. A weak financial sector too often limits the provision of formal financial services for the poor to public and member-owned institutions. In addition, financial sector weakness can restrict and discourage the development of sustainable MFIs and can limit their focus to credit activities. Financial sector strength is fundamental for linkages and intermediation across the financial sector, for competition, and for the funding and capitalization of the full range of financial institutions. In some countries, microfinance operates within a robust financial sector, in others within a weak one.

How much does the strength of the financial sector matter for MFIs to access capital for growth? MFIs can function in weak financial sectors and they often do. In some contexts, they become all the more important as formal financial institutions perform poorly and cater to a limited client base. However, these MFIs are for the most part credit-only institutions, able to function only on the basis of donor funding and internally generated resources. They function in isolation from and independent of the larger financial markets. Once MFIs demonstrate the need, willingness and capacity to diversify liabilities, weaknesses in the financial sector often limit their ability to achieve this diversification and to grow accordingly.

In many developing countries and countries in transition, financial sectors are small. But in finance, “being small” is seldom efficient (Caprio, Honohan and Di Vitta, 2002, p. 95). As small financial sectors cannot demonstrate the same economies of scale as those in larger countries, options to access financial markets for MFIs tend to be more limited, less efficient and more expensive. It is more difficult to diversify risk and to attract and manage liquidity. Small financial sectors are likely to be less competitive and to be incomplete, simply lacking some critical financial services and instruments. In addition, regulation and supervision are expensive on a per transaction basis because of the lack of economies of scale.

Developing financial sectors also tend to be led by the banking sector: stock markets are small with

few listed securities, and non-bank financial institutions, such as insurance companies and pension funds, do not play an active role. Corporate bond issuances are limited, and the most actively traded financial asset is government paper, mostly short-term treasury bills. Financial sectors with a limited range of institutions, limited total assets in the banking system in relation to GDP, and underdeveloped financial markets are far less likely to offer access to financial markets by MFIs.

The strength of the banking sector, with its predominant role in many developing financial sectors and a regulatory framework that may admit strong MFIs to the sector, becomes all the more important to inclusive finance. This underscores the importance of banking sector reform and competition policy, as well as the importance of regulatory structures and the performance of individual institutions.

A strong financial sector spreads risk throughout the economy to those people and institutions most able and willing to handle it. Weak financial sectors, and weak banks within them, also lead to high country risk. Integration into international financial markets, which is critical for the development of the financial sector overall, hinges upon country risk assessment. High country (or sovereign) risk affects the development of inclusive finance directly and indirectly: directly by influencing the access to and the price of international commercial borrowing, and indirectly by the negative effect on capital inflows from abroad to domestic financial markets, and outflows from domestic savings to lower risk countries.

The intermediation of private funds on competitive terms to the institutions that serve poor people requires some degree of financial sector strength, including the capacity to assess and manage risk. When the financial sector is weak, MFIs will have limited opportunities to tap into domestic funds through the market and credit for households and small firms develops more slowly and on a limited basis. The more robust the financial sector and its supportive infrastructure, the more likely that MFIs will be able to access financial markets and use increasingly sophisticated instruments. The less robust the domestic financial sector and the more fragmented its supportive infrastructure, the more likely it is that MFIs will rely on government and international donors and the credit enhancements they offer. The strongest MFIs will also pursue licenses that enable them to draw resources from the local economy directly through deposit mobilization, emphasizing the importance of an overall policy stance towards inclusive finance and the regulatory framework that enables it.

Issue 2.

Limited access of MFIs to domestic financial markets

A variety of factors hinder the ability of MFIs to tap the financial resources of the financial sector. Some pertain to the shallow depth of the market, some to limited capacities in the MFIs, some to perceptions of the market that are more myth than reality.

Institutional factors limit the ability of MFIs to access financial markets

Weak management and operational capacity at the institutional level is a fundamental reason why MFIs cannot access financial markets. Indeed, there are few MFIs that can qualify to obtain resources from

financial markets generally. This is largely due to low market confidence in the financial performance of these institutions. Similarly, their unconventional governance structures, limited ability to manage risk, lack of transparency (including audited financial statements and performance data) and the weakness of their balance sheets frequently cause financial markets to view MFIs with caution. Simply said: “The constraint is the number of institutions that can qualify to obtain resources, not the quantity of the resources” (*Member of an international network*). As an international fund manager adds: “The money is chasing the fifty best MFIs. The layer below is the challenge.”

Young institutions face special hurdles in accessing financial markets. They cannot often demonstrate a track record of sound performance and profitability, even if they are successfully growing. Reaching profitability can be delayed for a number of reasons, including, most importantly, the need to expand essential management and operating functions. In addition, the investment in product innovation and increasing outreach through branch expansion is likely to lower returns during the initial stage of growth, as will operational and managerial mistakes. Further, the non-profit and social orientations of some MFIs may be seen as incompatible with a business culture. Managers may not have adequate financial experience, may have limited general business experience and may never have created or managed a successful, scalable enterprise.

It is also observed that new entrants to the private funding market, assuming they gain acceptance at all, will pay more for their funding than managers with a successful history behind them. In part, this is due to the risk perceptions of the investors, but it is also because newer borrowers or entrepreneurs will have relatively poor negotiating power. As of now, only a limited number of institutions with proven track records are in a position to choose among funding sources. Fortunately, experience increases the level of comfort: “...financial markets provide reasonable terms once they have overcome their initial fears and have become comfortable with the MFIs they work with” (*Manager, international network organization*).

Most MFIs have not yet developed the skills to manage their assets and liabilities for market risk — the risk of loss owing to changes in market rates and prices. This includes liquidity risk, interest rate risk and foreign exchange risk (Schneider-Moretto, 2005, p. 4). Foreign exchange risk is treated in Issue 3.

- **Liquidity risk.** Defined simply, liquidity management is the ability to meet maturing obligations, appropriately matching assets and liabilities to cover liabilities as they become due for payment. Smaller MFIs often do not have back up liquidity or overdraft lines for short-term borrowing to accomplish this. Active liquidity management requires specific financial skills and systems for asset/liability matching to control risk exposure. The operations of the smaller institutions are not broad, deep or diverse enough to warrant sophisticated systems. While the short-term and revolving nature of their microfinance portfolios provides some mitigating opportunities to cut back lending if liquidity shrinks, most MFIs miss not having access to the short-term money market or bank credit for liquidity management purposes.

- **Interest rate risk.** Interest rate risk refers to exposure of the financial institution to adverse movements in interest rates. This can affect the amount paid on the institution’s debt service and therefore net earnings. While interest rate risk is more significant in the increasingly sophisticated transactions

of larger banks, it is also relevant for smaller institutions because they tend to lend at fixed rates and borrow at floating rates. Furthermore, the risk becomes more critical when MFIs make longer term loans at fixed rates since they cannot renew loan contracts in just a few months at a higher rate. Special attention should be paid to this risk in countries where interest rates are being deregulated and where microfinance providers offer longer-term fixed rate loans for housing or other finance needs.

Constraints on financial market confidence

Beyond the general concerns regarding the track record of MFIs, banks and other financial institutions have been slow to show confidence in specialized financial institutions. These institutions operate very differently from more traditional financial institutions. Commercial lenders, for example, are reluctant to allow unregulated MFIs to leverage their equity beyond low limits; they will lend them a smaller amount relative to equity than they would lend to a regulated institution, which is a sign of lower confidence.

While only rarely a requirement, it is often the policy of lenders to lend only to regulated institutions, thus leaving out many solid and successful MFIs. The risk profile of regulated institutions is simply more appealing to potential lenders. In some cases, this perception of the riskiness of unregulated MFIs reflects an unwillingness to engage with a different type of organization or to adjust the existing loan evaluation methodology; in other cases, the perception of risk is warranted.

Ownership. The status of many MFIs as non-profit institutions makes it difficult for them to secure loans. NGOs that are not legally established as corporations have no clear ownership and no capital base that is formally the property of the owners that can be leveraged to raise debt. When there are private owners, the bank knows whom it can hold responsible for the loan. Without this assurance, it is more difficult to borrow from a bank. When non-profit institutions learn the challenges and difficulties they face in accessing the financial markets, they are frequently motivated to transform into corporations. As expressed in MicroRate's *The Finance of Microfinance*: "Why would any sane MFI exchange a comfortable existence, free from governmental supervision and taxation, for the burdens of being a regulated financial intermediary? The answer is simple: MFIs are growing so fast that they have developed a voracious appetite for funding" (Von Stauffenberg, 2004, p. 5).

There is, however, no consensus on what types of ownership structure are best or most effective under what types of circumstances. Most non-profit structures would be considered unappealing to market lenders. Yet, the case of the Fundación WWB Colombia in Cali demonstrates that a non-profit institution with strong financial performance can access capital markets. The organization successfully floated a bond issue in Colombia without any guarantee, based instead on its strong reputation and investment grade rating. While some contend legal status and ownership structure are defining factors, others contend that reputation and performance are more important. A commercial bank, like bond buyers, looks at the management team, credit risk and the track record of a potential borrower, as well as the ownership structure and the range of products and markets over which it is spreading its risk.

Risk assessment. In contrast to bank loans, borrowing on credit markets requires independent risk assessments to help guide bond purchasers. Risk assessments of MFIs, when they are made, are

often unfavourable, in part because there is inadequate knowledge in the rating agencies about MFIs and the products and services they offer. In addition, investors and banks that do not do business on a regular basis with MFIs are unlikely to be familiar with their operations and unique structures and methods.

But the high-risk perception of MFIs is often warranted. This is because many MFIs do not have well established and easily understood risk management or other important operational systems in place. Moreover, the accounting and auditing standards applied by unregulated institutions often do not meet national — let alone international — standards of sound practice. An international fund manager expressed “amazement” at what was allowed. This does not increase the confidence of commercial banks or other lenders or investors in MFIs.

Potential lenders are also concerned that they cannot depend on the legal system to recover defaulted loans that they might extend to organizations that lend to low-income populations on unsecured terms. This is due to a combination of factors, including inherent weaknesses of the legal system, the absence of bankruptcy law protections, fear of a political backlash, or simply the impracticability of recovering assets in the hands of so many borrowers.

There is another reason that commercial banks shy away from lending to MFIs. They believe that MFI portfolios are inadequately secured and thus that regulatory authorities might require the bank to take additional provisions, adding to the cost of lending. Rating agencies that issue opinions on commercial banks (owing to the securities that the banks themselves sell to the market) also see microcredit activities as risky. Hence banks with a larger percentage of these types of loans in their portfolios could be rated relatively poorly. Although there is no explicit rule that tells agencies that they should assign risk in this way, it is a common practice. Banks are hesitant to lend to specialized MFIs because they do not want to see their own ratings lowered and their regulatory capital increased by lending to institutions with uncollateralized portfolios.

The high charges on bank lending to MFIs also stem from the small size of loans to some MFIs. At the same time, however, commercial financial institutions feel the pressure to keep interest rates down because so many of the ultimate clients are poor. While it may be justified to charge higher rates for cost and risk management reasons, commercial banks frequently do not want to get “caught” charging higher rates to MFIs than to corporate borrowers. This is because the bank would risk criticism for lending at high interest rates to “the poor.” Often banks prefer not to engage in this market at all, rather than charge the rates they feel would be necessary to cover their costs.

Balancing the double bottom line. The social investment mindset of commercial lending institutions willing to accept a lower return on lending is not widespread. There are some social investors and other lenders who are willing to renounce higher yield in exchange for achieving social objectives or for contributing to the development of the financial market in the longer term. But this sentiment is relatively rare, as noted by a member of an international network organization: “Many international investors in the micro/SME industry have turned down opportunities to invest unless a return in the 15-25 per cent range is planned...Investor insistence on high and quick financial return does not help the institutions to grow but instead hurts their ability to grow and operate soundly and effectively.”

A role for guarantees

There are continuing calls for guarantee funds and other guarantee mechanisms as a means of bolstering access of MFIs to capital markets. It is argued that guarantees are warranted to correct “market failure,” such as inaccurate market evaluation of risk. Proper structuring of guarantee schemes is required, however, to address misperceived risks in lending without undermining the risk management of the lending institutions. For this reason, guarantees are often partial so that the lending bank bears some of the risk of default by the MFI despite the guarantee. When not subsidized, the cost of a guarantee to the borrowing institution in relation to the improved terms of the loan becomes an additional consideration. One measure of success of any guarantee is the ultimate ability of the borrowers to gradually bear the full cost of borrowing. A second measure of success is whether the initial guarantee serves its purpose in assisting the lender to appreciate the “true” risk of the borrower by establishing a continuing relationship that no longer requires the use of a guarantee.

Studies are underway to test the effectiveness of such guarantees in helping MFIs achieve long-term access to commercial markets. Until these studies are concluded, the general effectiveness of these guarantees in helping MFIs achieve long-term access to commercial markets is an open question.

Bonds, securitization and equity investment

Obtaining a bank loan requires convincing a single bank to extend a credit. Banks have the staff capacity and interest to assess the creditworthiness of potential borrowers and that capacity can be applied to the MFI applying for a loan. However, successfully borrowing through a bond issue, as in the Compartamos example mentioned in box IV.1, involves selling the bond to a large number of investors, mostly institutional investors like insurance companies, pension funds, or mutual funds. For this broader investor group, more information must be made public to produce adequate confidence in the borrower. Thus, it is more unusual for an MFI to successfully sell a bond issue than to borrow from a bank. Nevertheless, some MFIs have issued bonds to investors on domestic markets. The successful issues have achieved a lot of visibility, although the number of issues is still very limited. Securitization deals are more recent and even less frequent. Yet these instruments are sparking increased interest in financial markets.

Bond issues. Bond issues by specialized financial institutions are becoming more prevalent, and successful issuances have attracted a lot of interest from investors, bankers and regulators (see box IV.1). But the number of these issues is still very limited. This is attributable to many factors, including the preference of many capital market investors for instruments issued by regulated financial institutions, the underdeveloped state of many domestic capital markets and financial instruments, the market perception of microfinance risk, and the relatively small number of MFIs that have an appropriate ownership and governance structure for bond financing.

Box IV.1.**Recent MFI bond issues**

MFIs are increasingly interested in tapping into capital markets to access additional longer-term funding sources. If they have the requisite reputation, they may be able to do so by issuing bonds. Typically, because MFI income comes from uncollateralized microcredit portfolios, MFI bond issues must be backed by guarantees or other credit enhancements that are provided either by state banks, development banks or multilateral agencies. Though still a marginal practice, the increase of these bond issues is expected over time to provide a local currency funding alternative for the larger and more mature MFIs. This could help deepen the local fixed-income markets of the countries in which they are issued. In spite of the challenges of the sophisticated underwriting processes, bond issues backed by microloans are increasing worldwide. The success of these bond issues in the last few years is a testament to the benefits of innovative public/private financial partnerships. Some of the more notable recent bond issues include the following:

US\$7 million FAULU KENYA bond issue (Nairobi, March 2005). Stanbic Bank Kenya Limited and its parent, the Standard Bank of South Africa served as the underwriter for a five-year bond for Kenya Shillings 500 million guaranteed up to 75 per cent by the AfD (Agence Française de Développement). Proceeds of the bond sale went towards expanding operations. This issue establishes a track record for Faulu Kenya that will be very valuable when the time comes to reach out again to capital markets for funding.

US\$30 million Fundación WWB Colombia (FWWB Cali) bond issue (February 2005). This peso-denominated investment grade bond issue had several groundbreaking aspects. It was the first time that an unregulated not-for-profit MFI issued bonds anywhere in the world. FWFB's bonds received an AA+ rating from Duff & Phelps in Colombia, even though the issue was structured without any supporting guarantee. The demand for this first bond issue by a local microfinance organization in Colombia was oversubscribed in the local markets by 1.87 times.

US\$44 million COMPARTAMOS bond issue (Mexico City, August 2004). Through its Mexican subsidiary Banamex, Citigroup organized a 500 million peso bond issue for Financiera Compartamos, the largest microfinance lender in the Americas. The International Finance Corporation provided the five-year bonds with a 34 per cent loan guarantee. The issue was rated AA by Fitch and Moody's. The initial yield was set to 170 basis points (1.7 percentage points) above the Mexican treasury bills rate.

US\$6 million MIBANCO bond issue (Lima, December 2002). Partially guaranteed by the US Agency for International Development (USAID), the Peruvian Banking supervisor authorized Mibanco to issue bonds up to US\$30 million over two years. The bonds were placed by Citibank and sold through a Dutch auction, whereby each interested investor makes an offer of an amount to purchase and the interest rate that the investor will pay. Through this process, the interested buyers — pension funds, mutual funds and insurance companies — determine the interest rate at the time of sale.

US\$700,000 (TK 50 million) BRAC bond issue (Dhaka, December 2001). The Bangladesh Rural Advancement Committee (BRAC), then the largest NGO in the world, enlisted the services of AIMS of Bangladesh Limited, the first and only Asset Management Company of the country approved to securitize BRAC's portfolio. This was the first time that a securitized debt instrument was introduced in Bangladesh and was, for all practical purposes, the first private bond issue in Bangladesh.

In general, the attraction of bonds for investors is that they are loans that they can more easily sell to another investor instead of holding them to maturity. Banks are often buyers of bonds for this reason as well. Bonds also do not require the investor to make the kind of assessment of the borrower that a bank undertakes before making a direct loan. Bond buyers rely on ratings and the recommendations of “buy side” investment advisors. For MFIs, the advantage of access to the bond markets as a form of borrowing from institutional sources is the possibility of attracting longer-term capital, larger sums, more favourable terms, and new investors.

However, the same reasons that make a bank reluctant to extend loans to MFIs may even more dissuade investors from buying the debt of these institutions. MFIs are generally not supported with bankable assets and do not have a credit rating. This prevents many major institutional investors from investing in MFI debt. It is only the strongest MFIs that have been able to place bond issues. Investors who purchase bonds issued by MFIs also realize that trading opportunities are limited: there is a limited demand for many MFI issuances and thus limited liquidity of the bond issue. Additional constraints to such issues include the relatively small volume and the lack of placement options.

Securitization. Securitization deals for MFIs are more recent and even less frequent than bond issuances. Bankers are hesitant to securitize the assets of MFIs given the relatively small size of the transactions in relation to the high structuring costs, the difficulty of lining up a back-up loan servicer, the absence of depth and maturity in this market, and the limited number of investors for this kind of security. An example of BlueOrchard’s Microfinance Securities is presented in box IV.2.

**Box IV.2.
Securitization: An example**

BlueOrchard Finance, July 2004 and February 2005

In February 2005, BlueOrchard completed a long-term lending facility generated by the Overseas Private Investment Corporation (OPIC). The structured financial instrument, Blue Orchard Microfinance Securities I (July 2004) & Microfinance Securities II (February 2005), provides loans of five to seven years. The total value of these loans is US\$92 million.

Developing World Markets (DWM) and BlueOrchard structured the securitization, and BlueOrchard originated and is servicing the investments made with the proceeds. DWM and BlueOrchard set up a special purpose company, Blue Orchard Microfinance Securities I (BOMFS I), to issue debt and equity securities to US investors and to simultaneously make the loans to the MFIs which back the notes. The debt issued by BOMFS I consists of four series of seven-year maturity, fixed-rate notes — three subordinated and one senior. Thirty-five per cent of the securitization proceeds of this second closing is guaranteed by OPIC, an agency of the US federal government, down from 75 per cent in the first closing.

An oversight role is being played over the life of the transaction by DWM, BlueOrchard, OPIC and State Street Bank, one of the subordinated note investors. The Registrar, Paying Agent and Collateral Agent is JP Morgan Chase Bank.

Equity Investment. A strong capital base provides the soundness required for mobilizing public savings and for leveraging additional debt funding. Shareholder capital has been called the most mature form of financing, but local equity investment for MFIs is still a major challenge in most markets. Many constraints that apply to debt and bond transactions also apply to accessing shareholder capital. The domestic markets are often not broad or deep enough to attract potential strategic shareholders. Frequently stock markets do not exist where shares can be publicly traded. As with other commercial sources of funding, the strength of the MFI is a critical factor in attracting equity finance. A report of the Council of Microfinance Equity Funds revealed that of the thousands of MFIs in operation, only 115 would be candidates for foreign equity investment (Kaddaras and Rhyne, 2004, p. 25).

Investors are also aware that for many years young MFIs will be struggling to turn a profit and will need to retain earnings for further growth and thus may require a significant time for equity investments to mature. These institutions need time to lay the foundations for longer-term growth. Equity can also be an expensive form of finance in terms of both the cost of mobilizing the capital and the return paid to investors. Further, equity investors are concerned with how they will “exit” from their investment. Where active public markets for trading equity securities are not available and where mergers and acquisitions are rare, “exit” opportunities for equity investors are extremely limited.

It is also difficult to find domestic equity investors with socially responsible perspectives. There has been discussion of the degree to which profitability should be expected from investments in “social finance,” or, in other terms, to what extent investors are willing to forsake return in the context of contributing to the achievement of social objectives. “Patient capital” is also lacking. While there are international social investors willing to place some patient capital, it is more difficult to find willing equity investors in domestic markets. India, for example, has plentiful resources in the domestic financial system, but equity investment in capital-based MFIs (such as non-bank finance companies) is very limited.

Strong MFIs have accumulated high levels of equity, often from donor funds and accumulated earnings, and therefore have a greater interest in increasing liabilities rather than raising new equity. In fact, data on Latin America indicates that MFIs have sought to better leverage their equity and increase commercial borrowing, thus lowering the relative portion of equity in the capital structure (Von Stauffenberg, 2004, p. 5). As institutions grow and mature, they may find that they can get no further leverage from their capital base. If so, they may then turn to task of mobilizing additional equity funding.

Agency relationships, strategic alliances and other partnerships

Receiving direct investments is only one sort of connection MFIs may make with the rest of the financial sector in a country or internationally. There is a range of other relationships in which MFIs also engage with a wide variety of financial market participants. These include “strategic alliances,” mergers and acquisitions, joint ventures, and contractual arrangements. There is equally a question of what type of relationship to maintain with donors after some start-up period.

The important opportunities generated by alliances and linkages among financial institutions have been emphasized many times. Numerous new arrangements have been and are being developed to link the operations of MFIs with commercial banks and other financial sector players. These arrangements enable

the tapping of funds on commercial terms when the MFI itself does not have sufficient strength, ability, or reputation in the financial markets to obtain such funds. Linkages may also be formed with non-bank financial institutions, such as insurance companies, retail organizations, and money transfer firms.

As these arrangements capitalize on the comparative advantages of vastly different institutions, they take many different forms. One example is banks that provide front or back office functions for an MFI; another is MFIs that offer bank services to their clients (e.g., credit cards or access to automated teller machines). There are also “service co-arrangements” in which the bank brings funds and the MFI lends and services the portfolio; they may arrange to share physical facilities, or banks may contract with MFIs to conduct operations as their agents. This arrangement is a typical way to link MFIs to money transfer firms and insurance companies. Arrangements can also be in the form of participation in governing bodies or risk allocation (such as a bank buying the portfolio of a non-bank financial institution). One such strategic alliance that banks have found to increase their presence in the microfinance market and link it to the domestic financial market is found in India:

“...Rather than lend directly to [small] NGOs up to a maximum of 4.0 or 5.0 times debt-to-equity, two of the largest private sector banks have contracted NGOs to act as service agents to help build the banks’ own microfinance portfolio. The NGOs identify potential microfinance borrowers, make credit decisions, disburse loans to borrowers on behalf of the bank, and monitor and service the loans. In return, the NGOs are permitted to charge the microfinance borrower a service fee. Since the bank holds the loan portfolio on its own balance sheet, it can grow its exposure to microfinance far faster than by lending limited amounts to NGOs that then on-lend this funding. Two years after pioneering this model, ICICI Bank now has more retail microfinance clients than the largest MFI in the country, which began operations twelve years ago” (Ivatury & Abrams, 2005, p. 14).

The many partnerships and alliances described above may last for many years, but are less permanent — and involve less of a mutual commitment — than arrangements that are ownership-based, such as the acquisition of an MFI by a bank or a merger of a network of independent MFIs into a single, more substantial institution that could itself convert into a bank. There is not a unanimous view on the desirability of setting up these various linkages. On the one hand, as one international financial service provider noted: “Partnerships unite banking infrastructure and technology and the MFIs’ clients. Partnerships have a bigger pay off than trying to do retail. It is possible to leverage skills, capabilities and investment.” At the same time, direct bank involvement in retail finance is preferred in some quarters: “My general view is that provision of these [financial] services by mainstream financial institutions themselves, whether specialized finance companies or universal banks, is a better route than linkages between non-profit MFIs and mainstream sources” (*Manager, international network organization*).

Donor funding can be a disincentive to financial market access

Donor provision of loans at concessional rates is critically important for launching microfinance operations and providing a demonstration effect. There is increasing concern, however, that donors continue

to fund the more successful institutions even when these institutions are in fact ready and able to access funding on commercial terms. This type of continued donor funding serves as a disincentive to seeking commercial funding, which may be critical to the success of the MFI over the longer term: “Donors have to stop funding the best MFIs. This is dis-intermediating” (*members of an international network organization*). A decision to seek lower cost donor funds is logical, but these funds do not build longer-term institutional independence and self-sufficiency, are often unreliable and susceptible to political changes, and can require significant effort and time to process.

Donors can participate in financial intermediation to pave the way for private sector finance. They can do this by lending, either alone or as part of private-public sector consortiums, by brokering pioneer banking relationships, by offering incentives for the entry of commercial institutions (through guarantees and other forms of credit enhancement), by taking equity positions in MFIs, by providing credit enhancement on capital market transactions and by promoting international investment funds.

These interventions and incentive schemes, which generally call for participation in the broader financial markets, are challenging for most donor institutions. In addition, there are concerns that international agencies may be crowding out domestic sources of capital. It is admittedly difficult for donors to “get it right” by participating in and facilitating financial intermediation but also by stepping aside to let commercial funders step in where appropriate. At the operational level, donor institutions are not always in a position to assist MFIs with management, technology, and growth issues in the same way that investors can, and they often are not permitted to make equity investments. Too frequently, they do not have the necessary skills and continuity to fulfil governance roles in financial institutions that an investment position requires.

Donors are called upon to fund MFIs that are not yet in a position to access purely commercial capital and to offer credit enhancement. Where it will facilitate institutional growth and sustainability, donors can play an important role in supporting the development of the infrastructure and human and organizational capacities required for financial services providers and MFIs to work together to expand access to financial services. New risk mitigation instruments and technology solutions may be needed, along with a long term approach to financial sector development. These areas leave many opportunities for international agencies to engage constructively without crowding out domestic sources of capital. In terms of the choice of institutions to fund, one member of a large international network stated:

“...Pioneering will be needed on a constant basis because the ‘financial frontier’ keeps shifting and so wise donor/social investors need to focus on the less profitable pioneers, while letting commercial investors go for the development finance institutions that are mainly scaling up the well-established models. In this sense, it is a problem if the donors/social investors also decide to invest only in ‘growing successes.’”

Issue 3.

International borrowing: Opportunity and risk

Investors in Europe and North America have expressed increasing interest in recent years in specialized, socially oriented investment funds, in particular in funds that seek to invest in microfinance in devel-

oping countries. This has provided an additional source of private funds that some MFIs have tapped, although in most cases there is an added degree of foreign exchange risk that does not arise when borrowing from domestic lenders.

The role of socially oriented international investors

There is an ongoing debate about the role of international financial market resources in inclusive finance. Some express concern that these funds distract attention from the development of the domestic market for MFI financing. There is also heightened concern about the foreign exchange risks to which MFIs may be exposed if these external funds are not made available in the currencies of the countries where the MFIs operate. Finally, others worry about the terms of such borrowing and about whether international loans to MFIs from funds that have developed in a context of particularly high global liquidity will continue to be available to MFIs in leaner times over the long term.

But these international funds provide resources to institutions in countries where domestic financial markets are not yet entering this market segment. By providing a “stamp of approval,” international investors raise the profile of lending to MFIs which is helpful for diversifying the MFI’s funding base and may prompt domestic market lenders to view the borrowing institutions (and microfinance generally) with less aversion.

How international funds see their role in relation to the mobilization of domestic resources is a question of long-term vision. Crowding out of domestic funding by international investors has been cited as a potential problem. This depends in part on the vision of the international investors. The more visionary international funds see their role as temporary: their ultimate goal is domestic financial market development. In the meantime, these funds enable the growth of social finance institutions. They can also play an important governance role as specialist investors in MFIs and have an ability to target younger and promising institutions. In short, these funds can bring management expertise, global knowledge of best practices, and innovation to the market.

Increasing concern about foreign exchange risk

As MFIs turn to international sources to access capital, the foreign exchange issue has become increasingly important. In fact, it is an issue that is front and centre in discussions about the future of financing microfinance (Women’s World Banking, 2004a). International investors and financial institutions are challenged to find ways to cover the foreign exchange risks at a reasonable cost and that appropriately match investor risk/return targets with the funding requirements of MFIs.

While international interest rates are often lower than comparable domestic interest rates (even corrected for inflation), they carry a foreign exchange risk. This risk is the possibility of a loss or gain from variations in the exchange rates between the currency of the loan and the local currency in which the MFI operates. This risk is serious for MFIs whose assets are virtually all in local currency. Local currency in many developing countries is more likely to devalue than appreciate (Ivatury and Abrams, 2005 p. 10) making all the more risky the proposition of entering into debt denominated in foreign currency

without a mechanism in place to cover the accompanying risk. The cost of instruments to hedge foreign exchange risk, when they are available, sometimes eclipses the cost of the risk being covered, especially for small transactions in small developing countries that do not have significant foreign exchange derivative or swaps markets.

Financial institutions in developed countries have access to a wide range of sophisticated financial instruments to manage foreign exchange risk. The existence of these instruments goes hand in hand with sophisticated methodologies inside the financial institutions to manage this risk. For the most part, neither exists in lower-income countries, although they are becoming more prevalent in many emerging market countries. Generally, in the countries with the greatest need for microfinance, these instruments do not exist. When they do, the amounts of the transactions are too small to justify the costs.

The serious concern about MFIs taking on unmanageable foreign exchange risk has led to increasing pressure to cover this risk by developing techniques and mechanisms for exchange risk management as well as mechanisms to encourage lending in local currency. Microfinance investment funds and multilateral investors need to look more carefully at the institutions they are funding, and pay closer attention to the currencies in which they are lending and receiving payment to make sure they are not weakening the very institutions they intend to strengthen by contributing to any serious currency mismatches.

A viable solution, and perhaps the only solution in many low-income countries, may be for the investment funds and international banks to fully accept any foreign exchange risk that their lending may entail. This would require these funds and banks to lend to the MFIs in the currencies of the countries where the MFIs operate or to provide them with full parallel coverage of foreign exchange risks. Where such funds and banks operate with MFIs in several countries, they may be able to use sophisticated hedging techniques and their balance sheets to diversify their foreign exchange risks across several countries and currencies. Several larger international funds and banks have already developed such mechanisms and instruments, for example, by issuing their own bonds in the financial markets and then lending in local currencies (see box IV.3). Further, some regulators in emerging market countries have gone so far as to prohibit financial institutions under their jurisdiction from accepting any currency mismatch in their portfolios.

Issue 4.

Drawing resources from the domestic economy: Savings as an alternative funding source

This chapter has addressed the participation by MFIs in domestic and international financial markets through debt and equity instruments. This last issue treats financial intermediation in its basic form: offering deposit services to savers and intermediating those savings to borrowers.

Savings mobilization serves dual objectives. It provides sources of funds for lending as well as a valuable service to depositors. Mobilizing savings is a means of providing a service that many poor and low-income people need desperately, as well as a primary and affordable source of loanable funds for regulated MFIs that can accept deposits. The development of savings instruments warrants full con-

Box IV.3.**International funds mitigating foreign exchange risk: Some examples****HIVOS-TRIODOS FUND**

As of 2003, Hivos began to provide a 100 per cent guarantee on the foreign exchange risk of all loans made by the Hivos-Triadodos Fund.

DEUTSCHE BANK FUND

The DB Fund makes loans that are structured as subordinated, non-amortizing, and very low cost financing (1 to 3 per cent annual rate) with maturities of three to eight years. Loans from the DB Fund cannot be used as working capital or as funds for direct lending to programme participants. Rather, loans from the DB Fund leverage capital from local commercial financial institutions, at least at a 2:1 ratio. As an exception in certain difficult environments, the DB Fund will accept lower leverages as long as within two years a 2:1 leverage ratio is achieved. MFIs earn interest on the US\$-based deposit of the DB Fund proceeds, which helps defray the cost of local currency loans from the commercial bank: DB Fund loans remains in US\$ unless the MFI defaults on the loan to the local commercial bank, thereby avoiding foreign exchange risk.

BLUEORCHARD FINANCE

BlueOrchard (see box IV. 2) works with borrowing institutions to help them put into place 95 per cent coverage of foreign exchange risk. BlueOrchard is also developing local currency lending instruments.

ACCION BRIDGE FUND

Funds of the Global Bridge Fund are used as collateral for irrevocable standby letters of credit and/or similar financial guarantees issued by Citibank in favour of MFIs. The Fund was designed to support MFIs located in Latin America, the Caribbean, Africa and other regions of the world where ACCION may expand as part of its strategic mission. The Fund guarantees not only short-term lines of credit but also the issuance by the MFIs of short-term fixed-income instruments. Participating MFIs will use the Global Bridge Fund guarantees to access local currency funds from local banks. This insulates the MFIs from the risk associated with fluctuations in foreign exchange rates incurred when borrowing from lenders outside their country.

sideration by MFIs that serve low-income populations and small enterprises. Offering savings services, however, requires a level of institutional development to meet safety and soundness requirements that many institutions have not yet reached. And while concessional funding and guarantees may sometimes hold down the cost of borrowed funds, they may also provide a disincentive to mobilize deposits, especially for small amounts that are often costly to manage.

Arguments are made that savings are lower cost funds to fuel loan portfolio growth than domestic and international borrowing. Generally, it is posited that term deposits are cheaper and easier to obtain than loans. This is not, however, always the case. Mobilizing savings requires considerable institutional development, and the actual cost of funds can be higher than borrowing, notably in markets where

subsidized wholesale funds are available. Whether savings are lower cost funds depends certainly on the nature of the savings instrument, with term deposits less expensive in terms of operating costs than managing many small demand deposits with frequent transactions. It also requires staff skills and systems that are different than those required by organizations engaged only in lending. Finally, the ability to mobilize savings depends on the macroeconomic conditions in the country and the regulatory environment.

In some cases, donor funding has created disincentives, if not competition, for the mobilization of savings. For example, the proliferation of cheap funds for on-lending through government and donor sponsored APEX organizations hinder financial intermediation. Also, the focus of donors on micro-credit (rather than the full range of microfinance services) has had an influence on limiting the range of products and services offered, particularly savings products.

Evidence on the ground has shown that, indeed, regulated MFIs are showing an increasing preference for local deposits as an increasing percentage of their liabilities (Abrams, 2002, p. 10). With full regard for the challenges and risks of introducing savings mobilization, experts worldwide recognize the fundamental importance of savings mobilization: “Ultimately, the most sustainable solution is collecting domestic savings” (*International fund manager*). “Savings is the frontier that we spend most of our efforts to solve” (*Financial sector specialist, international organization*).

Conclusion

As one member of an international network stated recently: “Having access to capital, whether from local or international sources, is a critical determinant of the ability of MFIs to continue expanding client outreach and deepening services, at a pace which will permit them to meet the demand for their services and to fulfil their potential for poverty alleviation.” Inclusion of MFIs in financial market development will continue to be a function of the broadening and deepening of financial markets, the capacity of institutions to access these markets, and the development of the financial infrastructure to increase the flow of information and link institutions.

When a variety of financial institutions provide a variety of microfinance products and services and when these institutions fund the liability side of the balance sheet in increasingly sophisticated ways, this is a sign that inclusive finance is becoming more integrated into the financial sector as a whole. Yet, numerous questions remain: which type of institutions will best be able to access financial markets? As markets develop and information is more readily available, is there a convergence of returns across institutions? How can the whole system work to reduce costs and manage risk better? What is the influence of policy in creating competition and strengthening financial markets? These and other questions need to be considered by policymakers and other stakeholders in their efforts to build inclusive financial sectors, as will be discussed in more detail later in this book.

Chapter V

THE POLICY FRAMEWORK AND PUBLIC SECTOR ROLE IN INCLUSIVE FINANCE

“We recognize that the appropriate role of government in market-oriented economies will vary from country to country.”

“Monterrey Consensus,” adopted by the Member States of the United Nations at the International Conference on Financing for Development, Monterrey, Mexico, March 2002

At the heart of the “enabling policy environment,” as outlined in Chapter I, there needs to be a clear vision of the roles expected of public sector and private sector stakeholders in bringing about an inclusive financial sector. Realizing this vision requires a better understanding of what impedes achieving it and how both the state and private sectors can be best mobilized in any particular national setting. This chapter addresses a range of issues: overall government vision and policy stance, the ongoing debate on the liberalization of interest rates, government involvement in financial intermediation, subsidies and taxation. It also includes a section on financial infrastructure. Concerns regarding regulation and supervision are treated in Chapter VI.

Government has an important role to play in building an inclusive financial sector. Experience has shown that the role can be supportive, but that government intervention can also impede financial sector development. The questions regarding the government role are not whether to engage, but what to do and how to do it in a specific country setting.

Issue 1.

Country level policy frameworks: From vision to strategy

Exercising the role of government includes an overall policy stance, a corresponding regulatory framework, and a set of legal structures that encourage responsive financial services for poor and low-income households and for micro, small and medium-sized enterprises. A vision of the overall financial sector as regards financial deepening, stability and access sets the stage for the specific strategies for inclusive financial sector development. Policy derives from the political process in the country, which should be based on open debates among the stakeholders. While an open debate may increase politicization of decision making in the financial sector, an informed one allows difference perspectives to be heard and countered with experience and expertise.

Country visions and strategies

The consultations underlying this book identified as a key constraint to the development of inclusive financial sectors the lack of a coherent government policy stance fostering a competitive and fair financial

sector overall. They also pointed out the frequent lack of an explicit policy on financial sector inclusion. These constraints seem to be widespread. For example:

“The absence of a clear vision of the state regarding microfinance activities is a great limitation for the access to financial services by poor people. Current conditions of access are favourable only for the privileged class, that is to say the large firms and large importers” (*Manager, MFI technical support agency, Comores*).

There were also many calls for a more conducive policy framework. As one consultant in Southeast Asia stated: “The [microfinance] sector has grown under a policy of ‘benign neglect.’ This cannot go on — we need a coherent and clear, transparent policy framework to go forward.” Most countries have taken a fragmented approach, one that does not aim specifically and coherently to increase the access of all people to appropriate financial services. This means that there has rarely been a clear articulation of how the social policy objective of outreach and the financial policy objective of stability should interact and balance each other.

Many people see microfinance as primarily part of social policy for poverty reduction. Thus, it has been generally overlooked in thinking about financial sector development, where it also belongs. A leader from an international network observed: “It’s our own fault; we looked for allies [in the social sectors].” The fact that there are long-term social objectives, the notable example being the achievement of the Millennium Development Goals, should not obscure the fact that inclusive finance is also about finance. Access to financial services merits incorporation into both poverty alleviation strategies and financial sector development strategies.

A number of countries have adopted explicit policies on financial inclusion, which are framed in a variety of ways. In addition, many governments have microfinance-specific policy statements and strategies (see box V.1). There are, however, only a limited number of examples of financial sector policies explicitly incorporating access, inclusion and poverty reduction. In some cases, policies favourable to financial inclusion have been adopted without explicitly addressing the issue. Three examples of inclusive financial sector development policy are outlined in box V.2, demonstrating different degrees of explicit reference to financial access or inclusion. South Africa has taken a different approach, as representatives of the financial sector, with the encouragement of the government, agreed on a strategy to extend banking and other financial services to the unbanked. They developed their own “Financial Sector Charter” and a time frame to implement it, which addresses the issue of access to a range of financial services (see box V.3).

Box V.1.**Examples of government policy stances on microfinance**

The Philippines: Beginning in 1997, the government took a decidedly pro-microfinance stance and enacted legislation that was favourable to the sector. The National Strategy for Microfinance has as its principles: (1) a greater role for private sector MFIs in providing financial services; (2) an enabling policy environment; (3) market-oriented financial and credit policies, including interest rates; and (4) non-participation of government in provision of credit. A Central Policy Coordination Office was established at the Ministry of Finance.

Source: Philippines Central Bank

Uganda: The three major government policy documents that drive the national economic agenda — the Poverty Eradication and Action Plan (PEAP), the Program for the Modernization of Agriculture (PMA), and the Medium Term Competitiveness Strategy (MTCS) — all include microfinance. These documents explicitly recognize savings as critical to the development of the sector as a whole. In 1998, a national Microfinance Forum including the Government of Uganda, the Bank of Uganda, donors, MFIs and their associations, was designated by the Ministry of Finance to become the main discussion group for microfinance. In late 1999, following a period of consultation, the government adopted a policy statement on microfinance regulation and supervision to develop MFIs to better reach the poor in rural areas. According to the policy statement, the Bank of Uganda foresaw the creation of a four-tier financial system that included banks, credit institutions, microfinance deposit-taking institutions, and all other financial service providers. The Cabinet subsequently approved the Policy Framework for Development of Micro and Rural Financing and the draft Bill for the Micro Finance Act 2001, with the aim to extend formal financial licensing to large deposit-taking MFIs and clarify the status of non-regulated MFIs. In 2003, the Microfinance Deposit-Taking Institutions Act opened the way for MFIs to reduce their dependence on donors, grow more rapidly, and offer savings services to clients.

Source: CGAP Uganda Microfinance Effectiveness Review, 2004; Nathan, O. et al, 2004.

Madagascar: A National Strategy for Microfinance (“Stratégie Nationale de la Microfinance — SNMF”) was approved in 2004. The implementation of the national strategy is undertaken through the Ministry of Economy of Finance and Budget (MEFB), along with the steering committee of the SNMF. A national coordination body (“Coordination Nationale de la Microfinance”) is in charge of coordinating the government’s microfinance policy. The Banking and Financial Supervision Commission (“Commission de la Supervision Bancaire and Financière”) at the Central Bank is the responsible body for the regulation and supervision of the microfinance industry. The activities of the microfinance industry were structured and organized during the late 1990s through a banking law which was enacted in 1995, and a law on mutual savings and credit adopted in 1996. In addition, a new law regarding microfinance has recently been adopted. This law applies to all decentralized financial systems (Systèmes Financiers Décentralisés), including “mutualist” and “non-mutualist” institutions.

Source: CGAP Madagascar CLEAR Report, 2005.

Togo: The microfinance sector in Togo is regulated and supervised by the “Cellule d’Appui et de Suivi des Institutions Mutualistes ou Cooperatives d’Epargne et de Crédit,” and the Central Bank of West African States (BCEAO). With the assistance of UNCDF and UNDP, the government worked on the development of a National Strategy for Microfinance. In February 2004, the principal stakeholders in the microfinance industry endorsed the National Strategy report. The goal of the national strategy is to establish, by 2008, a sustainable microfinance sector integrated to the financial sector, offering a diversified range of institutions and products and services in a conducive political, legal and regulatory environment.

Source: UNCDF Microfinance National Strategy Report for Togo, 2004.

Box V.2.

Inclusive financial sector development policies

Zambia — Financial Sector Development Plan for Zambia (2004)

The Financial Sector Development Plan (FSDP) (2004-2009), approved by the Zambian cabinet in June 2004, is aimed at achieving a financial system that is sound, stable, and market-based, supporting efficient resource mobilization necessary for economic diversification, sustainable growth and poverty reduction. The Financial Sector Development Plan aims to address the following issues: (1) low financial intermediation; (2) poor credit culture in the market; (3) the multiple and potentially conflicting roles of the government in the financial sector; (4) the weak regulatory framework for non-bank financial institutions, insurance and pension funds; (5) the undeveloped capital market; (6) the lack of long-term development and housing finance; and (7) the limited number of monetary policy instruments.

Following the collapse of most of the subsidized and publicly funded rural finance institutions in the mid-1990s, there has been a gap in the provision of financial services to low-income households in the rural and peri-urban areas. To address this gap, the Bank of Zambia is working on the development of a regulatory framework for MFIs which would follow the finalization of the FSDP. The FSDP provides recommendations for increasing the provision of financial services to the rural and peri-urban areas. The development of a microfinance policy is seen as a critical tool to set guiding principles. It would also allow the government to attain overall financial system stability and smooth integration of microfinance into the mainstream financial system over time.

Source: Bank of Zambia at www.boz.zm.

Bolivia — New Economic Policy (1985)

The Bolivian government did not establish an explicit microfinance policy, but created the necessary conditions in 1985 with its New Economic Policy, which liberalized the financial sector, unified the exchange rate, and imposed strict monetary and fiscal policies. The reforms included measures that allowed the successful launch of microfinance operations in Bolivia: liberalizing interest rates, eliminating directed credits, closing state banks and weak private sector banks, and strengthening the Superintendency of Banks.

In April 1993, the government approved Law 1488, also referred to as the New Banking Law, to become the basic statute for the regulation of all financial activities in Bolivia. In what constituted a turning point for microfinance activities, the New Banking Law mentioned the possibility of regulating non-profit microlending institutions. The law defined a financial entity as “a legal entity located in the country, whose social objective refers to the field of intermediation and financial services.” Those in financial intermediation were, in turn, divided into two large groups: banking and non-banking entities. The second group incorporated credit unions, mutual societies, and other non-banking financial entities into the formal financial system for the first time. The law did not define the rules for the regulation and supervision of the private financial funds or other “non-banking entities” to which it alluded (Gomez et al, 2002, pp. 1-2). “Only gradually and with a great deal of consultation did the Superintendency seek to solidify an understanding of microfinance into specific regulations” (Rhyne, 2001, p. 206).

Sources: Gomez et al., 2002; Rhyne, 2001.

Cambodia — Financial Sector Blueprint

In July 2001, the Cambodian government announced its Financial Sector Blueprint for 2001–2010. In this Blueprint, the government addressed the need to exert coherent and systematic efforts to develop a sound, market-based financial system to support increased investment and high and sustainable economic growth rates. Under the guidance of a long-term development strategy, the Blueprint detailed a sector development strategy and policy reform agenda for the banking sector, the insurance sector, the pension system, non-bank financial institutions, inter-bank/money markets, capital markets, and the financial market infrastructure. It explicitly notes the legal and public administration reforms targeted within the Governance Action Plan and poverty reduction, the primary development goal of the Socioeconomic Development Plan (2001–2005).

The sector development plan considers the interrelationship of (i) human and institutional capacity building, (ii) developments in related financial infrastructure, (iii) the establishment of a legal and regulatory framework, (iv) the emergence of relevant financial markets, and (v) the availability of technology.

The Financial Sector Blueprint views microfinance and rural finance as a fundamental part of the vision for the development of the banking sector. Within the banking sector, the Blueprint explicitly envisions (i) a competitive, integrated, and efficient banking system that is properly regulated and supervised and effectively mobilizes savings to provide financing to support the growth of the private sector, a reliable payment system and banking safety nets; and (ii) a viable, pro-poor and effective rural finance system for providing affordable financial services to enable the poor to enhance rural income and reduce poverty (Financial Sector Blueprint, 2001, p. iii).

Source: Financial Sector Blueprint, Kingdom of Cambodia, 2001.

Box V.3.**South Africa's Financial Sector Charter**

In South Africa, 15.8 million people aged over 16 are currently unbanked. Of these, about 88 per cent are black, 93 per cent earn less than R. 1,000 a month, 46 per cent are unemployed and 42 per cent live in rural areas (FinScope, 2004). There is an urgent need to draw them into the financial system to help improve their economic prospects and social stability in the country (where there is a very unequal and racially based distribution of wealth) and to enhance growth in the economy as a whole.

In August 2002, many participants in the financial sector and civil society of South Africa agreed at the Financial Sector Summit organized by the National Economic Development and Labour Council (a government forum for dialogue with business, labour and community groups) on the need to extend banking and other financial services to the unbanked. Representatives of the financial sector and the Association for Black Securities and Investment Professionals started negotiating a Black Economic Empowerment (BEE) transformation charter for the financial sector. The result was the Financial Sector Charter (FSC), which established targets in a range of areas. It was signed in October 2003 by 10 financial industry associations and came into effect on January 2004.

The charter addresses broad BEE issues of ownership, management and procurement, as well as the vital issue of access to a range of appropriate financial services and products. It established targets that participating financial institutions agreed to reach and a point scheme to measure progress toward the targets. Access, which counts for 18 of the 100 points institutions must earn to meet their targets, includes first order transaction accounts; savings products and services; credit for low-income housing, financing agricultural development or establishing or expanding black small, medium and microenterprises; and insurance products and services to mitigate risk. The response from various stakeholders has been largely positive.

In terms of access, the major banks started to implement their FSC commitments by offering a low-cost basic bank account, *Mzansi*, in October 2004. The response from customers was overwhelmingly positive. By May 2004, the banks had opened one million *Mzansi* accounts (although some of these reflect funds shifted from other accounts rather than new customers).

The date by which FSC targets must be met is 31 December 2014. There will be a review in 2008. For banking, the target for the 2008 review is that 80 per cent of the target population must have "effective access." The sector is also required to donate 0.2 per cent of its post-tax operating profits for consumer education. For additional information about progress in implementing the FSC see www.banking.org.za/documents/2004/MARCH/ProgressFinCharter.asp.

Source: prepared by FinMark Trust.

Public policy, politics and inclusive finance

The existence of a politically endorsed and nationally owned strategy for inclusive financial sector development increases the likelihood of follow-through on implementation. The politics of pro-poor

financial sector development is as much about identifying and solving technical problems within the financial system as it is about the political process of framing and implementing policy to address them. That is, policymaking is not only about whether a particular intervention will work as expected under stated conditions, but also whether the intervention will win broad support or at least acceptance by the population at large. It is also about whether policy is respected and applied consistently. The question of political economy has been framed as follows:

“In the case of technical problems in financial service provision, once fixed, they normally stay fixed. The financial technicians move on to new problems and further frontiers of efficiency. But in the world of development finance, problems of political economy are hardly ever finally fixed” (*Special Consultant, Foundation for Development Cooperation, Australia*).

While good policy and a participatory political process is thus at the centre of pro-poor financial sector development, the improper politicization of financial sector development provoked passionate responses during the consultations for this book.

Stakeholders referred to the persistent misuse of microfinance for narrow political gain, either through targeted credit to powerful interest groups or debt forgiveness to appeal to the general voting public. The political focus on short-term expediency can undo the years of development efforts of numerous stakeholders, creating frustration, and dampening support for development efforts. This is contrary to a vision of inclusive finance whereby microfinance is seen and treated as part of the financial sector.

A major challenge for public policy is to avoid treating microfinance as a charitable activity and not as “real” financial services. In such a situation, the generally accepted rules of the game for the mainstream financial sector are not applied. This can lead to ill-targeted subsidies and the undermining of a culture of credit discipline. Moreover, a lack of credit discipline (i.e., willingness to default on debt obligations) usually accompanies a perception by the debtors that the funds borrowed and not repaid are “free” money and not their own or their neighbours’ savings.

Accepted financial sector proposals may be undone by successor regimes for a range of well-intentioned and ill-intentioned reasons. One reason is that these proposals may not produce expected results. Another is that the results may not come fast enough. A third reason is that entrenched interests do not want to relinquish prerogatives regarding control of financial assets. A truly participatory political process, including full engagement by major stakeholders, can often help avoid some of these problems. Monitoring by stakeholders can also provide an important feedback mechanism about when policies are not working as anticipated and thus need to be rethought.

Given the political imperative to do so, how can governments best define the nature and extent of their support to inclusive financial sector development? The most controversial issues raised during the consultations related to the appropriate role for government in establishing interest rate levels, the direct provision of credit and the organization of public subsidies.

Issue 2.

There is still no consensus on the liberalization of interest rates

While there is greater acceptance by policymakers and populations in developing countries of the need to allow market forces more room to allocate resources, interest rate ceilings continue to exist, or have been reintroduced, in many countries. Concerned about high interest rates charged to the poor by formal institutions, policymakers are not universally convinced that liberalized interest rates best serve the needs of poor households and micro and small businesses. Imposing interest rate ceilings is a policy decision, either well intentioned or politically opportunistic. It can be politically appealing and expedient to “protect the poor” by re-imposing interest rate caps, but they can and do have negative market development consequences, and they frequently offer few benefits to the many of the very people they are intended to protect.

It is widely acknowledged that interest rate restrictions do not generally achieve the intended public policy purpose of expanding access to credit by lowering the price. In fact, low interest rate ceilings, when strictly enforced, have adverse effects on the supply of credit, its price and the transparency of the terms offered to borrowers. In some cases, financial institutions circumvent the ceilings by adding fees and other charges, thus reducing transparency with regard to effective interest rates; in other cases, enforcement is weak or non-existent, putting into question the rationale of such policy decisions; but in most cases, the supply of credit, particularly to rural areas and borrowers who are perceived as high risk, is simply withdrawn.

Interest rate ceilings continue to exist or have been reintroduced

Many countries decontrolled interest rates in the financial sector reforms of the 1980s and 1990s. Some countries retained some form of interest rate ceilings and some re-introduced them later. While most interest rate ceilings are not oriented specifically to microcredit, they can have a significant impact on the development of an inclusive financial sector.

According to the data collected by CGAP, 40 developing countries had some form of ceilings on interest rates in 2004. There were three basic forms: (1) 20 countries had interest rate controls, generally associated with pervasive control over the entire financial system; (2) 13 had some form of usury limit; and (3) another seven had de facto controls (CGAP, 2004).¹⁹

De facto interest rate ceilings exist when large state-owned banks offer large volumes of credit at below-market rates that private operators cannot match. Such loans would result in heavy annual losses for the state banks if not for subsidies to these banks provided by the government. Subsidized state-bank lenders make it difficult, if not impossible, for other financial institutions to compete in the same market if they charge sustainable interest rates. For example, in Vietnam, interest rate ceilings were lifted in 2002, but state-owned banks still follow policy guidance from the central bank or the govern-

¹⁹ The typology of interest rate ceilings can be laid out as follows: banking interest rate controls are generally codified into banking and central bank laws which grant the central bank of a country the legal authority to fix the maximum lending rate (and sometimes the minimum interest rate for deposits) for regulated financial institutions. Usury limits are part of the civil code and authorize a government body, generally the central bank, to set a limit that private lenders may charge. De facto interest rate ceilings are the result of political pressure and/or the need to compete with large subsidized government lending programmes that keep interest rates below a specific level (CGAP, 2004, p. 8).

ment, which perpetuates borrowers' expectations of subsidized loans (CGAP, 2004, pp. 9-10). A range of other country experiences is presented in box V.4.

Box V.4.

Country experiences with interest rate ceilings

- In **Bolivia**, through a January 2004 presidential decree, interest rate ceilings were placed on small loans.
- In **Morocco**, the 1999 microfinance law provided the Ministry of Finance the right to set a maximum nominal fee for microloans, a right that has not yet been exercised.
- In **Nicaragua**, the Parliament introduced interest rate ceilings in 2001. The national microfinance network association reported that portfolio growth fell from 30 per cent per annum to 2 per cent and several MFIs withdrew from rural areas. In order to survive, MFIs added fees and charges.
- In **West Africa**, the Banque centrale des états de l'Afrique de l'ouest (BCEAO) applies an interest rate cap of 27 per cent for microfinance. It is reported that some MFIs have withdrawn from the poorer, more remote areas. Increasing loan sizes has been another coping mechanism.
- In 2000, the Government of **Colombia** allowed financial entities specializing in microfinance to charge fees and commissions that are not part of the interest rate, which can be freely determined but is subject to a "usury" limit. In effect, this gave some relief to MFIs with respect to effective interest rates, as they usually charge the maximum allowed interest rate.
- Interest rates in **India** have been liberalized, with the exception of loans under Rs. 200,000 (US\$4,000) extended by formal banks, for which the interest rate cannot exceed the Prime Lending Rate (PLR). As lending rates are currently far lower for corporate lending, the interest rate ceiling of the PLR is not a major constraint. A bigger constraint is the political pressure to keep interest rates low for lending to the poor.
- In the **Philippines**, the lifting of the Usury Law in 1983 abolished subsidized credit at lower than market interest rates. The removal of the interest rate restriction then opened the possibility for banks to lend at market rates to small borrowers. The General Banking Law grants the Monetary Board the authority to regulate the interest imposed on microfinance borrowers by lending investors and similar lenders such as, but not limited to, the unconscionable rates of interest collected on salary loans and similar credit accommodations. The Central Bank of Philippines reiterates the importance of not subsidizing the loans through a lower interest rate than the prevailing one so as "to enable the lending institution to recover the financial and operational costs incidental to this type of microfinance lending."

Interest rate ceilings do not solve the policy problem

The difficulty is that interest rate ceilings are crude tools that can hurt rather than protect the most vulnerable. Interest rate ceilings can make it difficult or impossible for financial service providers to cover

their costs and can keep them from entering the market in the first place. They undermine the ability of these financial institutions to become sustainable. Unless microcredit operations can charge interest rates that are well above average bank loan rates, they cannot cover their costs. Interest rate controls also negatively affect financial intermediaries by limiting a positive return on savings, or discouraging them from offering savings products that are highly valued by poor and low-income people and are resources for investment in the broader financial sector. In environments with low interest rate ceilings, the growth of financial services providers that serve the low end of the market will be limited by the scarce and uncertain supply of soft money from donors or governments.

When governments try to set the “right” interest rate at the “right” level, they usually set them at levels so low that microcredit providers cannot cover their costs. These restrictions hurt poor people more than they help by causing existing market players to become unwilling to enter this market or they withdraw existing services from the most costly areas and the most difficult populations to serve. This forces poor people to rely on much more expensive and limited informal alternatives.

There were numerous references to interest rate issues during the consultations that expressed concern about the imposition of interest rate ceilings. In the words of a leader of a MFI in South Asia: “The fact is that imposing an upper limit on interest rates is actually an anti-poor step because it is the surest way to ensure that legitimate lenders will be driven out and closed down.” An equally firm view was the conclusion of the Expert Group convened by Women’s World Banking: liberalized interest rate were referred to as one of the “most important measures needed...to build a robust financial sector that services the poor majority.”

Legitimate concerns about high interest rates

Legitimate concerns were, however, expressed that high interest rates are not acceptable in the market segment that serves poor and low-income people. They may reduce the profitable business opportunities for the poor, and they may reduce their ability to accumulate assets. They may also lead inexperienced or financially unsophisticated poor or low-income borrowers into debt traps.

A manager of a national development bank participating in the e-conference expressed this concern, fearing that high interest rates limit the ability of small borrowers to repay loans and that the resulting non-repayment reduces future access: “The fundamental issues in product design and pricing remain unaddressed and the market fails to expand on the plea that there is no absorption capacity.”

This leaves the policy discussion in a difficult spot, as the concerns that very high rates are neither socially nor economically acceptable are easily understandable and represent a valid and persistent development perspective (Long, 2005, p. 1). At the same time, there are concerns that liberalized interest rates will lead to abuses in a context where borrowers have few options to seek out other credit providers, depriving these consumers of the ability to negotiate lower rates. Yet, experience shows that liberalized interest rates are one important factor that leads to the entry of new participants in this market segment. Finally, there is an additional concern that liberalized interest rates allow the continuance of elevated cost structures as MFIs are not pressed to become more efficient. Yet, there is also recognition that cost structures reflecting existing methodologies and technologies may already be at their minimum and all gains in efficiency have already been mined.

What solves the policy problem?

What would bring decontrolled interest rates down to “acceptable” levels? An important piece of the case for liberalized interest rates is the promise of competition, increasingly efficient institutions and well-informed customers. Underlying this premise is the critical assumption that financial markets, when allowed to function with a minimum of regulation, naturally tend to become increasingly competitive and financial institutions increasingly efficient.

The practical dilemma noted by stakeholders is that, in the absence of any controls, simply calling for competition to drive down decontrolled interest rates does not create the market or spur entry of new institutions when the conditions are not propitious. Removing controls does not take away the conditions that cause the high costs of service delivery in the first place. Nor does it assuage the political pressure to “do something now” as long as the high interest rates prevail.

Even when an increasing number of organizations that serve the low end of the market operate in a country, competition may be limited. This is particularly so in small towns and rural locations. This can raise concerns about how long it takes to develop a truly competitive market and how quickly competition per se can force costs and interest rates down. This remains an issue because lowering interest rates through greater competition apparently cannot be achieved easily in the short- to medium-term in some contexts, even those that are thought to be highly competitive. In other situations, microcredit interest rates have declined within a relatively short period of time due to competition in the market (CGAP, 2004, p. 11).

There is increasing concern that interest rates charged in microcredit operations should neither prevent achieving sustainability nor promote hidden inefficiencies, emphasizing the importance of disclosure and performance benchmarking across the sector. In that regard, a study in Bangladesh examines the questions of efficiency and competition with respect to interest rates (see box V.5). The study also reminds us that the largest MFIs could lower their interest rates, resulting in the demise of many smaller institutions. This may not be desirable for other social and economic reasons, thus emphasizing the complexity of the issue.

Box V.5.

Experience in Bangladesh in lowering costs

Evidence from Bangladesh suggests that both the questions of efficiency and competition require a closer look. A 2003 Palli Karma-Sahayak Foundation (PKSF) study (*Current Interest Rate and Financial Sustainability of PKSF's Partner Organisations*) concluded that there was no scope to reduce the interest rate of 29% APR, but that this was due to inefficiency in the microcredit operations of the partner organizations and that with greater efficiency the breakeven point could be reduced to 18% and the interest rate reduced to 25%.

Interestingly enough, interest rates have not been used as a weapon of competition. The large NGO-MFIs set the price and the others followed. The ability of the larger institutions to lower rates could result in the demise of many of the smaller organizations. Instead, MFIs compete on the basis of qualitative factors: larger loan size, shorter waiting period, flexibility, ease of access to general savings, local flavour and additional services.

Consideration needs to be given to a range of measures that lead to the lowering of interest rates over time. Some measures are regulatory, particularly with respect to market entry and costs of maintaining uncompensated mandatory reserves. Some are macroeconomic, particularly with regard to inflation and currency devaluation. And some are dependent on the operating environment where poor infrastructure leads to high operating costs. Yet, the greatest challenges are at the institutional level. At this level, the key to lowering decontrolled interest rates is to seek to lower costs on every front and pass these increased efficiencies on to customers. The measures to consider include:

- facilitating market entry for new financial service providers;
- requiring increased transparency with regard to interest rates, fees and other obligations;
- requiring transparency with regard to institutional efficiency;
- lowering the costs of operations through increases in efficiency;
- lowering the cost of provisions against loan loss by maintaining very low portfolio at risk;
- lowering the cost of funding to MFIs that show strong performance and low portfolio at risk;
- lowering the costs of operations through increases in investment in human and physical infrastructure in the country; and
- increasing the use of performance-based contracts with greater transparency in order to strengthen incentives to lower costs of operation.

In terms of political economy, there is also the question of whether within the context of a nationally owned national strategy, with commitments to build the supply response, and apply all needed measures, decisions based on short-term political expediencies could be avoided.

“Smart subsidies” and interest rates

Whether governments or donors should intervene in interest rate markets by providing subsidies to reduce costs to microcredit providers and then ensuring that these cost reductions are passed on to borrowers through lower interest rates is a widely and vigorously debated issue. In this regard, the term “smart subsidies” is finding increasing usage.

While there is no exact definition of what a “smart subsidy” is, it is generally used to reflect the concept of “maximiz(ing) social benefits while minimizing distortions and mistargeting” (Morduch, 2005, p. 2). The concept of smart subsidies also carries with it notions of leverage of other donor funding and transparency. This means that these subsidies are subject to rigorous evaluation to determine whether they have indeed attracted additional donors and investment to the market and whether the “social” aspects of returns are adequate. Smart subsidies are also rule-bound, time limited, and are usually affected through the use of performance-based contracts.²⁰

Most MFIs start out with heavy subsidies. This is warranted because their start-up costs are high and because they typically provide business and human services and assistance to clients beyond just credit.

²⁰ For a more detailed discussion of the issue of smart subsidies, see Morduch, 2005.

While the case may be strong to continue to use subsidies to cover these services and social assistance, experience suggests that ultimately, sustainability of financial services and charging interest rates to achieve it, is critical for the growth of the institutions, attracting new institutions and their ability to serve the market and thus enhance access to financial services over the long-term.

Were MFIs to charge interest rates reflecting their full costs during start-up stage, the resulting interest rates would indeed be very high. One use of subsidies that is therefore considered “smart” is to fund the start-up of new institutions to cover capitalization and operating shortfalls. “Donor subsidies should be temporary start-up support designed to get an institution to the point where it can tap private funding sources, such as deposits” (CGAP, 2004, p. 1).

The debate around whether indefinite subsidies to lower the costs of providing microcredit are helpful or wise is far from settled. One view is that subsidies can be used to lower MFI costs when there is enough competition or public oversight to give some assurance that the cost savings would be passed on to customers. The government could then target a subsidy that reduces the cost component and make it available exclusively to all members of the desired class of institutions. This view recognizes that an appropriate competitive environment and oversight infrastructure must be in place. Under these circumstances, a government could leave interest rates decontrolled and foster a subsidized MFI sector. A counterpoint on this issue of indefinite subsidies is stated as follows:

“Subsidized credit does not equal “cheap credit” (meaning, credit at interest rates well below rates available elsewhere in the local credit market) and the poor incentives that ensue. The early attacks on subsidized state banks centered justifiably on their “cheap credit” policies — interest rates on loans that were sometimes negative in inflation-adjusted terms and small if positive... Today, cheap credit is a well-understood problem, and a first principle of smart subsidies is to avoid cheap credit” (ibid., p. 3).

Another issue in this debate is the long-running discussion regarding the advisability of providing credit directly through government-owned financial institutions. As will be seen in the next section, there are controversies around this approach as well. The issue of subsidies is revisited later in this chapter. Policy options to achieve affordable and sustainable interest rates are discussed in Chapter VII.

Issue 3.

How much government involvement in financial intermediation?

Publicly owned banks and other state-owned financial institutions are the major providers of financial services for the majority of individuals in developing countries. Many of them operate with heavy subsidies, some less so, and others operate on a commercial basis. Despite frequent and repeated calls for indirect rather than direct involvement of government in financial services provision, as also expressed clearly by participants in the multi-stakeholder consultations underpinning this book, there is a renewed interest in developing countries in direct government involvement in financial intermediation. This interest has developed from an intention, for a variety of motivations, to better serve underserved market segments. Is this appropriate? Under what conditions does it work?

State banks have always been justified by the failure of private banks to adequately serve the economic and development goals of a country. In particular, governments seek to encourage serving locations outside the main metropolitan areas and the less advantaged economic sectors. The premise is that financial markets in general, and the banking sector in particular, are different from other markets and that government intervention can improve the working of the financial sector and the overall functioning of the economy. Arguments for state engagement in financial intermediation are based on the need to promote financial development and provide access to competitive banking services to unbanked and underserved areas and sectors.

It is also recognized that private banks may not find it profitable to open branches in rural and isolated areas. There is some experience suggesting that privatized state banks have closed such branches for being unprofitable. State intervention is designed to provide access to clients in those areas, based on the principles that: (1) granting access to banking services increases economic and financial development, with positive externalities for growth and poverty reduction; (2) access to financial services is a right, and the state should make an effort to see that they are universally provided; and (3) in some cases, public banks can foster competitive behaviour in an otherwise non-competitive banking sector by entering as market players.

Experiences of state-owned banks

Concerns about government ownership of financial institutions are based on negative experiences in a large number of countries and focus in particular on faulty risk management in direct lending to retail customers. Wholesale (or “rediscount”) lending (called “second-tier” operations) are seen as less controversial, although there too government apex institutions have not been without problems. Yet, there are also some examples of state-owned banks that are very successful in operating commercially. Some of these banks focus extensively on extending financial services, particularly savings, to the poorer segments of the population. The difficult questions that can be answered only at national level are: what works well, where and why?

Regulators are particularly outspoken about the problems posed by government-controlled banks given their inability to apply the same supervisory standards to these institutions, whether they are retail or rediscount, as to private ones. Expressing his frustration during the multi-stakeholder consultations, one banking supervisor stated: “One, you can’t enforce regulations; two, it’s bad for corporate governance because of conflicts of interest; three, it’s bad for risk management; and four, it’s bad for competition. The market just doesn’t grow.”

A large body of evidence suggests that direct government lending to poor people has not been effective or achieved stated governmental objectives. As a result, governments should either reform the way these activities are conducted or remove themselves from this activity. Additional research and experience suggest that government lending programmes in countries with weak overall governance are often used as vehicles for political patronage, introduce market distortions, and result in extremely low loan repayment rates.

- A study by the International Monetary Fund (IMF) on the Middle East and North Africa region showed that inefficient state-owned banks stifle private participation in the financial market at

large, impede competition, increase the cost of financial services and result in high fiscal costs associated with subsidies (IMF, 2005, pp. 8-10). The 2005 IMF review of experiences with World Bank/IMF Financial Sector Adjustment Programmes (FSAPs) noted that the most common set of recommendations in each country related to the need for improvements in corporate governance of state-owned institutions (IMF, 2005, p. 3).

- A recent Inter-American Development Bank study is more nuanced in concluding that: "...state ownership of banks has a negative impact on growth in countries with low financial development but no statistically significant effect on growth in countries with high financial development... [All in all,] state owned banks are a heterogeneous family that may work satisfactorily in some countries and disappointingly in others" (IDB, 2004, pp. 22-23).
- A recent analysis of over 2,000 institutions reporting to three microfinance databases found that only 7 per cent of the borrowers from state institutions were being served by financially sustainable programmes. In contrast, 64 per cent of the borrowers from private microlenders were being served by sustainable operations (Gonzales-Vega, 2003).

Successful state-owned banks. There is, nevertheless, a renewed interest in the potential of state-owned banks within the "new development finance paradigm." There is special emphasis on their potential to serve rural areas (Young and Vogel, 2005, p. 11), and there are a number of successful institutions in terms of outreach and sustainability.

Successful cases include BRI, which has shown that a government owned agricultural development bank could be transformed into a profitable self-reliant public sector intermediary and a major microfinance provider. The Government Savings Bank of Thailand is also a successful state run savings bank. The Government of Mexico created Financiera Rural, the state-owned successor to BanRural, which has shown excellent performance. The Chilean BancoEstado has a country-wide distribution network that gives it a presence in the poorest rural neighbourhoods in Chile.

Characteristics that affect the success of state-owned banks. This leads to the question of the conditions under which it is justified for governments to involve themselves in financial intermediation. Are there important distinctions among different types of state-owned banks and the products and services they offer? What makes one succeed and the other fail?

There is no doubt that there is a distinction to be made between savings and credit institutions. One feature of several successful state-owned banks is that they are savings banks. Experience suggests that successful state-owned financial institutions offering credit services are rarer. Government-owned postal systems have long been important providers of savings and payments services in developing and developed countries. What is more contested is the role of governments in credit provision. This is because the fundamental principles of successful credit delivery (selection of borrowers on the likelihood of repayment, credit repayment discipline and pricing in relation to costs) can be a challenge to defend against political interference. Nonetheless, as noted above, experience indicates that some state banks have successfully met this challenge.

In addition to the above-mentioned principles for credit operations, the ability to deliver on the following factors indicates in which situations state-owned banks may function well:

- a well-defined mandate lowers the likelihood of a compromised mission and conflicting objectives;
- clear accounting of explicit and implicit subsidies is required to reflect true costs;
- sound governance is essential, with an independent board of directors and strong technical management who are accountable for solid financial performance;
- transparency in delivering audited financial statements that account for subsidies and are monitored by the public in a clear way (as through reporting to the legislature); and,
- most importantly, government must be committed to the protection of the institution's operational independence from political concerns and pressures, reflected in the governance structure and backed by policy statements, laws or charters and transparent public reporting.

Given the importance of state-owned institutions in serving poor households and firms in developing countries and their potential to serve the unbanked and underbanked, the attention policymakers give to their sound performance, transparency, governance and independence from political considerations is well founded. These issues are revisited in Chapter VII.

Priority sector lending

Governments sometimes mandate commercial financial institutions to allocate a percentage of their lending to certain economic sectors or to the less advantaged segments of society in an effort to broaden the access to financial services of those targeted. Earlier directed lending programmes fell into disfavour. In a number of countries these programmes were applied in a way that distorted market signals and did not achieve the intended purpose. Recently, some better-designed programmes have resulted in increased commercial bank involvement in finance for micro, small and medium enterprises. Overall, the following cautions come up repeatedly with regard to priority sector lending schemes:

- when lending requirements are coupled with interest rate ceilings or subsidies, they do not lead to sustainable outreach over time;
- without previous experience in microlending, mandated portfolio quotas tend to result in poor performance;
- if not monitored, commercial banks can find loopholes around the minimum lending requirements;
- if the penalty for non-participation in priority sector lending is small, banks may choose to pay the penalty rather than participate;
- state-owned or managed banks operating under subsidized conditions may crowd out private sector institutions who seek to stay in the same market segment.

The above notwithstanding, priority sector lending requirements can work well when they bridge the divide between financial institutions that have not reached into underserved markets and the customers in these markets. Where this involves correcting preconceived notions about costs and risks and

good performance is demonstrated, this type of lending can lead to the establishment of lasting banking relationships, although it is important to note that successful experience to date in this transition is defined by the few rather than the many.

As an alternative approach, governments can give banks incentives or disincentives (rather than mandates) to increase outreach. They can also cause all banks to provide minimum banking services for otherwise excluded segments of the market on terms that are consistent with market principles. Furthermore, they can encourage banks with a social commitment to offer very basic services to groups currently excluded (Claessens, 2005, p. 32). Examples of priority sector lending requirements that are often cited and reviewed are Priority Sector Lending (PSL) in India, as well as the Community Redevelopment Act of the United States (see box V.6 for a range of additional examples). Success over time will depend to what extent financial institutions realize that actual risks are lower than perceived risks and to what extent they find innovative ways to serve the market and lower costs, leading to a longer-term commitment to the particular market segment.

Issue 4.

The role of subsidies and taxation

Governments seek to influence economic behaviour by establishing financial incentives and disincentives through subsidies and taxation measures. Subsidies often have a negative connotation, although governments all over the world use them regularly. While some governments and recipients have misused subsidies, others have used them effectively. The same may be said about using the tax system to influence the behaviour of particular economic actors. Indeed, tax advantages and incentives should be considered a form of subsidy. Here we consider how subsidies, including through the tax system are used to influence the provision of financial services.

Subsidies: Valuable or counterproductive?

Consensus has yet to emerge on whether and how to organize and monitor public subsidies for financial services. While subsidies have many drawbacks when they are misused or are applied without the necessary transparency and care, they can help to pursue social objectives and to correct for “market failures.” Subsidies are subject to the same cautionary note with regard to politicization as other forms of government intervention.

Numerous constraints can hamper the implementation of successful subsidy programmes. Constraints include wasted subsidies, excessive fiscal costs, and the capturing of subsidies by the relatively well off who already have access to financial services. There are concerns that subsidies can distort the market and do not produce the intended outcome because they favour more inefficient financial service delivery and often do not reach the intended target group. Amid these concerns, there is a call, as pointed out above, for “smart subsidies” that would serve the purpose of institutional and market development without unduly distorting the market or lowering the incentives for strong institutional performance. The question is how subsidies are allocated most efficiently to achieve the greater good. While some subsidies are counterproductive, others can be valuable.

Box V.6.**Recent experiences in directed lending programmes**

India: Priority Sector Lending (PSL) in India mandates banks to lend 40 per cent of their total loan portfolio to priority sectors. Such lending includes economic sectors like agriculture, small-scale industries, transport operators and education. They can lend directly or by proxy, as in lending to the National Bank for Agriculture and Rural Development or the Small Industries Development Bank of India. The Reserve Bank of India has had to encourage private banks to do more by way of direct lending. As a follow-up to the 1999 Task Force Report on Microfinance, PSL was extended to microfinance. This has caused banks to focus on both wholesale lending to MFIs and on linkages with Self-Help Groups. Private banks often consider microfinance to be a good alternative in the context of this obligation and some go so far as to say that they would do it anyway.

Brazil: Since 2003, the Government obliges banks to lend 2 per cent of their demand deposits to the microfinance sector. Under the same legislation, an interest rate ceiling of 2 per cent per month was imposed, loan sizes for individuals and small enterprises were defined, a minimum term of 120 days was designated, and maximum loan originating fees were defined. Some banks have chosen to maintain unremunerated reserves rather than lend in the microfinance market. The additional constraints of the maximum loan size and the interest rate cap are not conducive to the success of this policy.

Venezuela: In 2001, the government forced all financial institutions to lend 3 per cent of their gross portfolio to microfinance, with a two-year deadline for meeting this goal. A 0.1 - 0.5 per cent fine was to be imposed in case of non-compliance. In 2004, the obligation was toughened to 10 per cent of the portfolio, with an interest rate ceiling of 80 per cent of the weighted average lending rate of the six largest banks. It is reported that this arrangement has benefited Bangente, as banks lend to this specialized microfinance institution in order to fulfil the requirement. There is concern, however, that some commercial banks just reclassify some of their existing portfolio as microfinance.

Colombia: In Colombia, the government proposed to the banking system that it make a commitment to microfinance on a voluntary basis. There was a clear positive response from the banking system. Banks can invest in microfinance through either retail or wholesale operations. The one concern expressed is that wholesale financing from commercial banks to NGOs lowers their incentive to transform to formal institutions in order to mobilize savings.

Nigeria: The government implemented in 2001 a voluntary scheme calling for all licensed banks to set aside 10 per cent of their profit for equity investment in SMEs, through fresh equity capital or the conversion of debt into equity shares. As the program is optional, there has been limited take-up and the investments are concentrated in Lagos.

The debate around subsidies is clarified by looking into the nature of the subsidy, which is defined in terms of its structure, implementation, and duration. Opposing views suggest that the question is not one of subsidies or not, but rather whether specific subsidies are well-designed. One view states that:

“...the jump from criticizing this kind of cheap credit to criticizing other kinds of subsidies is made far too quickly by leading microfinance advocates... These advocates emphasize the need to strengthen financial systems over more immediate efforts to reduce poverty... While there is wide acceptance of subsidies to help institutions get through initial start-up periods wherein costs are high before scale economies can be reaped, there is much less acceptance of the idea of using subsidies in an ongoing way to aid clients. From a theoretical vantage, the argument for using ongoing subsidies is solid, and, in practice, well-designed subsidies may be easy to implement and effective for borrowers...” (Armendáriz de Aghion and Morduch, 2005, p. 245).

An alternative view states that:

“The view that the poor have to be offered financial services in a subsidized manner is more damaging than the earlier stage when the financial sector simply ignored the poor. This is because by offering limited, rationed, politically accessed, subsidized services to the poor, governments tend to discourage the organized private sector from addressing this market, and further entrenches the informal sources — moneylender, etc. since the subsidized services are never enough and never available when needed. This thinking is more damaging than specific regressive/repressive financial sector policies such as ceiling on interest rates or directed credit” (*Member of international network organization*).

Addressing issues of purpose, efficiency, and market distortion best focus the debate on whether a subsidy is valuable or counterproductive. The conventional view has been that prolonged subsidies reduce the independence of the subsidized institution, obscure inefficiencies and create barriers to productivity increases. New research suggests policy can be more nuanced, based on an analysis of the efficiency of MFIs (see box V.7).

One challenge for policymakers is thus how to design more efficient or “smart subsidies” to obtain a specific market outcome without introducing distortions and long-term subsidy dependence. Another challenge is how to design a subsidy that efficiently reaches the intended groups of people. The effects of the subsidy on the retail institutions and the financial markets need to be considered: does the subsidy serve the purpose of institutional and market development without weakening internal risk management systems of the institution, or, alternatively, does it unduly distort market forces? “Smart subsidies” cover the non-financial elements of an MFI’s operations and are distinct from the ability of an MFI to cover financial costs. Costs that are “smart” to subsidize are, for example, start-up costs, research and development, costs of high-risk/significant impact products, costs for capacity building, costs for building customer capacity and costs of building capital access (Development Finance Forum, 2004, pp. 49-51).

In designing and implementing subsidy programmes, the goals of reducing interest rate spreads, assuring autonomy and financial sustainability, and also assuring the ability of the institutions to serve the target client group, must all be kept in mind. One proposal is to co-share costs and risks with the private sector (Claessens, 2005, p. 31).

Box V.7.
Subsidy and efficiency in MFIs

Many supporters of microfinance have contended that MFIs can and should become financially sustainable. However, after more than 15 years of microfinance operations, it seems that less than 5 per cent of MFIs cover their costs. Those that do grew large enough to achieve scale and outreach advantages. Others that are not fully sustainable are generally much smaller. While one might conclude from this that the entire sustainability premise is wrong and unrealistic, a closer look reveals that the MFIs that struggle to become fully self-sustaining are not necessarily poorly managed or inefficient. Rather, these operate in a context which imposes constraints that make it impossible for them to reach the scale necessary for full financial sustainability.

Indeed, a major research project of the International Labour Organization in cooperation with three European academic institutions is currently underway to unpack the notion of efficiency in MFIs and what its relationship might be to sustainability. Based on surveys of 50 MFIs worldwide covering the period 1999–2003, the study first seeks to isolate the effects of location, legal form, staff costs, scope for externalizing transaction costs and competition. Treating these factors as essentially exogenous to the firms, efficiency is then a question of whether a given MFI performs well in relation to the best of class operating in the same or a similar market and context. See www.ilo.org/socialfinance.

Preliminary findings of the study suggest there are at least four major combinations of efficiency, financial sustainability and poverty focus:

- Some MFIs are poverty focused and efficient, but not fully financially sustainable. This group consists of MFIs with low administrative costs per client and per loan portfolio, a return on assets between 0 and 25 per cent, and clients with loan amounts of less than 20 per cent of gross national product (GNP) per head.
- Another group consists of MFIs that are less focused on the poor, has a low level of efficiency (a high percentage of portfolios at risk, loan loss provisions exceeding 10 per cent) and insufficient financial sustainability.
- The third type comprises MFIs that are modestly efficient in terms of staff productivity figures, perform reasonably well financially (provisions for bad debt of below 5 per cent and a loan loss ratio of less than 0.5 per cent) and are clearly poverty focused (average loan amounts of less than 20 per cent of GNP per head).
- The fourth category consists of MFIs that are not very efficient, are modest performers in terms of financial sustainability, and are not very focused on the poor (average transaction sizes of US\$500 and more), high administrative costs per client, but acceptable levels of write-offs (between 0.5 and 2 per cent). This type of MFI tends to charge relatively high interest rates.

In other words, some MFIs are efficient and poverty focused but not sustainable; others are efficient, poverty focused and sustainable as well. For some MFIs, sustainability may not be attainable by moving up a learning curve or trying to expand to a scale that is beyond reach. One could argue that in such instances there is a case for long-term public sector support, albeit on certain conditions. First, policy makers should be able to separate efficient from inefficient MFIs. This seems easier than it is in practice, as financial performance is often treated as synonymous with efficiency. Secondly, the subsidy should be shaped in a way that minimizes and even excludes negative externalities. This might be done by paying for fixed investment in institutions but not subsidizing financial or human resources. Third, the subsidy must not lead to slack performance in the MFI itself. In this regard, MFI receipt of the subsidy could be governed by incentive-based contracts that are time-bound, transparent and staggered. As with so much else in the field of building inclusive financial sectors for development, in the end it is for individual countries to decide what policy to adopt as regards the admissibility, scope and conditions of subsidization.

Taxation: Incentives and disincentives

Participants in the multi-stakeholder consultations expressed concerns about unfair treatment of alternative financial institutions by tax regimes on the one hand and the lack of sufficient tax incentives on the other. The short discussion here addresses the issue of fairness and the level playing field for different forms of taxation and complaints of inadequate tax incentives.

*Fairness and the level playing field.*²¹ There are concerns about important differences in how tax regulations are applied to financial institutions (e.g., whether loan-loss provisions are treated as an expense, or whether sales tax is collected on interest payments) and about the inconsistent application of the rules across institutions within the financial sector. Because banks usually operate under special tax regimes, in some respects more onerous, in some respects less so, than non-bank financial institutions, numerous issues exist around the choice of the best tax instruments to apply to specialized financial institutions, both in terms of efficiency and in terms of ‘fairness’. This arises in respect to three main sources of tax revenue, namely income and profits taxes, sales or expenditure taxes, and taxes on transactions.

Many financial institutions serving poor people consider that they should be tax-exempt or that they are unduly taxed in comparison with other institutions. In some countries, NGOs and charitable organizations are granted exemptions from income and profits taxes. In other countries, NGOs and charitable organizations do not have tax-free status or access to special exemptions. There is also discussion around the question of maintaining the tax-exempt status for newly transformed formal financial institutions as long as profits continue to be re-invested in the new entity. In many countries, the tax consequences of changing from an NGO to a formal financial institution are so significant as to be a disincentive to transformation. Tax exemptions are of course an indirect subsidy.

Calculation of taxable profits is often done in a different way for banks, for example, taking particular account of loan-loss provisions. Furthermore, the tax rate for bank profits may differ from that applicable to other sectors. As a result, alternative non-bank financial institutions can find themselves

²¹ Not addressed here are implicit taxes, such as unremunerated reserves at the central bank.

less favourably treated. For example, non-bank finance companies in India cannot deduct provisions as an expense for tax purposes, whereas the regulated financial institutions are allowed to do so.

In almost all countries that have a value added tax (VAT), banking is effectively outside the VAT system, whereas other licensed financial institutions may be in the VAT net, possibly placing them at a disadvantage.²² For example, in the Russian Federation, non-commercial MFIs were subject to a 20 per cent VAT on interest earnings, while banks were exempt from the same tax. Efforts on the part of microfinance practitioners to change the law resulted in the amendment of the VAT law to also exempt them.

Transaction taxes, including so-called “stamp duties” on loans, checks and other money transfers, have often been applied to some banking business. Indeed, several Latin American countries have recently had recourse to sizable *ad valorem* taxes on a wide range of banking transactions (cheques, cash withdrawals and deposits, securities transactions, etc.) in order to boost fiscal revenue quickly. The potential for an adverse long-run impact on financial sector development of imposing such taxes at high rates is a concern. However, applying *ad valorem* rates increases the progressivity of transactions taxes and reduces the burden on small transactions. Indeed, non-bank financial institutions exclusively serving poor people can be exempted from them without significant loss of revenue.

Tax incentives. There are also calls for tax incentives for financial institutions serving the micro and SME market segments. There are conflicting principles for and against tax incentives, such as nurturing the capacity to serve poor people (“infant industry” argument) versus seeking equality of treatment and letting competition determine the outcome (maintaining a “level playing field”).

Tax incentives (exemptions, deductions, transition periods) can serve to encourage and enable the market for inclusive financial services to develop. Provided that governments have in place the administrative and legal mechanisms to monitor the commitment of financial institutions to serve the lower end of the market, designing fiscal schemes that relax the fiscal burden on financial institutions interested in serving this client segment should encourage market expansion, including the decision of larger banks to downscale. To avoid distortion, tax incentives, which are in fact subsidies, should be designed to have the least impact on the relative prices of services. Experience has shown that taxation can become an extremely complicated field with the tax code full of special dispensations for one special interest or another, usually with negative consequences for the overall fairness of the tax system and its ability to collect revenue.

The first consideration in making changes in a tax regime is to develop a clear understanding of the tax environment, including an analysis of the extent of any unfair practices and disincentives, many of which may exist unintentionally. Proposed taxes need to be assessed in terms of their impact on financial institutions, enterprises, and individuals in this market segment. Taxes should be based on the type of activity or transaction and should apply equally, or in an otherwise rational, transparent manner, to all institutions offering it.

Tax incentives, like subsidies, should be undertaken with caution and should be reviewed periodically. Like other policies for building inclusive financial sectors, they should be part of the discussions among all the relevant stakeholders.

²² Although in practice, VAT-exemption may not always be all that advantageous to the banks, if they cannot make VAT deductions and therefore effectively bear the VAT on their purchased inputs.

Issue 5.

Policies to broaden and strengthen financial infrastructure

Increased attention has been given to inadequacies in financial infrastructure. The underpinning financial infrastructure covers the range of support mechanisms provided by the public and private sector to foster financial sector operations.²³ A strong financial architecture is important for promoting financial market development, competition and access of the poor to financial services. Supportive infrastructure includes measures to enhance transparency, information sharing, innovation, and risk mitigation with a view to enhancing competition in the sector so that retail financial institutions may deliver lower cost and higher quality services. While much of the infrastructure can be provided by the private or non-profit sector, oversight, standard setting and legislation are clearly government functions.

Elements of the financial infrastructure of special importance to financial services for poor people include risk-mitigating information infrastructure that promotes transparency (credit bureaux, rating agencies, accounting and auditing services), a payments, clearing and settlements system that is accessible by the institutions serving poor people, secured transaction laws, and the independence of the legal and judicial systems. These elements are essential to a properly functioning financial sector. Thus, policy decisions need to be made about priority investments and the degree of government involvement in putting this financial infrastructure into place.

Infrastructure that enhances risk mitigation

One of the most commonly cited reasons why retail financial institutions do not serve poor and low-income people is that it is too risky to do so. Information about credit risk is hard to come by, and most institutions are not in a position to evaluate information that is not presented in a way that they understand. In this sense, improvements in the quality, type, and availability of information and its flow are important to overcoming the barrier of perceived risk.

Credit bureaux. Critical to an inclusive financial infrastructure is the role that credit bureaux play in financial market deepening and risk management. Providing credit information designed to evaluate appropriately the real risk associated with serving micro, small, and medium enterprises as well as individual poor and low-income clients, would help dispel much of the perceived risk of serving currently unbanked people, enable entrepreneurship and lower the costs.

A credit bureau is typically a private enterprise that collects information on borrowers from banks that are members or subscribers to the bureau. This information is then shared with all other members/subscribers. In this way, banks can know if a potential borrower has had difficulty staying current on past loans or has built a strong credit history.

A complementary need that may everywhere be a government function is establishing identification numbers that facilitate information sharing and an effective property registry, although microcredit for the poorest customers usually does not require property as collateral.

²³ “Financial infrastructure” does not have one standard definition. Here it is defined as the information infrastructure available to the financial sector (credit bureaux, rating, auditing standards), the payments, clearing and settlements systems, as well as the system of recognized standards. The definition can extend to include legal systems, legislation and regulations, the international financial architecture and infrastructure that enhances innovation, such as technology, communications and human resource development.

Elements of the legal framework. More attention is now being given to strengthening property rights and to the functioning and adequacy of the legal and judicial system. But this focus has yet to yield a well-functioning infrastructure protecting debtors, creditors and shareholders alike. Bankruptcy laws are often inadequate, the litigation system out of reach for most poor people and the enforcement mechanism inefficient and ineffective. Deficiencies in the legal system can affect both borrowers and creditors adversely. Concerns regarding weaknesses in the legal system go beyond the financial sector. The process of improving legal systems is a longer-term and fundamental development concern.

Infrastructure that enhances transparency

Standards, disclosure requirements and codes of practice of trade associations are common tools to enhance transparency. Accounting standards and external audit requirements serve to push financial institutions to produce better accounts, clearer and more comprehensive financial information, and improved management and control systems. Disclosure requirements (and voluntary disclosure through standardized performance reports) not only increase transparency but are an incentive to improve performance, notably when benchmarking is involved.

Some countries have enacted consumer protection laws, with ombudsman services that provide information, receive complaints and seek redress directly or through the court system. Enhanced consumer protection and disclosure requirements on the pricing of products are often constructive alternatives to imposing interest rate ceilings. The balance between protection and restrictions and between innovation and change is always a concern for government, consumers and retail financial institutions. Dialogue among trade associations, including bank associations and microfinance networks, as well as the appropriate government agencies, is a key to this debate.

Ratings performed by specialized, neutral and internationally recognized agencies serve to enhance transparency. Rating has come to mean significantly different things with regard to microfinance. It is important to clarify the difference between traditional rating and microfinance rating, since the function and the source of funding for each are different.

Generally, enterprises arrange to be rated when they intend to issue debt instruments in financial markets. This is not the case for the ratings of MFIs, although some have been rated by traditional rating agencies. In general, MFI ratings are external assessments of performance by internationally recognized microfinance rating agencies. The ratings contribute to increasing the assurance level of national and international funders. The “who pays” question is different between the two cases. Traditional ratings are paid for by the institutions seeking to issue securities while the cost of microfinance ratings has been shared between the institution being evaluated and international funders.

Infrastructure that increases efficiency and reduces costs

It is in the interest of the broad range of financial institutions to develop clearing and settlements systems able to process an increasing number of transactions. A larger number of transactions will generally drive costs downwards. The parameters of these systems need to be such that smaller financial

institutions can benefit directly or through linkages with larger financial institutions. Many see the design of such systems as a public good.

Access to payments and clearing systems. A critical aspect of financial integration is access to financial networks. These systems are increasingly sophisticated in terms of technology. Access to the payments and clearing systems, as well as information sharing among banks, is generally limited to larger banks. Access to these networks by smaller financial institutions is also an issue in industrialized countries (Claessens, 2005, pp. 23-24).

Most specialized MFIs do not have direct access to payments and clearing systems. It is difficult for them to meet clearing requirements, and “piggy backing” on other banks is not always workable.

“Many developing countries lack an efficient electronic clearing and settlement system among local depository financial institutions. In addition, in those countries where such inter-bank clearing systems exist, they generally do not permit access to non-bank financial institutions because they are owned or controlled by banks who do not want to let in competition” (*Senior manager, credit union association*).

The implementation of payments systems can be expected to bring more transactions into the main-stream economy. Electronic payments can expand the options for secure receipt of wages and income as well as spending. They can be an incentive to using other financial products, notably savings accounts. In fact, alternative payment systems exist, notably through some postal systems and in networks of credit unions, both domestically and within international networks, including the network established under WOCCU and payment systems under the Universal Postal Union and Eurogiro.

Infrastructure that enhances innovation

Here again, infrastructure that serves to foster innovation, increase efficiency and lower costs is a public good. Technology and communication infrastructure has received increased and well-justified attention. Capacity-building initiatives that are network-wide, countrywide or regional, as well as research and development activities, merit support in light of their contribution to enhancing market conditions in favour of inclusive finance.

Financial infrastructure requirements are achievable even in the most remote locations through partnerships with commercial financial institutions, using smart cards, wireless technology, credit bureaux and financial literacy programmes (VISA, 2004). Shortcoming in the infrastructure pertaining to inclusive finance is clear. An economy without financial infrastructure to mitigate problems associated with uncertainty, risks and opportunistic behaviour restricts finance to those who have the necessary connections or wealth to reassure existing financial institutions. More open systems to share information, better and publicly available assessment of risk, greater participation in financial networks, better laws, and clearer property rights can all increase access to financial services by customers and access to financial markets by MFIs (Rajan and Zingales, 2003, p. 9).

Conclusion

Government policies, laws and regulations can constrain the building of inclusive financial sectors. But they can also serve to re-engineer and revitalize the financial sector, and they can bring particular focus to issues around financial inclusion. Critical choices are required for the government policy stance, the role of government in financial intermediation and the development of fiscal incentives for inclusive financial sector development. Given these complex issues, many stakeholders have called for a minimalist role for government intervention — for governments to adopt a “do no harm” approach which aims to ensure that laws, regulation and supervision do not impede the development of an inclusive financial sector. Others, convinced that this minimalist approach is clearly insufficient, are unwilling to be passive, and they actively seek positive inducements to speed inclusive financial development.

Questions of how governments in countries with underdeveloped financial sectors that are intent on improving access can deepen and broaden financial sector development can lead to a polarized discussion around interventionist and laissez-faire views. In allowing and fostering various configurations of permissible activities for financial institutions, governments will in practice make choices that are most likely neither exclusively interventionist nor excessively laissez-faire. The seven strategic option sets outlined in Chapter VII revisit many of these issues in a manner aimed to foster constructive dialogue about the policy directions that individual countries may wish to pursue.

Chapter VI

LEGAL MODELS, REGULATION AND SUPERVISION IN THE CONTEXT OF INCLUSIVE FINANCE

"Don't fix problems that do not exist; don't ignore problems that do."

CEO, microfinance regulatory body

The range of financial institutions that participate in the provision of financial services and the regulatory and supervisory regimes that oversee them are critical elements of financial sector development. They determine the development and the direction of an inclusive financial sector. As retail institutions grow, they develop more sophisticated financial products and services and become more adept in accessing resources to fuel the growth of their portfolios. The legal, regulatory and supervisory framework is challenged to not only keep up, but to lead the way for the development of inclusive finance. In many countries, this framework is underdeveloped. Retail financial institutions are often frustrated by the incompatibility of the existing framework with their growth trajectory. Policymakers and regulators are challenged as well as they seek to redefine the opportunities for inclusion and to respect the fundamental principles of protecting the customer and the financial system. It is not surprising that numerous issues are raised in this context.

This chapter looks at legal, regulatory and supervisory issues from the perspective of the public policy goal of increasing access. It treats the questions of access as an objective of regulation and supervision, the importance of various institutional models, the issues of when and how to regulate, and a selection of concerns in the area of regulation and supervision of building inclusive financial sectors.²⁴

The importance of regulation and supervision

The financial sector is one of the most heavily regulated sectors of the economy. There are several good reasons for this.²⁵ One reason is macroeconomic: a breakdown in the financial system would bring any market-based economy to a halt. Theory, as well as 200 years of history, document that financial institutions, left to themselves, take on excessive risk; they can fail en masse during a cyclical economic downturn, resulting in a major financial crisis. Some banks fail in such situations because of their own lending practices. Others fail because of their financial linkages with other institutions.

²⁴ This chapter focuses on regulatory issues associated with microcredit and the mobilization of savings. It does not generally consider other regulatory issues, particularly those related to payments and insurance services.

²⁵ Understanding some of the basic considerations of financial regulation is fundamental to addressing the constraints to better regulation and supervision of microfinance activities. A useful reference for the basics of financial regulation is Goodhart et al (1998).

Prudential supervision of banks seeks to limit the risks banks can take by overseeing their loan and investment portfolios.²⁶ This oversight is based on the rules set by the banking regulators to ensure adequate capital resources to handle the most difficult situations. Most countries also establish a “lender of last resort” in anticipation of this eventuality. Generally, the central bank is charged with providing liquidity to the banking system when households and enterprises lose confidence and seek to withdraw their funds all at once, triggering a crisis.

Regulation entails rules imposed by public authorities and implemented by financial institutions. Regulation is always about making judgments and trade-offs, considering the costs and benefits. Prudential regulation seeks to minimize some risks and to leave others to be borne by the financial institutions on their own. Devising an effective regulatory regime involves striking a balance between too little regulation too late and too much regulation too soon. Excessive regulations can accrue costs to public authorities and financial institutions that are higher than the risks being mitigated. Full awareness of the limitations of regulation and supervision is important — not all risks or practices can be covered. Finance itself is about risk. As a result, attempts to remove all risk would be regulating away one of the very functions of finance and financial contracts.

Beside the fundamental macroeconomic case for prudential regulation of banks, governments typically regulate banks and other financial institutions to protect depositors. In the case of secure savings, deposits are guaranteed, either implicitly in government-owned banks or via deposit insurance in privately owned banks. Deposit insurance facilities have an interest in the supervision of private banks to limit excessive risk-taking with the funds of savers and thus with the reserves of the deposit insurance fund.

The traditional objective of regulation is thus to keep inherent aspects of financial market behaviour from harming vulnerable customers, individual financial institutions or the broader financial system. More recently, the concerns of regulators have extended to preventing the misuse of their financial systems for money laundering or financing terrorism. Although far from widespread, some industrialized and developing countries add explicit development or social considerations to these universal functions of financial regulation. There is increasing recognition that, in addition to their importance for customer protection and financial stability, legislation and subsequent regulation and supervision have an impact on access to financial services.

Particular considerations for developing countries

The context in many developing countries is one of weak financial sectors in weak economies. The economies in these countries are subject to greater volatility in terms of economic growth, inflation, and nominal and real exchange rates. In addition, financial markets are generally thin in terms of number of players and narrow in terms financial instruments. Accordingly, markets in developing countries are frequently volatile and illiquid. In some cases, financial legislation and regulations are not

²⁶ Regulation is prudential when it is aimed specially at protecting the financial system as whole as well as protecting the safety of small deposits in individual licensed institutions. Prudential regulations (e.g., capital adequacy norms or reserve and liquidity requirements) almost always require a specialized financial authority for their implementation. Non-prudential regulation (e.g., disclosure of interest rates and of information regarding the individuals controlling an institution), sometimes called “conduct of business” regulation, may often be self-executed and can often be dealt with by others than the financial authorities (see CGAP, Consensus Guidelines, 2003).

respected, or even properly defined. Supervisory authorities have limited capacity and will too often want to focus more on prudential regulation that mitigates systemic risk rather than on the regulation and supervision of small institutions that offer financial services to poor people.

Structural obstacles are also far greater in developing than in industrialized countries. Accounting practices are often weak and obscure, which makes it difficult for bankers to evaluate borrowers. Furthermore, strong and transparent accounting and auditing systems are lacking, which hinders the ability of banking supervisors to evaluate bank financial statements and management controls. These factors also make it difficult for bankers to evaluate borrowers. This increases the tendency to rely more on collateral rather than on cash flow when evaluating borrowers. This is exactly the opposite of what is needed in microfinance where cash flow considerations, social and family circumstances, and repayment history replace collateral as the primary determinants of eligibility to borrow. At the same time, legal protection for creditors is often weak in developing countries. Legal rights to pledged collateral of borrowers in default are highly circumscribed in many markets, making it difficult for banks to rely on collateral for risk mitigation. In addition, the financial experience and literacy of the general public are often lacking. Under these conditions, the problem of client vulnerability to financial institution exploitation is great.

In this context, implementing regulation is particularly challenging. This is often true when banks perform poorly and are undercapitalized. As less reliance can be placed on the internal control systems of financial institutions, relevant authorities need to actively monitor and supervise banks and to authorize and carefully monitor deposit-taking institutions. There is considerable advantage to keeping the regulations, and thus capacity for monitoring, simple and straightforward. Clear procedures should match the capacity of retail financial institutions to comply as well as the capacity constraints of supervisors.

Issue 1.

There is still uncertainty about what, when and how to regulate

There is considerable uncertainty about what to regulate, when to regulate, and how to regulate microfinance operations. It is simply not clear to many stakeholders, including regulatory authorities, to what extent government should oversee microfinance operations and how much to spell out in legislation and regulatory frameworks. This uncertainty is attributed to a lack of understanding of the risk profile of portfolios of microcredit and loans to SMEs, and authorities thus frequently err when demanding that general or specific prudential regulations must apply. This can lead to limitations on market entry, over-regulation, under-regulation and concern for regulatory risk on the part of regulators. In some cases, regulatory and supervisory authorities prefer to desist completely from addressing the regulatory issues that microfinance raises, rather than failing to meet the challenge of supervising large numbers of small institutions that they may not understand.

The range of institutional models is frequently limited

In many countries, there is a limited number of legal models for financial institutions whose mandate includes outreach to the poor and to micro and small enterprises. Either the models do not exist, or, when specialized legal frameworks have been developed, only a narrow range of models for microfinance providers are permitted under legislation. Too often, one model is favoured in relation to, or even to the exclusion of, other models.

It does not have to be this way. A range of legal structures in microfinance can enable institutions to provide responsive, efficient and sustainable services to different client groups. They can offer different products and serve diverse economic sectors and geographic areas. In fact, overall diversity of institutional form may be an important factor in protecting developing financial markets from instability.

In addition to the question of institutional models, there are legal issues around giving larger financial institutions permission to introduce microfinance products and services. Allowing larger institutions to compete with other MFIs means applying the same regulatory parameters to their microfinance portfolios as for smaller specialized institutions. At the same time, concerns are raised that in adjusting standards (e.g., acceptance of non-traditional alternatives to collateral), there will be “regulatory arbitrage,” as banks claim that some assets are “microloans” when they are in fact consumer loans with different characteristics and a different customer base.

Adding diversity to the types of financial institutions allowed to operate in an economy can increase access to “unbanked” populations and give more alternatives to customers. Diversity contributes to competition in terms of improved pricing, and it also increases the variety and quality of products and services available. Owing to their different operating modalities and risks, a diverse universe of financial institutions can function as a cushion against the volatility of financial markets and can constitute part of a strategy for promoting financial sector resilience. At the same time, a pro-diversity policy can lead to a proliferation of the number and type of organizations. This might yield a chaotic financial sector that may exceed supervisory capacity.

Policymakers are challenged to consider the trade-offs between openness of entry to new market participants and concerns regarding the soundness of these institutions. Moreover, decision makers must carefully evaluate the design of new institutional models that support the expansion of microfinance activities by existing institutions and even consider the advantages and disadvantages of strategic partnerships and consolidations that may occur among the variety of market players. These questions are revisited in Chapter VII.

When to regulate

In most countries, MFIs pose little risk to the banking and payments systems as a whole and therefore are not a primary concern for regulators. However, the decision of when to regulate is critical for the protection of customers and for the soundness of microfinance portfolios, either in specialized regulated institutions or as a specialized unit or activity in a larger financial institution. The “when to regulate” issue is raised over and over again by regulators and supervisors worldwide.

There is one straightforward and compelling case for prudential regulation: to protect public savings and savings of members of cooperative structures that are equally at risk. Thus, a strong case can be made that MFIs must be prudentially regulated by a government-backed regulatory authority as soon as they start to intermediate savings from the public, i.e., accept deposits from the public and lend them out. But two other critical factors must be taken into account when deciding whether to regulate:

- ***The capacity to supervise.*** There is no point in introducing prudential regulation unless it is determined beforehand that the authorities have the capacity to supervise implementation of the regulations effectively. Regulation is only as good as the supervision behind it.

- **Proportionality.** In the context of limited supervisory resources, resources need to be put where they are most needed to stem systemic risk and/or where the risk profiles of the portfolios of the institutions under consideration require special attention.

Beyond these fundamentals, there is often uncertainty and disagreement on when to regulate. There are questions about what is done with the funds of the savers, who the savers are, and who holds the risk of institutional failure.

There is no straightforward way to draw a clear line in the sand with regard to when to regulate the various types of savings services. The line between credit-only MFIs and deposit-taking MFIs is not always clear. The “fuzziness” is introduced by the issue of what we mean by “public savings” and what the costs and benefits may be of introducing prudential regulation. Some of the key questions involved are listed below and are set forth in table VI.1:

- whether savings are placed by the retail institution in relatively safe financial instruments, such as government paper or commercial bank accounts, or are used to increase lending;
- whether compulsory deposits that may be required before or during the term of the loan should trigger the need for prudential regulation, as clients are net borrowers;
- whether the mobilization of voluntary savings from “members” should trigger prudential regulation, as in savings cooperatives. In this case, however, the concept of “member,” as distinguished from the general public, is not always clear, particularly when cooperative institutions have a large and heterogeneous membership.

Table VI.1.
When should savings mobilization be regulated?

The case for regulation is clear when...	There is a grey area when...	There is no need to introduce prudential regulation when...
...savings are mobilized from the general public that are then intermediated (on-lent).	...savings are deposited in regulated financial institutions (“frozen”).	...compulsory savings are mobilized as loan collateral and clients remain net borrowers.
...membership boundaries are so “open” in the case of cooperatives that a “member” is not different from a public “depositor.”	Clients “top-up” their compulsory savings, i.e., deposit more than is required by the loan contract.	...institutions are small and community based, where the cost of supervision outweighs the benefit.
	...member-based organizations are very large and not able to supervise themselves.	
<p>“The broader the deposit base, the more flexible the use of deposits, the more the need to regulate is compelling” (<i>Independent consultant</i>).</p> <p>In other words, the further away the client is from his or her savings, the greater the need to protect the client through prudential regulation.</p>		

What kind of regulation and who regulates?

There is a continuing call from many quarters for “self-regulation.” This is sometimes deemed a substitute for direct governmental regulation and supervision. There is a need to clarify what “self-regulation” is, as the term is used in different ways. Both internal regulation and industry regulation are termed “self-regulation.” In addition, it is critically important to specifically define who the “industry” includes before “industry self-regulation” can be properly evaluated for potential effectiveness.

Given the increasing complexity of structures, different levels of oversight are important and necessary but should not be confused. The four levels of regulation (direct governmental regulation, industry self-regulation, internal financial institution regulation) and market discipline are complementary. The essential point is not to confuse the state regulation required when public savings are involved with “self-regulation” at the industry level, which cannot be a substitute for government supervisory oversight.

Table VI.2 lays out four levels of oversight and the responsibilities at each level. The fourth level (“market discipline”) is included to indicate the important role that markets play in disciplining financial institutions. While this is not a regulatory function, it is nonetheless of critical importance to financial sector development and when considering what other kinds of regulation a particular situation might require.

How to regulate microfinance

The “how” of regulating microfinance activities needs to take into consideration the specificity of microfinance risks, the ways MFIs do business and the rapid evolution of organizations that serve this market. Balancing prudence and flexibility is a challenge. As one member of an international MFI network stated:

“Key to fostering innovation and growth within the financial sector is the building of a legal and regulatory regime that is flexible and dynamic enough to respond to the ever changing nature and scope of the risks that are inherent in the provision of financial services. This is easier said than done, however.”

There is a clear need for open and informed dialogue among stakeholders to devise appropriate regulatory regimes for MFIs. Microfinance portfolios are different in several respects from the portfolios of commercial banks. These differences call for special treatment in regulation. Two fundamental differences are the risk profile of these portfolios and the various techniques and technologies employed to serve these borrowers. The primary differences with respect to risk profiles involve having many small loans with many poor or low-income borrowers who may not have collateral, clear title to property, regular and predictable cash flow, or unequivocal credit histories. Because MFIs may use different lending techniques and documentation than other lenders and because the MFI market is undergoing rapid technological change, supervisors may be challenged to understand many attributes of microfinance that are different from conventional banking.

Table VI.2.
Degrees of regulation and oversight

Nature of Regulation	By whom	Implications
State Regulation	Central Bank Supervisory Agency	<ul style="list-style-type: none"> • State is ultimately responsible for systemic issues and for institutional soundness. • State protects depositors. • With risk-based supervision, increasing emphasis is placed on monitoring of internal systems and risk-management policies, rather than on portfolio review. • Only the state has the ability to apply sanctions, including withdrawal of license.
Industry Regulation (Monitoring) (Self-regulation)	Industry Association	<ul style="list-style-type: none"> • Builds industry standards. • Valuable for institutional development and transparency. • Cannot replace state regulation because of inherent conflict of interest issues and the inability to sanction non-compliance. • Complements state and internal regulation.
Internal Regulation	Internal MIS Internal Audit External Audit Governance Bodies	<ul style="list-style-type: none"> • Effective internal controls critical to avoid excessive risk taking. • Relieves burden on external regulators. • Increasingly important under risk-based supervision. • Allocates important responsibilities to management and directors.
Market Discipline	A range of market participants (clients, creditors, external auditors, raters, shareholders in publicly traded financial institutions)	<ul style="list-style-type: none"> • Requires transparency and disclosure. • Creditors and customers assess overall risk. • Publication of audited financial statements and ratings. • Increasingly important as markets deepen and MFIs integrate into financial markets.

The regulatory framework for microfinance should take the specific risk profile of MFIs into account. Table VI.3 summarizes the risk issues and subsequent regulatory considerations. Box VI.1 describes a very useful resource on the regulation and supervision of microfinance activities.

Table VI.3.
Microfinance risk and regulatory considerations

The risk categories encountered are the same as commercial banking...	...but the nature and range of risk can differentiate significantly				
Credit risk	The range of products and services is more limited; many small loans to many small borrowers; limited documentation; no physical collateral.				
Ownership and governance risk	Ownership is different: may be NGO, may be evolved from non-profit organization that remains principal shareholder.				
Operational risk	Credit decisions can be decentralized; systems are not sophisticated; accounting and auditing may be rudimentary; management team may have social motivation and limited business experience.				
Liquidity risk	Lack access to short-term credit lines; limited financial instruments with which to raise funds; matching savings and borrowings may be new challenge.				
Foreign exchange rate risk	Difficult to hedge relatively small foreign exchange positions.				
<p>...therefore regulations should be adapted accordingly and be...</p> <table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th data-bbox="240 1428 812 1480">more prudent where necessary...</th> <th data-bbox="812 1428 1380 1480">more flexible where possible...</th> </tr> </thead> <tbody> <tr> <td data-bbox="240 1480 812 1858"> <ul style="list-style-type: none"> • Limitation in number of products and services • Lending limits • Insider lending prohibition • Strict loan classification and provisioning • Stricter capital adequacy • Higher liquidity ratio </td> <td data-bbox="812 1480 1380 1858"> <ul style="list-style-type: none"> • Lower minimum capital requirements • Credit review procedures instead of an exclusive focus on documentation • Acceptance of microlending methodologies • Collateral requirements modified • Allowing for ownership by originating NGO in the case of transformation • Streamlined approval of new branches </td> </tr> </tbody> </table>		more prudent where necessary...	more flexible where possible...	<ul style="list-style-type: none"> • Limitation in number of products and services • Lending limits • Insider lending prohibition • Strict loan classification and provisioning • Stricter capital adequacy • Higher liquidity ratio 	<ul style="list-style-type: none"> • Lower minimum capital requirements • Credit review procedures instead of an exclusive focus on documentation • Acceptance of microlending methodologies • Collateral requirements modified • Allowing for ownership by originating NGO in the case of transformation • Streamlined approval of new branches
more prudent where necessary...	more flexible where possible...				
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Box VI.1.**The Microfinance Regulation and Supervision Resource Center**

The Microfinance Regulation and Supervision Resource Center is a valuable resource to stakeholders in inclusive finance who are interested in learning more about regulatory matters. It was developed as a joint project by the IRIS Center at the University of Maryland and CGAP. The aim of the Resource Center is to address the need of banking regulators and supervisors, MFIs, national microfinance networks, and other stakeholders to understand issues concerning the optimal mix of regulation and supervision for microfinance by disseminating information on world-wide experiences.

The Resource Center consists of the following sections: (a) the Comparative Database on Microfinance Regulation; (b) the Reference Library; (c) the Basics of Regulation; and (d) the Information by Country. The Resource Centre provides opinions of international and local experts on microfinance regulatory reforms and the impact on the microfinance industry. The Information by Country section also has a collection of country-specific links to the relevant laws and regulations affecting microfinance, as well as recommended reading.

The Microfinance Regulation and Supervision Resource Center can be accessed at www.microfinancegateway.org/resource_centers/reg_sup.

Issue 2.**The challenges of applying tiered regulation and risk-based supervision to microfinance**

Having a broad range of legal structures helps financial service providers offer responsive, efficient and sustainable services to different client groups. They can offer different products and serve diverse economic sectors and geographic areas. In fact, as discussed above, overall diversity of institutional form may be an important factor in protecting financial markets from instability and may also enhance access to financial services by underserved groups. However, regulators face a challenge in calibrating the oversight and control of risk to the varied profiles of these institutions. In the past, especially in developing countries, financial institutions were — more or less — either subject to banking regulations or not. Now, a more complex set of regulations may be applied to different tiers of the financial sector. Related to this is the challenge of adopting risk-based supervision, which is becoming a standard approach, at least of sophisticated banks in an increasing number of countries. Supervisory authorities adopting a risk-based approach are addressing what this means for smaller, less sophisticated financial institutions.

Tiered regulatory structures

It is recognized that a continuum of institutions providing microfinance will not usually develop fully without a regulatory environment specifically designed to foster their growth. A tiered approach to

regulation can be an important part of this environment. Such an approach applies different regulations to different types of institutions, with the most intense regulations restricted to “tier 1” commercial banks. This allows the authorities to take into account the different types of institutions offering micro-finance services, the different products and services they offer and the different markets and populations they serve. It is useful in designing regulatory structures, in tiers, to recognize basic differences in the structure of ownership, governance, capital, funding and risks faced by different financial institutions. This allows keeping regulations appropriate and as simple and straightforward as possible. This should also enhance the capacity for monitoring.

The establishment of tiered structures fosters diversity in institutional models and calibrates regulation and supervision to the specific products and services offered and their associated risks. It recognizes that credit-only institutions need not be prudentially regulated, but may require registration and oversight of activities in relation to their commercial or non-profit tax-free status. Where prudential regulation is required, in a tiered structure a range of financial institutions is licensed by the regulatory authorities to provide banking and other financial services to the public. The licenses generally specify limits to the products and services that the institution can offer, as well as the regulatory standards to be observed. This means that small specialized institutions or limited banks may coexist with large universal banks in a tiered regulatory structure that remains under the jurisdiction of the banking regulators. In some countries, new or amended banking laws and legislation create specific legal structures that lead to the establishment of tiered regulatory structures.

Risk-based supervision

Globally, financial systems have been changing in a way that has been challenging the adequacy of traditional approaches to prudential regulation. The traditional approach to regulation is to set limits on different types of decisions that financial institutions might take and ask supervisors to assess performance and risk management thereafter against those rules. The new approaches give more weight to requiring financial institutions to strengthen internal risk analysis and management and control systems. These approaches ask supervisors to seek evidence of sound risk management and internal control capabilities within the financial institution. No external supervision can substitute for sound management. Supervision schemes now increasingly require that banks follow particular risk management practices, rather than having limits set on their portfolios.²⁷

One reason for the change is that the increasing complexity of operations and speed of portfolio adjustments in banks make external supervision based on the periodic sampling of portfolios increasingly unreliable. In industrialized countries, and increasingly in developing countries, regulators see strong internal management control as the first and most important protection against imprudent or improper actions and positions. In this context, the quality of risk management techniques is paramount.

²⁷ Risk-based supervision focuses on the risk management capabilities of financial institutions, rather than focusing on portfolio quality. It does not focus primarily on the risks themselves but rather on an institution’s ability to identify, monitor and manage risks. Implementation of this approach entails an assessment of an institution’s governance, management and operational systems, with less emphasis placed on sampling of the loan portfolio (compliance-based supervision). Risk-based supervision focuses regulatory resources where risks are greatest.

Introducing risk-based regulation and supervision is a current challenge worldwide. Applied to microfinance, it would appear as an increased emphasis on risk management in MFIs and a fundamental shift of emphasis among managers and regulators to better anticipate and manage risks, rather than just react to them. Under this approach, MFIs would need to meet a series of process standards, including having an independent risk control and audit function, and effectively use risk reporting systems.²⁸ Is this an attractive approach? On the one hand, the great number of small loans makes the application of traditional portfolio examination by periodic sampling unwieldy, making risk-based supervision appealing. On the other hand, being able to apply risk-management models requires sufficient institutional strength and risk management capability within the financial institution, bringing us back to the fundamental question of MFI capacity.

Risk-based supervision recognizes that the oversight and control of risk is shared at several levels. It also recognizes that in the case of deposit-mobilizing institutions, state regulation enters into play and includes the ability to enforce corrective action in the case of non-compliance. Box VI.2 describes a risk-based approach to supervision in the Philippines, including a summary of provisions related to MFIs.

Box VI.2.
Applying risk-based supervision in the Philippines

Bangko Sentral ng Pilipinas (BSP), the Philippine central bank, is adopting a risk-based approach to supervision over all financial institutions under its jurisdiction. Under this approach, emphasis is placed on each regulated institution's risk management system. The important elements that supervisors should verify are: (1) the level of board and senior management oversight; (2) adequacy of policies, procedures and limits; (3) adequacy of risk measurement, monitoring and management information systems; and (4) comprehensiveness of internal controls. To enhance the effectiveness of the risk-based approach to examination, the CAMELS* rating system is being adopted.

With regard to BSP's approach to supervision on microfinance, emphasis is placed on the following elements: (1) well-defined standards, credit policies and procedures; (2) specific measures to be undertaken to ensure collection, such as close supervision of borrower's projects and operations; (3) a Loan Portfolio and Other Risk Assets Review System that serves as an adequate loan tracking system and a regular monitoring of past due loans and portfolio at risk; and (4) a comprehensive manual of operation for microfinance.

Source: Bangko Sentral ng Pilipinas.

* Regulatory rating system based on a standard checklist of Capital adequacy, Asset quality, Management ability, Earnings record, Liquidity and Sensitivity to interest rate variations.

²⁸ See Vogel and Fitzgerald, 2000. See also the "Toolkit for Institutional and Product Development Risk Analysis for MFIs" (MicroSave and Shorebank Advisory Services).

Issue 3.

The need to focus on the adequacy of supervision

“Don’t try to regulate what you can’t supervise.”

Advisor, international donor consortium

The lack of supervisory capacity in a number of countries hinders progress made in creating and adapting legislation and regulations that foster access to financial services. Mandating supervision without the corresponding capacity is not only unwise, it is dangerous. A crucial question with regard to all financial supervision is whether the supervisor has the tools, the capacity and the capability to supervise the regulated institutions and to control compliance with regulatory requirements. While increased market entry leads to more competition, market entry needs to be limited by the ability to supervise the new and old market participants. It is unsafe to promote entry without the necessary supervisory tools and the capacity to apply them to monitor new market players. For many supervisors, microfinance is a completely new field that presents new and particular challenges in an environment where the supervision of commercial banks is already overwhelming.

A range of supervisory issues

Overall, the development of supervisory tools for inclusive finance proceeds slowly, based in part on uncertainty about their application. As participants in the global consultations underlined, supervisory capacity is strained and uncertainties abound. As one consultant from East Africa noted: “The Central Bank is challenged to provide efficient supervision of existing regulations, while the growing and intermediating SACCO [cooperative] sub-sector is not well regulated, resulting in significant sub-systemic risk.” And as an e-conference participant observed: “There is a lack of consistency as to how financial institutions are treated under regulation ... everyone interprets the rules as he wants.”

Capacity to supervise. Until recently, most central banks and bank authorities had not seen the importance of understanding the nature and nuances of microfinance. Often, legislation and regulatory measures for microfinance have been drafted without due consideration of the actual burdens of supervising many small, unconventional MFIs. Supervisors, who may be absorbed by a formal banking sector in transition or one in crisis, may not be prepared to supervise a large number of small institutions. Supervisory authorities too often lack understanding of the specific characteristics of micro and SME finance, which is new in many countries. They are also properly concerned about not being able to deliver, due to a lack of capacity to supervise so many institutions and to the concern that these organizations may, under certain circumstances and regulatory schemes, then be eligible for government bailout in the event of difficulties. There are also reputational risks for supervisors if specialized institutions are not monitored properly, and potential costs for the customers, the institutions and their investors, if the institutions have financial difficulties or fail.

Rigorous application of regulations. Not enough emphasis has been placed on how supervision is to take place. This should be clear before putting into place legislation and regulations. Supervisors need to rigorously enforce capital requirements, strict loan classification and provisioning rules, and other measures.

Accounting systems and auditing procedures. Tougher standards are meaningless if accounting systems and auditing procedures permit financial institutions to misrepresent the quality of their portfolios, the veracity of earnings and the adequacy of capital. The weakness of auditing firms and accounting practices is a concern that must ultimately be addressed by supervisory authorities.

Regulating and supervising institutions in rural areas. Some legal and regulatory frameworks do not focus adequate attention on institutions serving rural areas. For example, standard requirements for physical infrastructure (e.g., safes, thick plate glass windows) penalize institutions with premises and operating procedures unlike those of conventional banks. In addition, supervisors, whose capacity is already stretched thin, do not conduct as much off-site and on-site supervision of rural facilities as of urban ones.

Corrective action. The range of corrective action that can be imposed by supervisory authorities is far more limited for deposit-taking MFIs than what can be applied to more conventional banking activities. Given the limited number of possible responses, it is important that supervisors see and respond to problems sooner rather than later and prepare for the consequences if deposit-taking MFIs fail. Adequate monitoring is essential for assuring the continued sound track record of deposit-taking MFIs and their increasing integration into the financial system.

Issue 4.

Should regulation incorporate access to financial services as a policy goal?

“We have to make the regulators responsible for not just the ‘safety of depositors’ money’ and ‘system stability’ but add a third criterion, ‘how universal is access to savings.’”

Consultant, international network

Regulation deals with protection, soundness and stability, but not explicitly with access. Yet, increasing access to financial services is the cornerstone of a vision of inclusive financial sectors. As a result, it can become an important goal of public policy. In carrying out their prudential and client protection functions, at a minimum, regulatory authorities could be aware of the impact their decisions have on access of poor people and SMEs. They should also be aware of the extent to which regulation and supervision put into place “facilitative conditions” (G: ENESIS, 2004, p. 6). This does not mean that the traditional concerns of regulation should be compromised, but rather that access should not be inadvertently restricted. Indeed, some measures within the parameters of regulatory and supervisory frameworks can foster access. This can be done by taking into consideration the impact of regulations and supervisory

tools on financial inclusion and by being open-minded about allowing for the introduction of innovative and well-supervised financial products and the methods for their delivery.

Adding outreach explicitly to the regulatory framework

There is increasing interest in including access to finance and, more specifically, access to microfinance, in banking regulation and supervisory practices:

“...the role of regulation in the financial sector is changing. It is shifting from a focus on purely preserving stability and correcting market failure to one that actively seeks to develop financial markets and, in particular, to provide access to un- and under-served consumers. This is introducing new and uncharted influences on the financial markets, making that much more challenging the role of the policy maker” (G: ENESIS, 2004).

As a former central banker from Bolivia recalled: “Supervisors should approach the regulatory and supervisory systems for microfinance with fresh minds, rather than assuming that they can simply adapt a few of the traditional banking sector’s regulations” (Trigo Loubière, 2004, p. 30).

Incorporating access considerations into banking regulation and supervision would require:

- changing mindsets about the market segment;
- allowing a range of financial institutions to introduce microfinance products;
- treating microfinance as a business line across the full range of institutions and supervising it as a separate asset class;
- allowing for greater innovation in product development and a greater range of products than regulated financial institutions are traditionally permitted to offer;
- allowing institutions to “graduate” to other institutional forms and regulatory regimes and to grow organically to serve the micro and SME market;
- bringing micro and SME finance institutions into the mainstream financial sector;
- allowing space for innovation in operations by developing regulations with a view toward increasing flexibility without sacrificing soundness;
- adjusting supervisory practices on the basis of a better understanding of the risk profile of micro and small enterprises, as well as of poor households; and,
- reconsidering international standards in the context of access as a policy goal.

In South Africa, considerable discussion has already taken place on the questions to ask regarding the incorporation of market development and access into the regulatory framework, incorporating the considerations mentioned above (see table VI.4).

Table. VI.4.
A framework to evaluate regulation in South Africa

Driving Objectives	Facilitative Factors	Potential outcomes
Systemic Stability	<ul style="list-style-type: none"> • Prudential regulation, • Compliance requirements, • Minimum capital requirements, • Reporting requirements 	<ul style="list-style-type: none"> • Positive: Stable, healthy system; negative externalities of failure minimized • Negative: Compliance cost and barriers to entry means potentially less competition
Market Development (including access)	<ul style="list-style-type: none"> • Improve competition • Improve infrastructure • Allow space for product innovation • Allow space for organizational growth • Develop capacity of informal sector • Liberalize with global market • Consumer education 	<ul style="list-style-type: none"> • Positive: Diversity of suppliers; geographic spread and products; greater access; increased levels of savings • Negative: Potentially more systemic risk, and product risk
Protection of Consumers	<ul style="list-style-type: none"> • Increase disclosure • Create protective institutions and redress • Improve information flows • Consumer education 	<ul style="list-style-type: none"> • Positive: Greater faith in more inclusive market • Negative: Potentially higher compliance costs; stifled distribution channels to low income market
Market Efficiency	<ul style="list-style-type: none"> • Improve information flow • Improve infrastructure 	<ul style="list-style-type: none"> • Positive: Lower costs for consumer
Public Safety	<ul style="list-style-type: none"> • Customer identification • Risk management • Compliance requirements • Reporting requirements 	<ul style="list-style-type: none"> • Positive: Reduced criminality; increased confidence in system and suppliers; international connectivity • Negative: Reduced access to financial systems; increased costs

Source: G:ENESIS, Presentation to South African Workshop on Financial Regulation and Tiered Banking, 22 November 2004.

Experience with regulatory treatment of microfinance

Experience with the regulatory treatment of microfinance suggests that access has not yet been generally made part of regulation and supervision. In general, bank regulators treat microfinance as a risky sector because they believe that microcredit borrowers normally do not post appropriate collateral, do not have adequate business plans and financial statements and are lacking guarantees or other forms of credit enhancement. It is, however, increasingly well recognized that this “conventional wisdom” is not necessarily true. As more information about microfinance in a country is accumulated, it serves to increase the ability of policymakers and regulators to assess the true risk in this line of business. A more sophisticated approach to regulation that takes into account the experience of lending to poor people and their enterprises is required.

Much progress has been made in developing legal and regulatory frameworks for microfinance. This has been in response to the growth of MFIs and the involvement of international networks and donors. Concern has been expressed that this progress has been accomplished outside of the established financial regulatory framework and that there has not been a fundamental change in the mindset of regulators and supervisors. There is evidence that:

“...when regulatory authorities took microfinance seriously early on and responded with a supportive yet not overly restrictive approach, the sector has developed and matured. Where regulatory authorities ignored or avoided microfinance, the sector has been slower to develop or has developed outside the regulated financial sector” (Trigo Loubière, 2004, p. 2).

A number of specific concerns related to the question of regulatory constraints to increasing access have been raised consistently by stakeholders:

- entry requirements are onerous, both in terms of minimum capital requirements and licensing procedures;
- uncollateralized loan portfolios are not allowed or carry excessive provisioning requirements;
- even where uncollateralized portfolios are allowed for microfinance, the lack of traditional collateral can become a constraint to accessing resources from financial markets, due to legal restrictions or excessive risk weighting of the asset;
- there is not enough regulatory leeway to introduce new products;
- the ability to open new branches is restricted, and requirements for branches do not correspond to the needs and possibilities of the institutions concerned, particularly in rural areas;
- reporting requirements, including accounting rules, are ill adapted to the functioning of the institutions concerned; and
- non-bank financial institutions are excluded from access to the interbank market and to the payments system.

Regulating to increase access with soundness

Increasing access entails introducing flexibility in regulations and supervisory practices while at the same time assuring the protection of depositors. Adjustment of regulatory regimes might thus include some like those set forth in box VI.3.

Box VI.3.

Proposed regulatory adjustments to expand access to financial services

- Lower minimum capital requirements.
- More flexible approval of new products and delivery systems as well as fostering regulators' understanding of credit methodologies.
- Expedient licensing procedures.
- Acceptance of non-traditional substitutes for collateral as well as the use of portfolio quality measures as a basis for assessing risk.
- Simplified reporting requirements, adjusted to the methodologies of the financial institutions concerned.
- Faster approval of new branches allowing for rapid expansion of branches whose infrastructure is adequate for the operations in question.

At the same time, the risk profile of the financial institutions concerned and the products and services they offer requires the strict application of regulatory parameters in key areas to ensure financial soundness. These include:

- strict entry requirements in terms of “fit and proper” tests (standards for owners, directors and managers);
- minimum capital requirements lower than commercial banks, reflecting the economic scale of institutions and the ability to supervise;
- deposit-taking institutions may be required to demonstrate solid performance in lending operations during a transition period before being allowed to actually mobilize deposits;
- strict and early provisioning for overdue loans;
- conservative requirements on currency and maturity mismatches; and
- rigorous internal and external audit procedures.

The question of balancing soundness and access in the regulatory and supervisory regimes is revisited in Chapter VII.

Issue 5.

New regulatory issues that need to be considered

Governments have been challenged by more recent regulatory and supervisory issues, as have the financial institutions themselves. The following issues have been identified as of particular concern at the present time.

Introducing deposit insurance schemes

Deposit-taking institutions expressed the need for some form of deposit insurance, given the need to protect small savers. There is, however, limited experience in establishing deposit insurance schemes for deposit-taking MFIs. There are a number of issues that have been raised. The first is how the coverage can extend to many tiny accounts. The second is whether MFIs should be insured through a separate deposit insurance mechanism or whether they should participate in a larger deposit insurance scheme, the same as for banks. If these institutions are insured through a separate mechanism, are there enough institutions to diversify risk? How can the insurance be priced when there is inadequate actuarial experience? If MFIs are insured along with banks, how is payment into the system determined and is there a risk that MFIs could essentially be bailing out poorly capitalized and under-supervised commercial banks? How are the inherent moral hazard concerns different in the case of deposit-taking MFIs?

Indeed, there is a school of thought that deposit insurance is a bad idea precisely because of moral hazard. Barth, Caprio and Levine (2006) examined evidence from 150 countries and concluded that governmental deposit insurance schemes are ill advised, as financial institutions that have the benefit of such schemes are not so rigorous about managing risk. Nevertheless, stakeholders in inclusive finance find the topic of whether, and, if so, how best to design deposit insurance for MFIs topical and worthy of discussion.

Regulatory response to foreign exchange risk

Concerns about the ability of financial institutions to manage currency mismatches have led to regulatory restrictions on foreign exchange exposures. Such restrictions are prevalent in several emerging market economies and can take the form of prohibitions on holding uncovered net liabilities in foreign currencies or changes in the provisioning regime to take into account foreign exchange risk. Such regulation is less prevalent in regulations for MFIs, but the issue is likely to become increasingly important as borrowing in hard currency increases.

There is a strong argument for regulators prohibiting any financial intermediary in a developing country from holding currency mismatches in their portfolios. As noted in Chapter IV, socially responsible investment funds and international banks that lend to MFIs in hard currency need to carefully examine any foreign exchange risk that the MFI may incur. With their stronger balance sheets, their greater financial sophistication, and their superior access to foreign exchange hedging techniques, these institutions should to the greatest extent possible either take the corresponding currency risk by lending to MFIs in the currencies of the country where they operate or ensure that the borrowing institu-

tions have the maturity and the controls in place to cover any foreign exchange risk in their portfolios. Regulatory authorities need to be more vigilant about such risks and should be encouraged to develop suitable frameworks or even prohibitions within their own country context to ensure that MFIs that borrow foreign currency denominated loans are able to cover their foreign exchange risks.

A role for international standards in regulation and supervisory practices

International standards are an important consideration in framing national policy. Legislation, regulations and the interaction with international agencies are important in the course of national financial sector development. The Bretton Woods institutions are particularly important as they monitor implementation of selected international standards and codes. International standards for financial system stability affect the market segments on which we are focusing. This includes standard setting designed to improve accounting practices and banking supervision at the national level.

Building access into international standards. International standards do not consider access considerations at the present time. The Basel Core Principles on Banking Supervision lay out the principles of sound practice and are the fundamental documents for monitoring the building of supervisory practice at the national level. There is on-going discussion with regard to the revision of these principles; addressing the question of access is timely. The Basel Committee on Banking Supervision advises on standards and reporting requirements for central banks, but it is the domain of national supervisory authorities to determine which supervisory tools to employ and how. Supervisory authorities need to interpret these international standards within the national context, develop the rules for implementation, and assure the capacity to enforce rules developed at the national level.

Much attention has been given recently to the “International Convergence of Capital Measurement and Capital Standards, a Revised Framework,” commonly referred to as “Basel II.” Designed for the large international banks, this will certainly have important consequences for the functioning of the international banking industry. It is important because of the recommended changes in the determination of regulatory capital, the reinforcement of principles of sound supervisory practices, and the promotion of greater reliance on the internal control mechanisms of financial institutions. It was never intended that Basel II would be fully implemented in most developing countries, nor for banks that are not internationally active, although some parts are generally recommended. It is critical that national supervisory authorities weigh in particular the advantages and disadvantages of adopting the new capital adequacy framework in Basel II. Concerns are justifiably raised that small banks should not have to comply with each component of Basel II, nor be impacted negatively through their transactions with larger financial institutions.

More important than Basel II for microfinance is the Basel Committee’s Core Principles on Banking Supervision.²⁹ These 25 Core Principles are a basic reference for effective banking supervision and are designed to be applied by all countries in the supervision of their banks. The Bretton Woods institutions’ Reviews of the Observance of Standards and Codes assess the application of the Core Principles,

²⁹ More information about the Core Principles is found at www.bis.org/publ/bcbs30a.htm.

among other standards, while broader assessments are made in the joint World Bank/International Monetary Fund Financial Sector Assessment Programmes. Access to financial services has been increasingly introduced into the latter exercises making them potentially a powerful tool to help governments build inclusive financial sectors.

There is widely expressed concern about the potentially negative impact of the new measures being introduced under the international framework for anti-money laundering and combating the financing of terrorism (AML/CFT). All financial service providers, including those working with low-income clients, will be affected by these measures. International AMF/CFT standards were developed by the Financial Action Task Force (FATF), established in 1989 by the member states of the Group of 7. Financial service providers are required to enhance internal controls to cater to AML/CFT risks, undertake customer due diligence procedures, introduce heightened surveillance of suspicious transactions and keep transaction records, and report suspicious transactions to national authorities. These measures could bring additional costs of compliance to financial service providers and customer due diligence procedures may restrict formal financial services from reaching low-income people. This is a rapidly developing field and there is a need for further analysis (see CGAP, 2005).

Conclusion

Traditional regulatory and supervisory regimes focused on the fundamentals of protecting depositors and the stability of the financial system. It is timely to consider integrating the objective of increasing access of the poor and micro and small enterprises to financial services into regulatory and supervisory schemes. Fulfilling a vision of inclusive financial sectors entails integrating access considerations across the financial sector, underlining the important repercussions the regulatory and supervisory framework has on the degree of access to financial services.

Regulators and supervisors need to consider the options of adapting legal structures, regulations and supervisory tools to microfinance. The major concern is the extent to which access considerations can be built into the objectives and operational framework of regulations and supervisory practices, allowing innovation and flexibility while respecting the fundamental objectives of systemic stability and customer protection. Regulators and supervisors can take better account of their impact on financial inclusion without compromising their fundamental objectives. Policymakers need to evaluate regulatory approaches from the perspective of financial inclusion, striking the right balance between appropriate and necessary regulatory requirements and increased access to financial services. The stakes are high because the regulatory framework has a proven effect on the degree of outreach of financial service providers offering savings and other services to the unbanked and underbanked. These issues are revisited in Chapter VII.

Chapter VII

POLICY ISSUES AND STRATEGIC OPTIONS

*“If only we could better understand the options and choices before us.
We must do so. The stakes for the ultimate clients are very high.”*

Manager, regional network organization

This book has sought to identify key constraints to financial inclusion at the levels of the customer, the financial institution, the financial markets, the policy and legal frameworks, and the regulatory and supervisory environment. In much of the discussion, the role of government in financial sector development has been either an explicit focus or has implicitly shaped the discussion. There are core government roles, such as maintaining economic stability, assuring an overall conducive policy environment and regulation and supervision, all of which require careful design. At the same time, much is driven outside the governmental sphere of action. Policymakers can only set the framework for establishing financial inclusion and industry regulation. Ultimately, it is the capacity of financial institutions themselves serving customers with a range of services that is the cornerstone of financial sector development.

The present chapter considers a number of policy options which the relevant stakeholders in policy formulation at the country level may wish to consider. The chapter aims to facilitate discussion and debate to help policymakers develop stronger policies. It is framed by the “vision” of inclusive finance outlined in Chapter I and informed by the analyses in Chapters II to VI.

In the following sections, seven areas are highlighted, each of which gives rise to a range of options for policy making. These options are based on the experience of many different countries. The options are related. Policy choices in one area may have a profound influence on those in another area, strengthening or diminishing the intended effect. We are not in a position to say whether one set of choices is superior to another in any given economic, social or political setting. This is the responsibility of the policy making process in each country. There are no fixed recipes; one size does not fit all.

Option Set 1.

Government intervention in the market for financial services — how much intervention, what kind, where and when?

Governments have been widely concerned that access to financial services is not equitable and have sought to improve the way the market functions through a variety of policy interventions. These policies aim to increase access to financial services by poor people, by sectors of the economy, or by geographical areas that have shown themselves to be of little interest to commercial providers due to perceived high risk and low profitability. The vision, as outlined in Chapter I, is that an inclusive financial sector

should be self-sustaining. In many cases, however, to offer services to all of the population, whether basic savings accounts or social protection or affordable health insurance, some form of government intervention may be needed. This option set considers the range of policy instruments governments have used, with varying degrees of success.

In a broad way, policies to expand access to financial services for poor and low-income people are about how much emphasis to place on market-based approaches. These approaches create incentives or disincentives for market responses. The alternative is to pursue non-market provision of financial services. The degree to which any of the interventions are temporary or permanent and how they are used in combination with one another are also important policy considerations. Different combinations of policy enticements and restrictions on market behaviour, as well as direct state provision of financial services, have been used with greater and lesser success at different times in different national contexts.

Policymakers can opt to...

...remove barriers to the entry of competent firms that wish to provide financial services for the poor. Many policymakers who wish to create a competitive environment suggest lowering barriers to entry for a wide variety of financial institutions. Barriers to entry protect some types of firms and discourage others. This often results in keeping prices artificially high, allowing price coordination or preventing geographic or market segment expansion. Barriers to entry often extend to ownership structure, favouring one institutional model over another for reasons other than safety and soundness. In addition, they can reduce innovations in product design. At the same time, it is essential to limit market entry to assure quality market participants (in terms of mission, sound governance, financial strength, and viability) and to guarantee adequate supervision.

The presumption in a market economy is that the public is best served when entry of new firms to an industry is unrestricted. In theory, these firms compete for customers, lower prices and increase variety and quality. Finance is a special case, however, as regulation and supervision is required of banks, and some form of licensing is usually required for non-bank financial institutions, especially if they are allowed to accept deposits. Indeed, “fit and proper” tests for management and governing bodies of financial institutions are required as part of the regulations aimed at guaranteeing that savings of the public are managed with the standards set by public policy. More generally, firms in any industry are supposed to register with the authorities for tax and legal purposes. Both licensing and registration should be transparent and quick, and registration should be a routine practice. In the financial sector, the oversight authorities can exceed their essential prudential and other mandates and create legal and illegal barriers to entry, as when effective licensing requirements are opaque or when the officers in charge themselves require the payment of bribes.

...treat all service providers the same way or allow preferential treatment. In order to correct some failures that may occur in financial markets, policymakers need to determine to what extent and how policy objectives call for the introduction of incentives, subsidies and directives that may affect the way financial service providers compete. Some organizations may get preferential treatment, such as tax-free status or preferential access to capital or benefit from subsidies or incentives, while others may be bur-

dened by special rules and practices, such as unnecessarily high reserves or provisions that banks would be expected to make for non-collateralized lending.

...consider which subsidies are valuable and which are counterproductive. Most financial systems have some sort of subsidies, whether they are transparent or hidden, temporary or permanent. This policy option involves an examination of who gets subsidies and whether they are efficient and sustainable. “Smart” subsidies are context-specific and are designed to achieve a clearly defined outcome and target specific recipients. They are often designed to cover the non-financial aspects of an MFI’s operations. They may also support innovation in the provision of financial services that increase outreach, seed new retail or wholesale institutions, facilitate access to remote rural areas, reduce the high fixed costs of servicing small accounts used by poor and low-income people, reduce the perceived risk of lending to small and microenterprises and households through establishing credit bureaux or properly structured guarantee funds, and help build the managerial and operational capacity that these institutions require. Partial loan guarantees can also function as smart subsidies when they are structured properly and can encourage banks and other financial intermediaries to engage directly in microcredit. Guarantees can help MFIs and other microfinance providers without adequate access to commercial sources to increase their access to funds. Nonetheless, guarantee funds can undermine portfolio quality because the financial service providers do not bear the full costs of recovering loans. They should thus be subject to regular evaluations and more comparative research is needed as to the virtues and drawbacks of alternative schemes.

But subsidies, even when “smart,” are set through a political process and can be misused, giving favour to politically influential parties or individuals. In those cases, subsidies may be inefficient and weaken risk management of the financial institution. They can also unduly distort a market by disadvantaging some supply-side market players or lead customers to undervalue the price of the service. They may not reach the target group, and they may weigh on government budgets. The merit of any subsidy program should also be judged against alternative uses of public funds. Finally, transparency and performance-based agreements in subsidy practices are important for determining the financial health of the subsidy-receiving institution and for determining the value produced in relation to the costs to the national budget. In addition, governments may wish to use the resources in order to implement measures outside the financial sector (e.g., physical infrastructure) to reduce transaction costs.

...intervene more, or less, in financial markets through mandates. Governments often seek to encourage and shape retail financial services through additional policies, including interest rate ceilings on loans, portfolio quotas and directed lending programmes for banks (such as requiring that a percentage of the loan portfolio be extended in rural areas or to poor people). The products offered through these policy interventions may or may not respond to customer preferences. The question is whether the policies have their intended effect to serve and protect the consumer and encourage financial institutions to provide these services over the long term.

Motivation for serving the market comes in large part from within retail financial institutions, not from specific mandates that governments compel them to follow. Experience has shown that success rates of external mandates that are incompatible with the retail financial institution’s objectives are frequently

low and that requirements to provide loans to unprofitable sectors are usually counterproductive. Experience has also shown that narrowly targeted programmes are less successful than programmes that provide institutions leeway to fulfil an obligation in a way compatible with their own business strategies.

...engage directly in providing financial services, or disengage from such activities. There are many state-owned banking institutions that provide retail services. Some of these institutions are extensively engaged in serving the lower segment of the market, particularly on the savings side and in rural areas. There are also government-owned financial institutions that operate as a “second tier,” providing funds, technical assistance and other services to retail financial institutions such as MFIs, savings banks and credit unions that directly serve a particular market. But many other state-owned banks contribute to government deficits or have failed to provide adequate access. The question is: what makes one succeed and another fail?

Experience suggests that if a government chooses to provide financial services directly, policymakers need to be certain that these institutions have a well-defined mandate, work on commercial principles, have a clear accounting of subsidies, and demonstrate sound governance and professional and transparently hired management. They also need to commit to the protection of the institution’s operational independence from political interference, comply with the general framework of the legal and regulatory framework. If this cannot be assured, experience indicates that it may be better to disengage from the direct provision of financial services and to adopt more indirect interventions. Countries contemplating restructuring their state-owned banks might consider evaluating the extent to which appropriate conditions exist in their country for strengthening the banks, forming strategic partnerships with other successful banks (public or private, domestic or foreign), or enacting other reforms, including privatization.

Policy decisions about market entry and the conditions for a “level playing field” are critical for developing the incentives for increased access within the financial system. Competition is not the only issue. Safety and soundness are important components of an inclusive financial sector policy. While poor and low-income customers benefit from greater competition among firms, they also benefit from the “bankability” of the firms that serve them. As the market has segments that offer little profit opportunity or realistic prospect of fully covering costs, choices are also needed on what government interventions to deploy to extend access to these otherwise unserved populations.

Financial sectors evolve — sometimes slowly, sometimes rapidly — as advances in experience and technology pave the way for new innovations. The nature of interventions should be adjusted according to this dynamic reality. Interventions should be judged by how they facilitate or hinder innovations in the business decisions, products, services and technologies needed to increase access. The balancing act for policy comes in freeing such institutions from disincentives or providing incentives that do not have unintended effects on national budgets, the health of the financial system, its retail institutions or their customers.

Getting the incentives right in the broader financial system, willingness to review and correct those that do not function as originally intended, overall macroeconomic stability, and the sequencing of reforms are important issues for policymakers. These issues are critical because they will ultimately

increase access or decrease it. They will affect the structure of the market and how it behaves for a long time to come. The following section explores the most controversial of these issues in greater depth.

Option Set 2.

How can we achieve affordable and sustainable interest rates?

A discussion of interest rates is bound to be one of most sensitive topics in any national stakeholder discussion, as interest rates are one of the key prices in any economy. But no global consensus exists on what constitutes reasonable and fair interest rates or how to bring them about.

There is solid evidence, however, that low interest rate ceilings have led to rationing of credit to the benefit of better-off and more powerful segments of the population and have discouraged financial service providers from mobilizing savings. Then, as financial institutions limit their operations and curtail expansion, lower-income households and small and microfirms are pushed into the high-cost unregulated informal market for credit. The intended policy goal of providing access to credit at lower costs is thus not achieved.

Backed by global experience, microfinance professionals, without denying the necessity to improve their efficiency, have taken the position that interest rate ceilings, when strictly enforced, prohibit microloans from being offered to the poorest members of a community on a sustainable basis. The same effect is noted in rural communities where the costs of service delivery are higher. The position of these professionals is based on financial analysis and experience, not on ideology. They also argue that interest rates rise to the level people are willing to pay for access to services. This is borne out by experience with borrower groups formed within certain MFI methodologies who often charge each other much more than what the MFI charges.

The call for deregulation of interest rates embodies optimism that the forces of competition will lower rates within a reasonable timeframe. The basic question then is whether it is preferable to bring about lower interest rates directly or indirectly. Policymakers emphasize how difficult it is *not* to impose interest rate ceilings when under social or political pressure. Some countries that removed controls later reimposed them. Other countries have repealed or avoided imposing interest rate ceilings, opting instead for a set of measures designed to increase competition, increase transparency, or drive down the costs of service delivery. Others have chosen to subsidize interest rates in indirect ways, such as through tax deductions for the individual, lowering the cost of funds or allowing tax credits for institutions.

The basic question is whether it is possible to support the growth of the financial sector so that financial institutions serving poor households and enterprises can charge interest rates that are simultaneously affordable and sustainable.

Policymakers can opt to...

...apply interest rate ceilings or liberalize interest rates. The basic argument opposing interest rate ceilings is that the higher cost of offering microloans (operating costs as well as provisioning and the constitution of reserves) warrants a higher interest rate for lending. Evidence shows that borrowers are frequently willing to pay the higher interest because it is lower than in informal markets and because

they need the credit and liquidity. In that sense, higher rates are justified. A common counterargument is that high rates reduce the prospects of success for microenterprises and adversely affect poor households, no matter to whom they are paid. In addition, higher interest rates could also hide a low level of efficiency. The liberalization of interest rates presupposes that competition from new entrants will drive down costs and, consequently, interest rates. Putting into place the conditions and actions to realize this scenario requires a more complex set of measures than issuing one single directive to remove interest rate ceilings.

The policies that entail the most pessimistic attitude toward a fair market outcome involve setting mandatory upper limits on interest rates. Thus, banking laws or regulations may give the government or the central bank the legal authority to fix the maximum lending rate and the maximum deposit rate. Together these determine the interest rate spread within which costs and profits have to be covered, assuming both rates are at their maximum. Evidence shows, however, that interest rate ceilings hurt poor people more than they help by causing market players to become unwilling to enter the market or to contract existing products and services.

The most optimistic case as regards the competitive response to establishing interest rates is full liberalization. Advocates usually couple the call for interest rate liberalization with a call for strong pro-competition policies. Indeed, competition policies are warranted in any event, as noted above, although the response of potentially competitive firms to opportunities in a market with a history of heavy state intervention may understandably be tentative. What is difficult to predict is the level of response to expect when the opportunity finally arrives for a truly liberalized environment. This could present a dilemma in which potential entrants wait to see if the policy will last, while the government waits for the supply response. At some point, the government may lose patience and validate the fear of the market by reimposing controls because the new competition did not emerge as anticipated or as quickly as anticipated.

...require full transparency of interest rates, fees and other obligations of the borrower and full reporting on the efficiency of financial institutions' operations. Truth-in-lending laws or voluntary measures with the same purpose allow customers to appreciate the full cost of borrowing, strengthening their bargaining positions. Reporting on the efficiency of operations permits comparison and benchmarking among institutions, thereby reinforcing the incentive to lower operating costs if indeed there are inefficiencies that can be corrected and passed on to customers.

...support the careful design of subsidies, in such a way as to minimize distortions and to assure transparency and the achievement of desired results. As pointed out above, one use of subsidies that is considered "smart" and can help reduce the costs of microcredit is to focus them on funding the start-up of new institutions to cover capitalization, innovations and expansion to new areas and operating short-falls. Another option is to use subsidies to lower some components of non-financial costs in an environment in which there is enough competition, disclosure, and public oversight to give some assurance that the cost savings would be passed on to customers. The government could then target a subsidy that reduced the cost component and make it available exclusively to all members of the desired class of institutions. This view presumes that an appropriate oversight infrastructure is in place, and with such a strategy, government could leave interest rates decontrolled and support a dependent and subsidized

MFI sector. As noted in Chapter V, however, the debate around the issue of whether or not indefinite subsidies to lower interest rates in microcredit is a wise use of subsidy is far from settled.

...recognize that a complex set of measures is required to lower market-based interest rates. Policy-makers need to recognize that interest rates are interconnected with other measures, particularly at the institutional and operational levels. These include: issues of competition (market entry and regulations), access to and cost of funds (financial market development), the high costs of poor communications infrastructure, and increasing efficiency at the institutional level (through, for example, simplification of loan appraisals, new technology for management information systems and payments transfers, training, etc.). Strengthening the financial literacy of customers, as discussed below, can also be important, and smart subsidies can further help reduce the cost of providing service.

Option Set 3.

How to fashion financial infrastructure for inclusive finance?

The “financial infrastructure,” as the name implies, is the set of ancillary services on which any country’s financial system relies to hold itself together. It helps the financial institutions to talk efficiently with each other through the information and communication systems; it also allows them to pass money and financial instruments safely and quickly through the payments and settlement system. It reduces the risks from lending to the non-financial sector through credit bureaux, property registries and bankruptcy processes, and from lending to each other through external audits and institutional credit ratings. It also works to reduce the risk to the system as a whole from financial difficulties in individual members through prudential regulations and supervision, with central banks serving as “lenders of last resort” in national financial emergencies. Finally, research and development on numerous aspects of financial operations and innovations are a shared interest and concern for the entire financial sector, as is ensuring a continuing stream of well-trained professionals in different aspects of financial service delivery.

Building a strong and efficient financial infrastructure is thus an essential part of financial sector development in developing countries, and it applies *ipso facto* to those parts of the financial sector providing services to poor and low-income households and to micro, small and medium-sized enterprises.

Policymakers can opt to...

...give priority to those elements of the financial infrastructure that are essential in managing risk and in reducing transaction costs. Strengthening credit bureaux and information technology are key focus areas. Information and communication technology are of constantly increasing importance and their development and evolution are radically changing the financial sector landscape.

It is commonly argued that an enabling environment that fosters competition and the competitiveness of banks will provide opportunities for entrepreneurs to create a credit bureau as an independent service to which the banks would subscribe. It would compile and provide the consolidated credit histories of borrowers based on information provided by the subscribers. However, it may be that one firm commands a major share of the loan market and will have less interest in establishing an independent credit bureau. This is because it would supply most of the information and its small competitors

would gain much of the benefit. Alternatively, the individual banking firms might come together in an industry association and create the infrastructure as a common project, sharing the cost, but perhaps excluding non-members from accessing the information. In some countries, the central bank sees as its prerogative the establishment of credit bureaux, and banks will participate if it is compulsory.

...support the establishment of guarantee funds. To the extent that they adjust for an unfair market evaluation of risk, guarantee funds can be considered as a correction for market failure. Credit guarantee schemes can be effective in promoting sustainable changes in lender behaviour. This can lead to financial sector deepening, in particular where necessary conditions for success are present such as an open, competitive banking environment, a dynamic and expanding business sector, and a high degree of transparency among market players.

Guarantee funds can also be designed to increase the access of MFIs and other microcredit providers to commercial funds. Such funds can foster lasting partnerships between the providers of microfinance and the financial institutions. Some analysts see guarantee funds that support loans to MFIs as a better instrument than guarantees for retail loans to micro and small entrepreneurs. Guarantee mechanisms best serve as accelerators, not as drivers, of financial sector deepening and, as pointed out above, should be regularly evaluated in terms of their effects on credit quality. They can also be designed based on a decreasing percentage guaranteed until the guarantee is no longer needed.

...provide avenues for MFIs to link into the infrastructure serving the major financial institutions. This opens an opportunity for joint public-private initiatives to upgrade and to adopt compatible systems of information and communications technology. It includes access to the payments and settlements system. Inclusion in the mainstream financial sector requires that non-bank financial service providers are recognized as having professional standards compatible with the banking system.

...focus more attention on the development of accounting principles and guidelines, public disclosure of information and transparency, and audit standards. These are an important foundation for better internal management and for external assessment. In addition, the assessments of independent rating agencies and credit bureaux are important tools that lenders and investors rely on to provide credible assessments of risk. In addition, the application of supervisory tools is facilitated if the information systems of financial service providers are sound.

...set the standards for service provision through the private sector or provide the service through the public sector. Given the range and complexity of financial industry infrastructure, some services are better provided by the public sector and others are more efficiently handled by the private sector or through private-public partnerships where private sector providers follow standards set by the government. Some may require on-going subsidy, particularly those that are considered “public goods,” such as training and capacity building. Others, such as credit bureaux or the development of communications technology, can quickly become self-sustaining on a fee-for-service basis.

Most countries have yet to build the range of financial infrastructure required to underpin and render less risky and more efficient the support of financial institutions that focus on increasing the access of poor and low-income people to financial services. In this regard, a forward-looking strategy would seek to

extend the country's financial infrastructure to include institutions that serve poor and low-income people and enterprises. Many of the needs of this sector are much the same as the needs of the financial sector as a whole, although there are also some specialized needs such as ensuring that auditors understand specific aspects of MFI operations. As inclusive finance sees microcredit as a stepping stone to mainstream credit, policymakers should be concerned that financial market infrastructure is in place to graduate and integrate poor and low-income borrowers and savers seamlessly into the financial mainstream.

It is implicit in this discussion that efforts are also often needed in strengthening the overall financial infrastructure of the country. If the system of commercial law and court capacity is weak, for example, it is weak for the mainstream as much as for microfinance. If confidentiality laws allow hiding corruption in mainstream financial institutions, they will also hide it in MFIs. If the payments system is slow for the main banks, it will be only slower for MFI transactions.

Finally, while the overall financial infrastructure should ultimately be self-financed by the industry through charges on its customers and firms, there is a role for public support. According to CGAP, one of the lessons from experience is that: "Some ongoing subsidies may be required to support financial infrastructure, especially those that clearly accelerate the development of support services markets or are considered public goods (e.g., establishment of national and regional networks or action research programmes)... whatever the intervention, donor support should emphasize local ownership to guarantee the continued existence of the service after donor support phases out" (CGAP, 2004, pp. 15-16).

Option Set 4.

What should regulators and supervisors do to foster financial inclusion?

The primary goals of financial system regulation and supervision are to ensure the soundness and stability of the financial system and to ensure that the payments system works safely and efficiently. It also seeks to protect customers of insured commercial banks and some other financial institutions against losses by preventing their failure and the fraud or opportunistic behaviour of management. More recently, regulatory authorities have also focused on contributing to public safety through combating money laundering and the financing of terrorism. They carry out all these functions by establishing regulations to be followed by individual financial institutions of various types and examining those under their purview for their adherence to the rules.

Traditionally, regulations have not tracked the status of access to financial services of different population groups nor sought to increase access as one of their policy goals. But should this be made part of the mandate of regulators and supervisors?

Policymakers can opt to...

...integrate access into the objectives of regulations and supervision and into supervisory practices. Governments and legislation should ask their regulators and supervisory authorities to play a proactive role in increasing access over time through an explicit assessment of the impact of regulations on increasing or limiting access and, beyond that, through the application of pro-inclusion regulations and supervisory practices.

...instruct all supervised financial institutions to collect and report data on usage of financial services. The authorities could use this data to monitor and encourage the expansion of services for underserved groups. A more controversial policy would be to target a minimum percentage of bank lending towards underserved customers, a practice that some countries follow.

...treat microfinance as a business line across the full range of financial institutions and supervise microfinance as an emerging asset class. This means allowing the full range of financial institutions to offer microfinance services, thereby treating microfinance portfolios as an asset class in terms of products allowed, risk categorization, reserves and provisioning requirements.

...reassess the risk in extending credit to the underserved and the institutions that serve them. Regulators might re-examine the risk profile of microcredit and small enterprise finance in light of experiences and in contexts comparable to those in their country. In this view, the expectation is that regulators have judged the risk to be greater than it actually is. A corrected assessment would allow the reduction of risk-weighting for capital adequacy requirements and of other regulatory constraints to expanding these forms of credit.

...differentiate between where regulatory constraints can be relaxed and where they need to be tougher because of risk. Regulations and supervisory practices may sometimes unnecessarily discourage the supply of credit to poor people in the name of protecting depositors. Pro-access adjustments may be introduced into the regulatory regime, including expedient licensing procedures, lowering minimum capital requirements where excessive, demonstration of portfolio quality as a substitute for traditional collateral, openness to approving new products and innovative delivery systems, simplified reporting requirements and more rapid branch approvals. Nevertheless, strict application of regulations in key areas is essential to ensure financial soundness, such as administering strict “fit and proper” tests for management and governing boards, demonstrating solid performance in lending before receiving permission to mobilize deposits, strictly applying capital adequacy and early provisioning requirements, implementing conservative requirements for liquidity, avoiding currency mismatches, and conducting rigorous internal and external audit procedures. The ability and capacity to supervise is a precondition for market entry of deposit-taking institutions.

...adjust supervisory practices and reinforce supervisory capacity. Reporting requirements can be simplified to align with the methodologies of the financial institution and with audit procedures that reflect the nature of the supervised institution’s financial structure. Supervisory capacity, although weak overall in many countries, can be reinforced. At the same time, it is critical to recognize that discipline has to take place at the institutional and industry level to make supervision work effectively.

...exercise national prerogatives in applying international standards. Policymakers can opt to focus on what international standards can do to strengthen their financial sectors. Importantly, policymakers need to work to apply the Basel Core Principles on Banking Supervision and adapt and implement Basel II and anti-money laundering requirements in their national context. At the same time, they can lobby to make these standards more sensitive to financial inclusion concerns.

Regulation and supervision affect the extent to which the financial system as a whole is more or

less inclusive. With due consideration for fundamental stability and consumer protection objectives of regulatory processes, regulators and supervisors can sometimes adjust regulations and supervisory tools to take better account of their impact on financial inclusion. This means, as stated previously, the two traditional goals of prudential regulation — safety of funds deposited in regulated financial institutions and the stability of the financial system as a whole — should be supplemented by a third goal: achieving broad-based access to financial services. The stakes are high because the regulatory framework has a proven effect on the degree of outreach of financial service providers offering savings, loans, and other services to the unbanked and underbanked.

Option Set 5.

How to promote consumer protection?

The concept of “fair treatment” is complex but basic to civil society. On the one hand, fair treatment embodies the absence of personal discrimination. Fair treatment also entails honest dealing between the service provider and the customer. It includes provision of appropriate information by both sides of a financial transaction with each side having the capacity to arrive at an informed financial decision.

Pro-consumer policies focus on both sides of the market — the buyer and the seller — and seek to foster a more informed and fair relationship. They seek a balance between consumer education, protection, rights and obligations and the impact these all have on price, competition and continued expansion of financial services. Policy options focus on financial literacy initiatives as well as regulating the relationship between the buyer and seller to differing degrees.

Policymakers can opt to...

...**“let the buyer beware.”** This minimalist option is often considered anti-consumer. It provides little consumer protection unless combined with effective and widespread financial literacy initiatives. The effectiveness of this approach depends on the availability of information, the level of the customer’s financial literacy and the level of competition.

...**increase consumer information.** This includes establishing a truth-in-lending law or transparency standards for publishing interest rates and other charges. This option requires policymakers to set the standards for transparent pricing but not the prices themselves.

...**invest in financial literacy initiatives.** The ability of individuals and enterprises to use finance safely and effectively depends in part on their degree of financial literacy. High literacy would encourage them to compare the alternatives available to them. Financially literate customers are in a stronger position to judge their needs for credit, insurance and other financial services and to access them at better terms and protect themselves against abuse.

...**insist that the retail financial industry take steps to protect customers.** Financial institutions may be required to design their own pro-consumer codes of conduct and practices or develop them in an industry association and pledge to follow them. Policymakers can be instrumental in setting standards for such pledges through dialogue with financial institutions and their associations. Financial institu-

tions may also create an industry ombudsman to censure practices that violate the industry code and/or establish a dispute settlement mechanism within a trade association.

...encourage the establishment of an independent oversight authority. Such oversight would involve monitoring, reviewing, publishing and making widely available annual ratings of financial institution good business practices, as well as information on consumer complaints and how they were addressed. The government may want to establish a consumer protection agency independent of the financial services industry, within or linked to the financial regulatory authority, which would actively promote consumer education, protection and redress.

The choices about the level of consumer education and protection within the financial sector are important because they can help make markets work better or they can undermine them; they can lead authorities to ignore abusive practices or work to eliminate them; and they can build consumer confidence in the financial system or weaken it. Effective policies require transparency in the relationship between the buyer and the seller, and they provide customers with the information and understanding needed to take responsibility for their own decisions. When promises of fair treatment are made to consumers, they must be backed by credible and unbiased enforcement.

Option Set 6.

How many financial institutions and of what types?

The case for a high degree of diversity in types of financial institutions is based on two primary considerations: they extend access to “unbanked” populations, and they also give customers alternatives. Diversity in financial institutions also contributes to competition in terms of service and pricing, and increase the variety and quality of products available. In addition, owing to their different operating modalities and risks, a diverse universe of financial institutions can be a cushion against the volatility of financial markets, and, indeed, part of a strategy to promote financial-sector resilience.

Some financial institutions are less successful than others in any given country environment. As the financial sector requires official oversight, questions arise about whether there should be limits to the diversity of institutions and, if so, of what nature. In addition, some institutional forms presume government subsidies, and policymakers may wish to redeploy budgetary resources elsewhere, making that institution no longer viable. Policymakers thus have had to consider whether to narrow or expand the types of financial service providers in their markets. They have also needed to decide what requirements to set in terms of size and permitted activities of each type of institution.

Policymakers can opt to...

...ensure there are no barriers to entry of new institutions or to the expansion of sound institutions that can add financial services to a broader segment of the population. This option requires authorities to be open to the idea of new types of providers entering their market area. It also encourages openness to innovative strategic alliances and agency relationships among existing providers. Further, it requires policymakers to examine minimum capital and ownership requirements and branch

expansion restrictions on existing providers. Examples of this option are the expansion of small rural banks to increase access in communities and permitting MFIs to provide retail services to poor customers as agents of larger commercial institutions. An assessment of current supervisory capacity is usually necessary when expanding the number and type of institutions, following the principle of “don’t regulate what you cannot supervise.”

...design new legal forms to increase outreach. A single institutional model is not likely to have the flexibility needed to respond to different market segments in different locations. The need for a diverse set of institutions, structures, and approaches requires policymakers to examine existing legal, regulatory and policy frameworks (for example, for cooperatives, rural banks, credit-only organizations, and legal structures to transform NGOs into formal financial institutions) to determine whether the diversity of the organizations permitted by law adequately serves the market.

One strategy for a legislative approach to permitting retail financial institutions to change their formal structure is “tiered” licensing and regulation. Institutional categories can be defined in legislation and may range from small microcredit organizations for which registration and reporting are the only requirements for permission to lend, to formal banks offering microfinance services that are governed by the banking law. Regulatory parameters are then set for each tier to match the degree of risk engendered by the range of products offered. Tiered licensing and regulation defines organizations by the nature of products and services offered and their target customer base. Policymakers have opted for tiered regulatory frameworks that allow variety and emphasize non-prudential regulation for small operations. Tiered regulatory and licensing frameworks can make use of existing institutional forms, such as associations, NGOs and cooperatives, or create new ones, for example, licensed MFIs, rural banks and specialized banks.

...consolidate the number or type of institutions. Many countries have introduced requirements to consolidate the financial sector by requiring NGOs to become licensed professional banking establishments or to obtain licenses or permits if they seek to pursue other aims and lines of business. In other countries, banking authorities have opted to close banks, reform them or privatize those that rely on government budgets. The advantages of consolidation are that larger institutions can take better advantage of economies of scale and scope. In addition, they may be a better match between the number of institutions to be supervised and supervisory capacity. The disadvantage is that if one legal option is closed off without another being put in place, or if one bank is closed without others entering the market, access and competition may actually decrease.

For example, concerned about the proliferation of NGOs providing financial services, some policymakers have opted to restrict the legal forms these institutions can use without putting alternatives in place. This generally tends to restrict access unless other organizations are willing and able to enter the market and fill the breach. Other countries have opted to establish new legal and regulatory frameworks which allow new institutional forms. Some of these new frameworks formalize NGO operations as specialized banks or finance companies. The range of products and services is restricted to the level of the license, and capitalization requirements depend on the size of the operation and whether deposit taking is offered or contemplated.

The first element in the consideration of whether to expand, transform or consolidate the permitted types of financial institutions is the established legal and regulatory framework and how willing policymakers are to review and change it. Any review is filtered by the national context and the types of existing organizational forms. To this are added judgments on how well existing institutions and frameworks serve poor and low-income people. Is retail capacity adequate? If not, would a licensing window facilitate new entry? If there is still inadequate capacity, would facilitated foreign entry bring the necessary skills and institutional capacity?

Would greater diversity of organizational form promote greater access of the poor to financial services or mainly prove to be burdensome for supervisory authorities? The answer in every country is different. On the one hand, it is unrealistic to expect one legal form to be able to serve the range of poor and low-income people with the variety of products and services they require to protect their assets and create wealth. On the other hand, creating new forms of organizations carries with it risks and costs, as does maintaining those organizations that perform poorly. It is, however, important to keep this question before policymakers because the political and economic environment is subject to change and thus the answer to the question may change over time. Periodic review and dialogue about the various institutional forms and their performance, in the context of asking how well the market serves its economic and social functions, is part and parcel of the effort to increase access of poor people to financial services in a sustainable and safe manner.

Option Set 7.

How should governments be organized to promote financial inclusion?

Whether national stakeholders opt for a more or less interventionist approach, governments have an important role to play in building inclusive financial sectors. This is true even in those cases where MFIs developed successfully without much government intervention. With the maturity of many MFIs, the increase in savings mobilization, and the mainstreaming of microfinance into local and global financial markets, the policy agenda and corresponding roles for governments and other national stakeholders in this sector are changing rapidly.

Governments influence financial sector development in significant ways. They can be organized more or less effectively to ensure that their roles, policies, and actions are coherent, effective, and efficient. A government comprises a diverse set of ministries and authorities. How should their collective effort to enable, strengthen and advance more inclusive financial sectors best be organized?

Policymakers can opt to...

...arrange various programmes in multiple ministries. This is the default arrangement, as different policy focuses in government would independently introduce financial initiatives as part of their sectoral mandates. These include, for example, agriculture, industry, social services, housing, and urban development. While this kind of a decentralized approach leaves space for champions of each programme's clients to press for resources, the financial landscape becomes cluttered with different financial institu-

tions with overlapping customer bases, approaches and mandates. Coordination can be difficult and a fragmented policy can result. Dispersion of supervisory functions is likewise not advised.

...bring together all inclusive finance initiatives under the authority of one ministry or office. Such a ministry or office would focus on economic development and poverty alleviation. This is a common practice. This approach allows a focused political champion of inclusive finance to emerge in government while also enabling the consolidation of different programmes. This frequently reduces operating and administrative costs and strengthens coherence among different programmes. The disadvantage is that this approach tends to isolate microfinance and related financial programmes as a separate and unequal financial sector for poor and low-income people, distinct from the financial sector for everyone else. It can also diminish creative thinking and innovation.

...develop a comprehensive financial sector development strategy assigning responsibility for policy implementation to the ministry or office responsible for financial sector development. This option views microfinance as “finance” and credit and savings as part of banking activities. It is based on the idea that no strong case exists for specific financial institutions to be kept out of the mainstream because of their clients’ poverty. This option argues for strengthening the coherence in financial policy development, notably creating an enabling policy environment with appropriate roles attributed to the finance ministry and regulatory and supervisory authorities. It has the disadvantage of diluting specific concerns related to microfinance and related poverty alleviation concerns.

Choosing from these options requires combining administrative and substantive policy logic on the one hand with political logic in each specific country on the other. How financial sector analysis is conducted (related in part to who conducts it) determines its coverage in terms of issues, how the issues are framed, and who participates.

It is important that a broad range of stakeholders and practitioners participate in policy development discussions at the national level, both for the information they can provide and for their views on what does and does not work. The effective participation and “buy in” of all relevant stakeholders not only boosts understanding, but also guarantees better policy and better monitoring of its implementation. Multi-stakeholder engagement also helps raise the awareness of policymakers which will make them more attuned to the importance of inclusive finance for achieving their broader political and development goals, particularly if the value of outreach to underserved segments of the population can be emphasized. Consensus building is not an idle phrase.

Raising the political profile of inclusive finance is actually a double-edged sword. While it is important for improved policy making, it also may tempt political leaders to make policy decisions for reasons of short-term political advantage rather than long-term development of inclusive finance.

Finally, donors have to be willing to listen and willing to respond to national priorities instead of pushing their own agendas. There is much activity in the donor community around the pledge to better coordinate aid policies. Microfinance has been a particular focus of the effort to examine donor practices and make them more coherent. Global leadership can contribute to concrete donor action, but in the end, the coordination of donors is most effective when it is led by the developing countries themselves. The imperative is clear for each developing country to build consensus around a strategy

for building inclusive finance and then to enter into joint accountability mechanisms with donors that wish to support that strategy so as to effectively monitor its coherent implementation.

Conclusion

In conclusion, not only do developing countries need to design appropriate strategies for increasing access to financial services by all segments of the population, but they must also be able to turn their strategies into effective policies and implementations. This also requires that governments determine the best ways to organize themselves for actual implementation. This includes both the efficient clustering of financial access programmes and activities within the government administration and ensuring adequate political attention is focused on financial inclusion. It also entails the cooperation of a full range of financial institutions and effective cooperation from development partners over the long term.

Chapter VIII

DIALOGUE AS A PRELUDE TO ACTION

“The General Assembly...recognizes the importance of scaling up microcredit and microfinance services and of using the Year [of Microcredit] as a platform to find ways of enhancing development impact and sustainability through the sharing of best practices and lessons learned.”

Resolution 58/111, adopted 23 December 2003

“We reaffirm our commitment to eradicate poverty and promote sustained economic growth, sustainable development and global prosperity for all... We underline the need for urgent action on all sides, including more ambitious national development strategies and efforts backed by increased international support.”

2005 World Summit Outcome (United Nations, 2005, paragraph 19)

As stressed from the outset, this Blue Book aims to help stakeholders at the country level to engage in a collective discussion that leads to new or strengthened national strategies for building inclusive financial sectors for development. Within each country, key stakeholders should come to share a common vision of inclusive finance. This means addressing three areas of concern: the integration of microfinance into the broader financial sector; the respect for the distinctive character of microfinance; and above all, the focus on serving well the needs of poor and low-income customers. Indeed, the strategy for financial inclusion should be an integral component of a country’s financial sector development plan with the aim of supporting the achievement of the Millennium Development Goals (MDGs) and of the goal of poverty reduction as stated in the national poverty reduction strategy.

The broad range of stakeholders — with important roles for government and regulatory authorities — can contribute to building this shared vision and to developing and implementing a national strategy. Designing and implementing strategies to purposefully build an inclusive financial sector provides the opportunity to go forward with the coherence that is often absent in processes that arise from multiple, independent initiatives. Strategies backed by research undertaken within the national context enable the design of relevant policies that fit a country’s particular state of financial sector development and the promotion of its inclusiveness.

Setting the stage for dialogue at the national level

The material in the previous chapters, which is based on international experience in a broad range of countries and institutional settings, can help stakeholders build their own understanding of what is required to build an inclusive financial sector. Yet, this material serves only as a prelude for a national

multi-stakeholder consultation. In function of the national context, processes to build inclusive financial sectors could be shaped in consideration of the following elements:

Assessment

- **Taking stock of the state of financial sector development and access.** An assessment of the current state of financial sector development and the nature of financial markets is the starting point for the discussion. This includes the degree of inclusiveness and the current state of access and usage of financial services. It should also include an expert appraisal of the degree of conduciveness of the legal and regulatory framework, the strength of financial markets and the performance of the range of institutions. Understanding the nature and extent of demand for financial products within poor and low-income populations is a fundamental piece of information that enables the consideration of what products and services the market may require. This may also suggest the type of organization that can best provide these products and services. As an international network organization observed during the Blue Book consultations: “A pro-poor policy stance must be based on knowledge and understanding of the sector to avoid the risk that a government introduces measures that hurt rather than help microfinance development.”
- **Analysis of constraints.** Obtaining a thorough understanding of the constraints to and opportunities for realizing this vision is a fundamental step in crafting a national strategy. Where are the bottlenecks? What are the constraints? What changes are necessary? These constraints may be found at the levels of policy, legislation, regulations, and guidelines. There may also be infrastructure, communications, and technology constraints. Furthermore, institutional and human capacity limitations may seriously constrain financial sector development. These areas can each be shaped by the development of the mainstream financial sector and its infrastructure, general institutional and human development in a country, and the ability of the customers to exercise demand for financial services.
- **Collaboration with external partners.** This collaboration can be an important means of reinforcing analytical capacity and testing policy options against international views and experiences and sound practice. Financial Sector Assessment Programmes of the International Monetary Fund and the World Bank are increasingly becoming vehicles to assess the “development” dimensions of the financial sector. In addition, national stakeholders may wish to consult recommendations, guidelines and conclusions drawn up by different international institutions and networks. A number of key references in international best practice exist (see box VIII.1).
- **Mobilizing technical and financial support from development partners.** This mobilization allows for additional analytical work and capacity building. It can introduce innovation and help provide financing for infrastructure and institutions. It cannot, however, replace the vision and commitment of national authorities.

Building a shared vision, policy and strategy

- **Mobilizing policymakers and the broad range of stakeholders and fostering their ownership of a dialogue process.** A national dialogue should include: ministers and senior government

Box VIII.1.**Key reference documents on international good practices on access to finance****Key Principles of Microfinance (CGAP, 2004)**

CGAP developed eleven key principles of microfinance. These were endorsed by the 31 member donors of CGAP and further endorsed by the Group of Eight leaders at the G8 Summit on 10 June 2004. More information is available at: www.cgap.org/keyprinciples.html.

Building Inclusive Financial Systems: Donor Guidelines on Good Practice in Microfinance (CGAP, 2004)

The donor guidelines on good practice microfinance provide practical guidance for donor staff on how to best interact with, and support, the various actors in microfinance. Through a highly participatory process, including comments from 20 CGAP member donors and 10 other civil society organizations and individuals, the authors sought to balance all views in updating the Donor Guidelines. More information is available at: www.cgap.org/docs/donorguidelines.pdf.

Building Domestic Financial Systems that Work for the Majority (Women's World Banking, 2004)

In April 2005, Women's World Banking reconvened the 1994 Expert Group on Women and Finance, joined by members of the Advisors Group of the International Year of Microcredit. The result is *Building Domestic Financial Systems that Work for the Majority*, a consensus document that treats the primary accomplishments of the last ten years and the challenges for the next ten. It also sets forth the need to build country-level financial systems that work for the poor majority, key actions needed to build retail capacity, the key roles that global actors need to play, the shared vision of the group for the next ten years and key actions for the next three years. More information is available at: www.swwb.org/English/PDF/Expert_Group_Booklet.pdf.

Access to Finance Resolution (World Savings Banks Institute, 2004)

In its Access to Finance Resolution, members of the World Savings Banks Institute call upon policy makers to facilitate access to finance through recognition of the importance of access to financial services and its impact on economic growth and poverty reduction and a corresponding set of policies. The Resolution encourages support for the collection and analysis of information on the "unbanked" and for building financial literacy, strengthening corporate governance and expanding and refining institutional arrangements. More information is available at: www.savings-banks.com.

officials; regulators and supervisors; key parliamentarians; local government associations and leaders; microfinance networks and other professional associations; the full range of public and private sector financial institutions that seek to provide inclusive financial services; academics and independent experts involved in areas as diverse as financial literacy and financial research; institutions that provide financial infrastructure services; and representatives of institutions speaking for small enterprises and household users of financial services. Finally, international financial institutions

and donor agencies should also be involved. Each of these groups has different perspectives and expertise on the subjects at hand which should enable an informed dialogue backed by facts and knowledge of the financial sector.

- **Building a shared vision.** This should be a vision of what a competitive, diversified and inclusive domestic financial sector would be like in 10 years and beyond. Stakeholders at the national level should define what the country's financial sector should look like compared to where it is today.
- **Analysis of policy options and policy formulation.** National strategy should be built upon a clear evaluation and analysis of policy options specifically tailored to a particular national context. These options should be based on global experience and best practices and should be based on the fundamental consideration of the appropriate role envisaged for the State. The strategy should set forth the actions needed to resolve policy issues, establish appropriate policy frameworks, and put effective policies in place.
- **Recognition of variation in policy options among countries.** Policy options shift over time within a country. This may be due to shifts in the degree of financial sector development or to changes in circumstances, governments, or policy objectives. In some settings with less developed financial sectors, the issues for debate begin with broad policy considerations. In such cases, it may be premature to discuss specific legislation and regulations. In other country settings, policy may focus more quickly on detailed measures.

Implementation

- **Implementation and on-going review.** Governments require commitment, energy, skills and political space to implement policy. Policy change takes place over years, not months, and it requires stakeholder monitoring for achievements and corrections as the process advances. Mechanisms and processes that assume regular review, monitoring, and evaluation of national implementation plans are therefore critical to their long-term success. Implementation requires investments in the major strategic areas: development of a conducive policy environment, including the legal and regulatory environment, the “professionalization” of the sector including support for the development of financial infrastructure and strong financial service providers.

Important process considerations

No one party can develop an effective national strategy in isolation. Multi-stakeholder dialogues that bring together government, central bank, regulatory and supervisory authorities, the full range of financial institutions, associations, academic experts, civil society, donors, investors and the private sector can facilitate the understanding of constraints and the development of a national strategy. This multi-stakeholder dimension cannot be overemphasized: policy change is most likely to occur when there is a critical mass of institutions and interests with the same concerns that are willing to act together. The value of concerted action should override concerns of competition among stakeholders. In the words of one participant of the Blue Book Global Meeting: “Financial sector development is a local process with local buy-in and ownership.”

At the same time, ministries of finance and central banks have to be centre stage. This is about financial sector development. National leadership and championship at the highest levels of the process are vital. There needs to be extensive involvement and ownership at both the political and technical levels of ministries of finance, line ministries, central banks and banking supervisors. As such, the process recognizes more than a technical perspective; it accepts that the political policy agenda must often first be established and then revised and even rejected when appropriate. Many different individuals need to be involved, and a forum for open interaction and debate is always required. Senegal provides an example of an in-depth consultative process that took place over many months, at both the regional and national levels, leading to the adoption of a national microfinance strategy (see box VIII.2).

In support of this process, it would be very valuable to acquire a comprehensive picture of financial inclusion and to track statistical indicators of changes in the degree of inclusion over time. Most countries have not systematically collected this type of data, which generally requires a substantial and expensive household survey for the initial stocktaking, complemented by the collection of data for compiling selected statistical indicators. As part of the activities for the International Year of Microcredit, however, the World Bank has spearheaded a multilateral effort to help develop a framework for compiling just such data (World Bank, 2005b), and it has proposed a minimum set of core concepts that household surveys on usage of financial services should try to measure (World Bank, 2005a).

Recent work of CGAP has shown that in many cases, national microfinance or financial inclusion strategies were initiated, developed and financed by donors. While this support is valuable, donor support is most valuable when it works on the basis of priorities set by national stakeholders. This principle is embodied in the *Donor Guidelines on Good Practice in Microfinance* (CGAP, 2004a), which builds on the commitment of donors to good practice and donor harmonization for increasing donor effectiveness. This is indeed a good basis for effective partnership for development in general and for building inclusive financial sectors in particular.

Dialogue at all levels needs to be ongoing. A periodic review of progress and adjustments in strategy based on experiences gained will raise confidence that the strategy remains on sound footing and will help to achieve a genuinely inclusive financial sector.

Box VIII.2.

Senegal: Building a vision for an inclusive financial sector

The Context

Since its emergence in the early 1990s, the microfinance sector in Senegal has been growing rapidly. As of end 2003, there were 510,883 clients, a loan portfolio of CFAF* 57.8 billion, and a savings portfolio of CFAF 42.99 billion. Today, there are more than 600 authorised Decentralised Financial Institutions (basic unions, savings and credit groupings and institutions having signed cadre-conventions). Three types of institutions are included in Senegal's microfinance sector: (1) credit unions for which savings is a precondition to obtaining a loan and which deal only with their members; (2) direct loan institutions; and (3) NGOs or projects with a credit component.

The Microfinance Unit of the Ministry of Economy and Finance and the Central Bank of West African States (BCEAO) supervise the sector overall. Credit unions operate under the so-called "PARMEC Law" (Law No. 95-03 of 5 January 1995 and its decree 97-1106 of 11 November 1997). Other types of MFIs sign renewable five-year framework conventions. In 2003, the Ministry in charge of SMEs, Women's Entrepreneurship and Microfinance was created, with the goal of promoting the sector.

Strengths and weaknesses

Senegal's microfinance sector has several strengths, including:

- the government's clear will to encourage the emergence of the sector;
- the existence of a legal and regulatory framework which is supervised and monitored by the Ministry of Economy and Finance and the Central Bank;
- the Ministry of SMEs, Women's Entrepreneurship and Microfinance, which is in charge of promoting and developing the sector and translating the vision into programmes and an action plan;
- the existence of a dynamic association of MFIs (APIMEC);
- donor commitment to further support the promotion and monitoring activities of basic and apex institutions, along with the action plan.

Despite those strengths, some weaknesses are noted, as follows:

- lack of a clear and shared vision on the sector's potential evolution and its positioning in the national economy;
- weakness in strategic options and procedures to carry out microfinance operations;
- insufficient functionality of the monitoring, control and internal and external follow up mechanisms despite the considerable growth of the sector in terms of geography and MFI operations;
- inadequacy of the regulatory framework for the operational and institutional model of some financial service providers;
- lack of professionalism, especially with regards to technical skills required for the collection, processing and production of data relating to MFIs' internal governance and sector supervision; and
- lack of appropriate financial resources for the promotion of the sector.

Sector development approach

Since November 2003, the key stakeholders in Senegal have engaged in a more detailed and refined financial sector development approach based on a clearly articulated common vision. The vision is formulated as follows: "to have a viable and sustainable microfinance sector, integrated into the financial sector, diversified and innovating, ensuring a satisfactory coverage of the country's demand and operating within an appropriate and conducive legal, regulatory, fiscal and institutional framework." Based on this vision, stakeholders have set up a policy and developed a new strategy and action plan.

Key stakeholders and international partners designated UNCDF to facilitate and lead the process of endorsing the national strategy and organizing the donor roundtable for financing. The process included the following steps:

- participatory, multi-stakeholder country assessment;
- endorsement of the assessment findings by key stakeholders;
- development of the national policy and strategy;
- design of the action plan and its budget;
- dialogue between stakeholders and role distribution; and
- enactment of the Bill or Decree to enforce the document.

Based on the vision, four strategic axes were defined:

- improvement of the legal and regulatory framework;
- viable and sustainable provision of appropriate, diversified and increasing products and services, particularly in the areas not yet covered by professional MFIs;
- strengthening of the collaboration between commercial banks and MFIs for the financing of SMEs; and
- establishment of the institutional framework for effective sector structuring and coordination and efficient implementation of the Microfinance National Strategy (MFNS).

The Government of Senegal approved the national strategy in 2005. A roundtable gathering all stakeholders including donors was organized in April 2005 to conclude details about the financing and implementation of the action plan. Approximately US\$40 million is expected to be mobilized, with the support of donors including CGAP, UNCDF, SIDA, KfW, AFD, IFAD, GTZ, UNDP, CIDA and BCEAO. Following the conclusion and recommendations of the donor roundtable, two specific studies have been launched to define the financing mechanisms and the modalities of the implementation of the national strategy.

Source: UNCDF.

* US\$1 = 520 CFAF.

Conclusion

Developing countries need to design appropriate strategies for increasing access to financial services by all segments of the population. They must also turn their strategies into effective policy measures and implementation plans. This means that multiple stakeholders must work together to design these strategies and determine the best ways to organize their implementation. Such an effort entails the cooperation of the range of governments, financial institutions, civil society organizations, development partners, and the private sector. And it requires all stakeholders to ensure that adequate attention is focused on financial inclusion over the long term.

We believe the payoff to a focus on financial inclusion in developing countries is very high. It will enrich the overall financial sector. By increasing the economic opportunities of poor and low-income people, it will help make economic development itself broader, deeper and more inclusive. Shared and sustained economic growth helps support political stability and social progress. But most of all, inclusive development of the financial sector will increase incomes, build financial assets, and empower and enrich the lives of millions of households currently excluded from economic opportunity. This is the ultimate objective of this endeavour.

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