SHAPING THE "BLUE BOOK" ON BUILDING INCLUSIVE FINANCIAL SECTORS FOR DEVELOPMENT

An Issues Paper for the Global Meeting
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"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,
announcing 2005 as the International Year of Microcredit

On the basis of the objectives of the 2005 International Year of Microcredit and the mandate to pursue consultations under the umbrella of the Monterrey Consensus, the United Nations Capital Development Fund (UNCDF) and the Financing for Development Office (FfD) of the United Nations Department of Economic and Social Affairs (DESA) launched a consultative process to deepen the investigation of the fundamental question of why so many bankable people are unbanked. The intention was to develop a publication that would help policy makers and other stakeholders better think through their approaches to encouraging the development of inclusive financial sectors. A multi-agency coordination group, composed of the World Bank, the International Monetary Fund, International Labour Organization and International Fund for Agricultural Development, is supporting the UN in this effort, as are a number of other international and regional organizations and financial sector experts.

As a major part of the preparations, a series of multi-stakeholder consultations have been organized in Africa, Asia and Latin America, culminating in the present Global Meeting at ILO Headquarters in Geneva. Views of governments, international organizations, private sector and civil society were gathered in informal and unscripted roundtable discussions at these meetings, as well in traditional plenary panel formats. In addition, UNCDF, the FfD Office and the World Bank Institute held an e-Conference from 28 March until 13 April in which over 800 people participated around the world. Material has also been gathered through an Internet survey and through in-depth interviews with experts in the field. A number of groups have organized consultations within the context of this project, such as the United Kingdom National Committee for the Year of Microcredit and Women's World Banking, which recently reconvened the 1994 UN Experts Group on Women and Finance.

On this basis UNCDF and the FfD Office have prepared the present paper as a first pass at what should be contained in the actual "Blue Book." The Global Meeting provides an opportunity to dig deeply into and debate the issues raised in this preliminary synthesis. More precisely, the meeting aims to:

1. Explore and debate the concept of "inclusive financial sectors;"

2. Analyze the dialogue and debate from the past months of Blue Book consultations, reflecting the results of the numerous consultations;

3. Work toward a common understanding of the nature of the most important constraints to building inclusive financial sectors in different country settings; and

4. Identify the most pressing issues at the current time, new perspectives on and the most promising avenues for concrete change.

5. Develop a better understanding of the concrete choices and options, including policy actions, that should be before stakeholders in the quest to build inclusive financial sectors, and

6. Determine how to take this debate forward.

The Blue Book will seek to address the problems preventing financial sectors from being more inclusive by asking a set of questions around the fundamental question of "Why are so many bankable people unbanked?" This issues paper, in turn, seeks to provide a sense of the results thus far and flag what we believe to be the key issues distilled from the process. This is not an attempt to reinvent the wheel. Sound principles regarding finance for micro and small and medium enterprises (SMEs) already exist and sound practice, with impressive results in many cases, has been demonstrated worldwide; the Blue Book consultations are built upon this.

The Blue Book will not solve any country's problem of how to bring more of the unbanked population within the formal financial system or assure that they have appropriate access to financial services. It will not eradicate poverty. Its aim is more modest. The Blue Book rather seeks to help the relevant stakeholders in any country solve that problem themselves. It seeks to provide a platform for continued discussion, debate, and consensus building at the country level on the potential contribution of access to financial services of the poor to the fight against poverty and for development.

Setting the Scene: Why We Wish to Increase the Focus on Building Inclusive Financial Sectors

Building inclusive financial sectors should be a major goal of development policy. Financial sector development overall is important for poverty reduction; promoting inclusive finance can reinforce this effect. Yet, the vast majority of people in developing countries do not have access to financial services and there is considerable disparity among countries in the inclusiveness of their financial systems.

The importance of financial sector growth is recognized

There is substantial evidence that financial sector deepening and economic growth are mutually reinforcing. Several excellent papers describing the empirical studies that have been produced over the years lay out this evidence in a convincing way.[1] Overall, there is increasing reason to believe that an efficient broad-based financial system provides a powerful facilitator of economic growth.

In addition, newer studies have addressed the question of financial sector development and poverty reduction. Although a lack of comprehensive data on access to financial services by the poor impedes analysis of the direct impact on poverty, more traditional measures of financial sector development have been used to indirectly estimate the impact on the poor. Such studies show that financial sector development benefits disproportionately the poorer segments of the population. These studies support the theory that there is a negative relationship between financial sector development and income inequality.

However, financial systems can do even better in helping overcome poverty through direct interaction with the poor. Microfinance — safe savings, appropriately designed loans, and other financial services for poor and low-income people — is an effective way to help poor people help themselves to increase incomes build assets, manage risk, and try to work their way out of poverty. For the poor, access to financial services can mean not only increased production, but also protection as the financial sector — through stored savings, credit and insurance — can serve as a cushion in times of crisis. More developed domestic financial markets fuelled by domestic savings can, over time, reach more of the poorer segments of the population, as well as those segments of the economy that most affect the lives of the poor.

Why financial sectors are not inclusive today: a systemic problem

Financial markets in many countries in the world are shallow, incomplete, segmented and inefficient. Institutional weaknesses such as the lack of credit-risk management capability, poor public sector governance, as in terms of competence and effectiveness of the courts in the areas of contract enforcement, collateral and bankruptcy laws, as well as traditions of obscurity in business accounting and reporting, and the cash-based nature of these economies impede the emergence of the virtuous circle of financial sector development and economic growth. Inherent

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[1] These recent papers include, among others: Steven Peachey and Alan Roe, "Access to Finance," a study for the World Savings Banks Institute, Oxford Policy Management, October 2004; Patrick Honohan, "Financial Sector Policy and the Poor: Selected Findings and Issues," World Bank, Washington, March 2004; David Porteous, "Making Financial Markets Work for the Poor," commissioned by FinMark Trust, October 2004, and Karen Ellis, "The Importance of Financial Sector Development for Growth and Poverty Reduction," Policy Division Working Paper, UK Department for International Development, London, August 2004.

information asymmetries are harder to overcome in this environment, leading to high transaction costs for both institutions and clients, an inability to manage client and institutional risk, and sometimes biases against certain segments of the market. This problem is notably worse in poorer developing countries and disproportionately affects smaller firms and poorer households in all countries.

Appropriate government intervention through policy, legislation and regulations is essential to overcome this. As the nations of the world agreed in the Monterrey Consensus in 2002, governments have a crucial role to play in creating an enabling domestic institutional environment for development, as the international community of nations has a parallel responsibility to provide an enabling international economic environment. In the domestic financial area, per se, governments need to foster an appropriate financial infrastructure to increase the flow of information, allow the broad range of financial institutions to offer financial products suited to the needs of the poor, and promote prudential regulation that, while curtailing systemic risk, should also help, not hinder, improving the access of the poor. All in all, this is about supporting inclusive financial sector development.

However, like everything else, government intervention can be of better and worse quality. Policy making needs to learn from both "government failure" and "market failure" and it needs to be determined by dialogue among all the relevant stakeholders, including private sector and civil society. Finding the best policy interventions in any situation is best conceived as an iterative process. This may not be elegant, but that is life. One size does not fit all.

Disclaimer: the scope of discussion here is limited

Throughout this consultative process, we have taken as a given that there are very significant issues outside the financial sector that are fundamental to building inclusive financial sectors. This begins with macroeconomic stability and political stability. We know, in particular, that an unstable macroeconomic policy framework with excessive government deficits will crowd out credit to the private sector, including to SMEs to the degree that they draw from the general private credit pool. We also know that excessively tight policy chokes off economic growth and private demand for credit, and that the art of making macroeconomic policy is in finding the "Goldilocks" policy package. Other requirements include basic education, basic physical and communications infrastructure, services such as electricity and water, and adequate personal security (as opposed to a climate of fear).

We are also acutely aware of the important considerations of political economy. The difficult parts 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 financial institutions through family conglomerates, improving access to credit of the less well connected, particularly the poor, is 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, homophobia and ethnic discrimination that operate in the world today.

We have decided, however, by choice and necessity that the Blue Book should stay within the limits of financial sector development issues, already a daunting task; the Blue Book will acknowledge the essential nature of these other issues in an introductory section.

Additionally, we have not addressed the pressing issue of impact. While this was considered outside the scope of the Blue Book exercise, we would note here that there is increasing recognition that researchers need to address this issue more systematically. One of the most fundamental constraints to such analyses is the lack of comprehensive data on the current state of access to and usage of financial services. This also impedes policy making and international cooperation, which should be able to monitor outreach numbers and calls for a greater effort to gather information systematically on access over time. Indeed, discussions are on-going internationally on how to address the lack of reliable and comprehensive data on access to financial services by poor and low-income people. The goal is to identify basic "headline" indicators and to compile and regularly update cross-country data so as to monitor them better over time.

A vision: Building inclusive financial sectors

An inclusive financial sector offers to the majority of the population sustainable access to a range of financial services suited to their needs. This is characterized by: (a) access of bankable households and micro and small enterprises to a full range of financial services, including savings, short and long-term credit, mortgages, insurance, pensions, money transfers,[2] leasing and factoring; (b) the cost-effective provision of these services, required to assure their provision over time, (c) soundness of institutions through performance monitoring and, where required, sound prudential regulation, and (d) competition, encouraging broader and more innovative product offerings at lower cost

More importantly, working toward this vision requires seeing financial services for the poor as an important and integral component of the financial sector.

Exploring the complex set of constraints to access to finance

The set of constraints to realizing the vision of financial inclusion is not only complex, but also specific to each country setting. Although it is a little bit artificial to separate them, given their interrelatedness, for convenience these constraints can be articulated around:

1) The factors blocking or limiting demand from (potential) clients;

2) The challenges retail institutions face in offering financial services to the poorer segments of the population;

3) The difficulty that financial institutions primarily serving the poor have in drawing funds from the general economy;

[2] Covering domestic transfers and international remittances

4) Coping with what is missing in the financial infrastructure (here taken as information and legal/judicial infrastructure);

5) The need to strengthen the policy, legal, regulatory and supervisory framework and national strategies for the financial sector; and

6) The challenges and opportunities of international cooperation and meeting international standards.

The following sections lay out the issues that the prior consultations suggest are of primary concern to stakeholders, organized around these six clusters.

Issues Cluster # 1

What Keeps (Potential) Clients from Seeking Greater Access?

On the demand side, we know that potential clients, meaning the bankable population, do not express demand for services from financial institutions for a number of reasons, including cultural, socio-economic and gender considerations, lack of confidence and trust in the financial organization, geographic location, their own transaction costs of accessing financial services and the lack of services corresponding to their needs. Also, many clients express demand for fewer services than they might otherwise use. The consultations addressed the question of factors affecting client choice and use of services, challenges to increasing demand by bankable people, methodologies and mechanism to best address client's needs for proximity services; as well as strategic actions to address the challenges and reduce constraints on the demand side. We distilled from the discussions the following areas of convergence of views, areas where views differed and questions that arose from the discussions.

1) Areas of Convergence

From the (potential) client's perspective, societal, physical and technical constraints come into play to keep the bankable household or enterprise from entering into needed financial transactions. These factors include the following considerations:

- Limited financial literacy and business acumen of borrowers restrict the demand for financial services.

- Geographic factors: Rural populations are further disenfranchised from access to financial services by being distant from central places and thinly dispersed.

- Cultural barriers, including gender, were routinely mentioned as constraints to access to finance, particularly for women, who do not have titles to assets such as land and property and often do not control cash flows of even their own ability to work. Ironically, the conditions in post-conflict situations sometimes broke down cultural barriers, as women became the sole breadwinners in many cases, as years of war led to displacement and the social and economic breakdown of society.

- Lack of trust and confidence in financial service providers keeps potential clients from placing their savings with financial institutions. Distrust stems from the failure of institutions, and experiences with hyperinflation, financial crises and corruption, which leave long lasting effects on trust — those who have lost their life savings to currency crises or to corruption are understandably reluctant to entrust funds to financial institutions.

- Lack of legal identity of the client is a significant barrier, which often affects women and ethnic minorities more deeply.

- Product offerings are not diverse enough and not sufficiently suited to clients' needs: the product pool has to be broadened, to help poor people build assets — not just debt — through voluntary savings, housing finance, insurance and money transfers, as well as a range of offerings to help businesses grow. The importance of savings in relation to other products came up consistently. Respondents called for the development of a far greater understanding of client needs and a better alignment of product offerings with economic activities and life cycles. One particularly challenging client group in terms of product offering is crop agriculturalists.

- While it is a widely held view that clients are not sensitive to interest rates, but place greater importance on the reliable provision of credit and safety of savings, evidence suggests increasing price sensitivity; this stems on the one hand from greater financial literacy, and savvy, of clients and on the other hand from increased competition among financial service providers.

- Bureaucratic hurdles raise significantly the transaction cost for clients.

2) Areas of Divergence

- There are inherent barriers to extending credit into new as opposed to existing economic activities and these would apply for microfinance as much as to larger loans. New activities are by their nature higher risk for the creditor. If proposals to lend for new micro or SME projects are rejected more frequently than for traditional ones, this could be a fact of life or something that policy makers should address.

- The question of trust and confidence in financial institutions holding personal savings came up across regional settings. The answer lies in some combination of rebuilding confidence in the institutions (e.g., through more rigorous supervision) and protecting individuals (e.g., through deposit insurance). One view is that the savings in all deposit-taking institutions, even microfinance institutions (MFIs), should be insured. Views also differ on what the role should be for government guarantees (explicit or implicit) to increase the trust of clients and how much to leave to the market to sort out.

3) Open Questions

a) Lowering cultural barriers is a deep issue. Are there concrete steps to reduce cultural barriers? Are there specific measures to suggest, aside from the fundamental questions of country economic and political stability and sound management and sound performance of financial institutions? Can technology play a role?

b) Proposals call for strategies under which either a specialized unit or a specialized institution is required to reach the poor, as well as specialized products. Do the poor need "poor-friendly" institutions, i.e., institutions with which they feel a special relationship?

c) Preferred microcredit customers seem to be "middle aged" repeat borrowers. How do you develop effective demand for microfinance by new and younger (potential) entrepreneurs? How should the evolution of client needs over time be understood and clients at different stages of the life cycle be targeted?

d) It has been observed that sometimes informal and formal financial institutions exist side by side. This suggests that the formal institutions are not satisfying some of the needs that the informal institutions are meeting. Does this imply opportunities for the formal institutions or is there something in the essence of the informal institution that makes it attractive and that the formal institution cannot duplicate?

e) The financial needs of the poorest of the poor need also to be addressed. While the destitute are less likely a market for microcredit, even they draw on microsavings services. What are the more effective instruments and incentives for effectively serving this population group?

f) It seems that insurance is the basic financial service least used by the poor. What is the potential market for personal insurance among the poor in terms of types of insurance (life or burial policies, disability, unemployment, health)? What range of the poor are potential customers for personal insurance?

g) International remittances are a financial activity of increasing importance (and are coming more into formal financial channels from informal ones). Is this an opportunity to bring potential customers into the formal financial institution? Is it a way to promote banking the unbanked, linking remittances to other product offerings? What are the disadvantages and advantages?

Issues Cluster #2

Why Don't Retail Financial Institutions Serve the Poor Better?

Despite the impressive numbers of new market entrants in microfinance and SME finance, representing a wide range of institutions, including mainstream financial houses, it is recognized that expanding capacity at the retail level is one of the greatest challenges. While many financial institutions serving the poor are well run, there is a sense that management, systems and operations, risk management and performance monitoring need to be improved across the range of institutions. Consultations addressed questions of constraints which have most impeded the expansion of the offer of financial services to under-banked clients by private and public financial institutions, the most significant risk factors and risk mitigation issues, information issues, cost issues, measure and incentives to expand supply, and opportunities to develop public-private partnerships.

Consultations touched constraints to outreach in terms of the range and nature of financial services offered, including the differentiation of constraints across products, which products are well or poorly offered, the degree of alignment of product offerings with client needs and their economic activity, and the greatest opportunities for innovation.

Discussion also touched on the range of legal structures of retail financial institutions (including non-governmental organizations (NGOs), cooperatives, mutual banks, private companies and state-owned institutions). The diversity of the market and the complex set of constraints institutions must address suggest it is important to understand the relative advantage of different institutional models and legal structures.

1) Areas of Convergence

- Experience over the past decade demonstrates that financial sustainability is possible for MFIs serving the poor. It has also been demonstrated that attaining sustainability is a challenge.

- There is no doubt that the greatest overall constraint expressed was the lack of management capacity in the financial institutions. This begins with governance and management at the top of the financial institution, but includes also middle management. Weak governance and management are often cited as the factor underlying all other constraints.

- Next to capacity constraints at the institutional level, the issue of high transaction costs across institutional models was most cited. The transaction cost issue is even more acute on the savings side, because of the very small amounts per transaction.

- Incentives, especially in profit-based institutions, to meet annual lending volume targets lead loan officers to lend larger amounts to larger customers, as small loans entail higher costs to them in terms of the workload per transaction. In socially oriented institutions, the incentive scheme can be altered to take account of the number of transactions and, of course, performance.

- The lack of credit information is a significant constraint in many countries, raising the perceived risk profile of micro, small and medium enterprises. Increased information (as through credit bureaux) but also increased transparency (as through external audits, better enforcement of accounting standards, and performance monitoring) would facilitate better risk assessment.

- It has to be appreciated that target borrowers are often not transparent about their business for understandable reasons. In certain economies in transition, for example, smaller enterprises have actively sought to avoid transparency to navigate around the tax system, but also to distance themselves from the pressures of criminal networks.

- Backing one institutional model for a retail financial institution, or a limited number of institutional models, has limited the degree of outreach to the potential markets in some country experiences. Different institutional models are appropriate in different national settings and in relation to different market segments. There should be no artificial limitation (policy-based entry barriers) on the types of retail financial institutions allowed in a country.

- There is a greater awareness of market niches, wherein separate institutions with a relative advantage are left to focus on the poorer market segments, while more commercial institutions focus on more well off market segments, yielding a pattern of institutional models linked to specific client segments. However, changes in technology and in profit opportunities globally can change the attractiveness of the niche markets to the big players.

2) Areas of Divergence

- There is still considerable tension around the “outreach vs. sustainability” issue. While the debate is no longer so divisive, the “double bottom line” is still viewed by some stakeholders as contradictory in terms. Fears are consistently expressed that microfinance institutions (MFIs) will shift away from original constituencies, the poorer groups, as they become more commercial.

- While MFIs may be moving “up market”, commercial financial institutions have been increasingly interested in moving “down market”, as competition pushes them to search for new clients. Even if the “missing middle” is thus approached from both ends, it is not clear that would be sufficient to serve this market segment adequately.

- The gap between real risk and perceived risk of lending to the bankable poor is large in some cases and could be zero in others. When such a gap exists, it raises the cost of funds to the retail institution and the cost is borne by the ultimate borrowers, absent subsidies. A difference between perceived and actual risk would be a good argument for subsidy (based on market failure), but it is not clear how one might determine the size, let alone the existence, of the gap.

- Technology can be a major driver in reducing costs, although the introduction of new technology can itself be costly and the use of such technology can alienate certain groups of clients, especially those with less technology awareness and skills. Technology designed for one market segment may not be appropriate for another, although the salesman may not tell you that. *Caveat emptor* is thus an appropriate warning when introducing new technology

- The entry of commercial banks into the micro and SME market segments is hailed as part of increased recognition of their profit potential. Yet, the entry introduces difficult competitive challenges for MFIs and regulated specialized institutions. The larger commercial institutions have larger capital bases, lower cost of finance, a wider range of products, a diversity of market segments and larger branch networks. They might drive the MFIs and specialized institutions to ever more marginal markets. Then, when profit opportunities arise elsewhere, the large banks might retreat from these markets, leaving them unserved. Is this realism or hysteria?

3) Open Questions

a) What are the most promising opportunities for rapidly increasing organizational capacity at retail institutions in terms of management, staff and systems? How do differences in ownership and governance of retail financial institutions serving the poor translate into incentives or impediments for improved performance?

b) What are the most promising means of lowering transaction costs? What are the limits to what technology can offer? Are there adequate incentives to pushing costs lower in a context of liberalized interest rates if entry barriers limit competition?

c) What have been the most recent advances in reaching out to the previously unserved rural populations? Where has there been real success in this area? Where are the opportunities for the future?

d) It seems technological change is providing more alternatives to “brick and mortar” branch banks or MFIs. How can such alternatives as agents (individuals, merchants), mobile banking, automated teller machines (ATMs), ATMs on trucks, and so on best be used to expand and deepen access to financial services? Are new technologies like ATMs mainly to be the province of large MFIs and banks? Might clients of small, specialized MFIs benefit as well? Could the technologies be introduced while the MFIs still struggle with implementing core information systems?

e) The argument has been made that small, private domestically owned banks, as well as certain state-owned banks can hold a relative advantage due to location and their capacity to know their clients due to proximity. What is the potential of proximity banks and other social finance institutions? Are they reaching the poor with products responding to client needs?

f) Is it possible to "map" the landscape of a financial sector to determine which institutions best serve different market segments? What is the evolution and potential of these market niches?

g) Is the ideal end state of financial sector development that financial services to the poor are provided by profit seeking financial institutions? Or is a further development of "double bottom line" institutions possible? What about subsidizing commercial establishments to undertake social functions? How likely are these scenarios? How much time would it take to withdraw dependence on subsidies? What would be the key actions needed in terms of creating incentives in the next ten years to achieve that end state?

Issues Cluster #3

Why Do Micro and SME Finance Institutions Not Draw More Funds From the General Economy?

The financial system serves to transfer financial resources from savers at home and abroad to borrowers (at home and abroad). The institutions specialized in micro and SME finance are relatively unsuccessful in participating in this general process. Constraints to greater financial market integration include the unfavourable risk assessment of SME and micro-loan portfolios and the inability to raise funds in capital markets. When they do get such access, concerns are raised with regard to the terms of both domestic and international borrowing and the capacity of many MFIs and other financial institutions to manage the risks they entail. There has been extensive discussion of the range of possible alliances and linkages to better intermediate funds from the broader financial community to institutions specifically serving the poor.

1) Areas of Convergence

- For the long run, the development of domestic financial markets, including a competitive commercial banking sector, is central. Financial intermediation that provides vastly increased financial services for the poor using domestically generated savings can be a virtuous circuit. It does not mean, however, that individual MFIs need be deposit-taking institutions and mobilize the savings themselves.

- The important opportunity from "alliances" and linkages was underlined over and over again. Numerous new arrangements exist and are being developed to link the operations of microfinance/SME finance organizations and commercial banks. This is a means to tap funds on commercial terms without the MFI itself having sufficient reputation in the financial sector to draw on such funds itself.

- Greater financial integration can improve the risk and liquidity management of MFIs through diversifying funding sources (including access to interbank lending, lowering the cost of commercial funds and lengthening maturities). However, the managerial capacity to minimize asset/liabilities mismatching, interest rate risk and foreign exchange risk is yet to be developed.

2) Areas of Divergence

- While there is a general view that micro and SME finance should be better able to draw financial resources from the general economy, a number of voices expressed concern about mission drift if institutions become increasingly dependent on purely commercial sources of funding. There are two concerns here: that the donor subsidy might be essential for an MFI to be viable and that the board of the MFI would lose its sense of mission if it had to make decisions with a view to keeping its private creditors happy. While some information is available on outreach and financial viability, as through the MicroBanking Bulletin of the Microfinance Information eXchange ("The MIX"), there is no body of knowledge on whether client focus is in fact related to the funding structure of an MFI.

- Increasing access of the poor to financial resources by mobilization of their own savings is seen by many as a direct route not only to raising resources but also to building a sense of community. Indeed, the demand for savings services usually exceeds that for credit. Others would underline that, given the high cost of mobilizing small savings, tapping the savings of the wealthier population through the wholesale market (second tier banks) or branch banking in affluent areas to collect savings to lend to the poor are the more viable models.

- The realization that the flow of remittances is huge to a large number of developing countries has raised the question of how best to attract these flows into domestic retail financial institutions, as opposed to their remaining in the cash economy. The unresolved question is whether this is an opportunity for deposit-taking MFIs or is best left to national savings or postal banks or even commercial banks. The question has been put in terms of comparing the cost of handling these new deposits on the one hand and the benefit of enticing potential new clients into the MFI by offering the new remittance-receiving service.

- There has been discussion of the degree to which profitability should be expected from investments in "social finance." One international network suggests encouraging a concept of social investment in which the saver accepts a smaller financial return in exchange for knowing her funds have helped to finance small and poor entrepreneurs. This would require aggressive promotion, but it was deemed feasible. Others are not so sure. Globally, "socially responsible" investing is a small share of financial market activity. When some of the largest financial institutions in the world take it up, it is often as a charitable activity by these enterprises, whose shareholders expect almost unremitting pursuit of profits.

- There is an ongoing debate about how MFIs should view international financial market funds. There is concern that these funds distract attention from enhancing the development of domestic financial markets, and there is concern about foreign exchange risk. While international interest rates are often lower than comparable domestic interest rates (even corrected for inflation), they carry a foreign exchange risk that is serious for institutions virtually all of whose assets are in local currency. Indeed, the cost of instruments to hedge foreign exchange risk, when they are available, sometimes eclipses the cost of the risk being mitigated, especially in small developing countries without significant foreign exchange derivative and swaps markets.

- International funders (public and private) that provide loans to MFIs contribute to the foreign exchange risk problem, even when lending on highly concessional terms. To the degree the funders can themselves borrow in local currency, they could lend in local currency, which would transfer the exchange rate risk to them from the MFIs. Some people argue it is time for these institutions and donors to produce a breakthrough in solving the foreign exchange risk issue, which the larger institutions are in a position to do and which some multilateral development banks have already done by issuing some of their own bonds in some emerging economy financial markets.

3) Open Questions

a) Where are there good opportunities in terms of the alliances and linkages between and among financial institutions in terms of efficiency and outreach to the poor? What kind of market based incentives can be put in place to encourage such linkages and alliances?

b) How can policy makers challenge various segments of the financial sector to innovate, improve quality and efficiency in serving poor clients while lowering the price of services? Is there such a thing as an optimal model in terms of bringing general financial intermediation to bear on finance for poor clients?

c) Is the process toward the integration of inclusive finance into financial sectors inevitable at this stage? If not, what could stop it? If so, how can it be accelerated? Does it have to embody the marginalization of specialized MFIs who face increased competition from bigger financial institutions?

d) Bond issues by specialized financial institutions are becoming more prevalent. What is the potential for this way to mobilize funds for this market segment? Could MFI loans be securitized on local or international markets? On what would it depend?

e) One approach to mitigating exchange rate risk is for international investors in developing country microfinance to lend in local currency and absorb the risk within their own diversified portfolio of instruments. Are there measures that could be taken to encourage such a shift in who bears the foreign exchange risk?

Issues Cluster #4

What's Missing in the Financial Infrastructure?

Increased attention has been given to the poor state of "financial infrastructure", defined in this case not as physical infrastructure, but rather as information infrastructure (accounting rules, auditing, credit information), and legal and judicial infrastructure (collateral and bankruptcy laws, legal protection of creditors, and the existence of competent and impartial courts).[3] Discussions in the consultations covered the support mechanisms that the public and private sectors provide to foster financial sector and institutional development, information flow and transparency, as well as bottlenecks in terms of financial infrastructure, and measures to address these constraints.

1) Area of Convergence

- There is increased attention to the importance of financial infrastructure, and little controversy around this need. For example, accounting and auditing standards are weak or lacking.

- The absence of credit bureaux is said to be a major drawback to an inclusive financial sector. Providing credit scores designed to evaluate appropriately the risk associated with lending to micro, small and medium enterprises, as well as individual poor clients could dispel the perception of the unreasonably high risk of serving those currently unbanked and enable entrepreneurship.

- More attention is now given to the poor system of property rights and weaknesses of the legal and judicial systems. However, in addition to better laws and better law enforcement, there also needs to be a change of expectations and then behaviours so there are fewer attempts at graft and illegal activities that perpetrators feel they could do with impunity. That is, most laws need to be self-enforcing, which may require a cultural change.

2) Areas of Divergence

- The shortcoming in the infrastructure pertaining to financing for the poor is clear. Most countries have yet to build a well-functioning infrastructure protecting debtors, creditors

[3] "Financial infrastructure" does not have one standard definition. It is generally defined as the regulatory, accounting and legal infrastructure in place to facilitate the functioning of financial institutions and markets. Other definitions refer to payments, clearing and settlements systems. The definition can also extend to international financial infrastructure in the sense of international financial architecture. In our context, financial infrastructure covers information and legal infrastructure. The regulatory infrastructure is treated in the next cluster in the context of policy for an enabling environment.

and shareholders alike. Typically bankruptcy laws are inadequate, the litigation system out of reach for the poorest and the enforcement mechanism inefficient at best. However, there is a lack of consensus on how much effort (at what cost absorbed by whom) to put into improving it. Thus, while a strengthened legal and court system requires direct government outlays, legal representation is generally a private responsibility.

- Could MFIs enforce bankruptcy through formal proceedings on a routine basis? This might be difficult given their social calling, yet necessary to maintain credibility in the community.

- Specialized rating agencies for microfinance institutions have increased the transparency and availability of information within the sector, as has the posting of comparable information on individual MFIs on The Mix on the Internet. The purpose of these exercises is to help donors, shareholders, oversight boards, potential investors and creditors, and management assess the performance of individual MFIs. Outside the social enterprise universe, that function is guided by profits and stock market performance, whereas the assessments by traditional rating agencies refer solely and specifically to the probability of default on a financial instrument issued by a rated corporation or government. The issuing entity bears the cost of traditional ratings and for obvious reasons, while donors usually bear the cost of MFI ratings. Even though they serve different purposes, one question is the degree to which MFIs (or their oversight boards) would or should pay for their own external "ratings" or assessments, as they would for an external audit when required.

3) Open Questions

- Generally, enterprises arrange to be rated when they intend to issue financial securities on public markets. This is not the case for MFI ratings, which are external assessments of performance, and not surprisingly there has been limited engagement by the large international rating agencies in MFI ratings. When should MFIs seek to be rated?

- How can credit bureaux that would report on SMEs as well as individuals to establish their creditworthiness be sustained? Could MFIs pay for their share of the services? Once SMEs are in a credit bureau database, would they become more feasible candidates for loans from traditional banks, particularly for medium-sized enterprises? What should be the public versus private role in this area? Should a government or central bank undertake to operate a credit bureau or subsidize it?

- How important is the existence of national ID systems to underpin credit bureaux and national scoring models? Are there particular areas of the information and communication infrastructure in which governments should consider investing (e.g., linking together MFIs in a country and in the process bringing them up to national standards.

Issues Cluster #5

Policy, Regulation, Supervision and the Role of Governments in Promoting Inclusive Finance

Government policies, laws and regulations can constrain the building of inclusive financial sectors, or they can serve to re-engineer the financial sector, with a focus on sustainable inclusion. The Bretton Woods institutions have identified a set of "first generation" issues (macroeconomic stabilization and financial liberalization, including removal of interest rate ceilings and withdrawal of government from financial service provision), as well as enabling legislation and some regulation covering institutions offering microfinance services. These policy prescriptions still remain on the agenda as recommended policy reform in a number of countries. In addition, the Washington institutions have identified a set of "second generation" issues that focus on institutional strengthening (fine tuning of regulations, treating microfinance as an asset class and activity potentially relevant across financial institutions, improving supervision, taxation issues). Developing countries have only begun to address these policy prescriptions.

While the views of most of the donor community on the cost in relation to benefits of direct state intervention in the financial sector in developing countries are clear, debate continues at the global level, based on the recognition that the appropriate role of government in market-oriented economies will vary from country to country. There is room for this debate on the role of government in terms of the conditions under which governments may provide, or mandate the provision of, financial services for the unserved markets.

1) Area of Convergence

- Financial sector development is a critical element of development in the light of its contribution to economic growth and equity, as well as enhancing financial stability. A robust financial sector can help strengthen financial services for the poor, but the latter requires an explicit policy consideration at country level.

- Despite the decades of discussion about the case for microfinance, discussants emphasized the fact that many policy makers still regarded microfinance as a charitable activity. Some discussants see the persistent misuse of microfinance in a number of countries for narrow political gain (e.g., "…microfinance is seen as a helpful tool for winning elections…"). Rather, it is widely held among stakeholders in inclusive finance that microfinance should be seen and treated as part of the financial sector.

- In some parts of the developing world, particularly in middle-income countries, consumer credit, especially as extended by merchants, has been expanding rapidly. It is oftentimes more expensive than credit from financial institutions and the costs are not transparent (e.g., installment buying). Households — and enterprises that use consumer finance for business purposes because they can access it — deserve the protection of official oversight that imposes transparency and fair dealing in consumer finance ("truth in lending").

- Governments have been challenged by "second generation" regulatory and supervisory issues, as have the financial institutions themselves (examples include permission to offer more sophisticated products, the application of collateral requirements, and expanded ability to raise funds in capital markets). There is a clear need for additional technical assistance for governments in selecting and implementing appropriate regulations, and for capacity building in financial institutions that serve the poor.

- Inadequate focus has been put on government supervision of microfinance in most countries. In many countries, supervisory authorities do not always understand the specific characteristics of microfinance and thus do not set appropriate standards of oversight. Mandating supervision without the corresponding capacity is dangerous. Governments need to invest in supervisory capacity.

2) Areas of Divergence

- A participant in a regional dialogue framed the question of political economy 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." This underlines that policy making is not "engineering". Accepted proposals may be undone by successor regimes. One reason is they may not produce expected results (expectations could have been unrealistic or oversold). Policy making has also seen fads that pass.

- A case in point is that while there is greater acceptance by policy makers and populations in developing countries of the need to allow market forces more room to allocate resources, interest rate ceilings continue to exist in many of them. This underlines the continuing concern about "usury", i.e., the exploitation by banks and other institutions of their market power to charge high interest rates. The pro-market answer to usury is to foster entry of new competition to bring down the price of credit. That the issue remains alive politically indicates there is no convergence of views on how to attain market-determined, competitive interest rates.

- It is also not clear how much government should oversee the microfinance institutions and how much to spell out in legislation. There is a continuing lack of consensus on what, when and how to regulate. The experiences reported regarding the enactment of microfinance legislation were diverse. In some countries, the governments have only recently begun developing microfinance regulatory frameworks.

- While governments do not regulate many NGO microfinance institutions, MFIs that take deposits are regulated, as are the large financial institutions that may offer microfinance, like savings banks or commercial banks. Issues raised in the consultations included the asserted need to regulate the large numbers of MFIs, the alternative of self-regulation, and what should be the regulatory requirements for commercial banks wishing to lend to specialized micro finance institutions, whose portfolios were not collateralized. In yet another area, the regulation of cooperative structures is still a challenge.

- There is apparent disparity and unfairness in taxation of financial institutions, which can be documented in many countries. What constitutes a "fair" taxation of the range of financial institutions offering financial services to the poor remains a subject of discussion. There are conflicting principles that could be applied, such as nurturing capacity to serve the poor ("infant industry" argument) versus letting competition determine the outcome (maintaining a "level playing field").

- Deregulation and privatization were pushed under the "Washington Consensus." We are now in a more eclectic period, where, for example, postal savings schemes are being reintroduced in some countries. At the same time, there is a sense that financial services should be fully priced and that while individual institutions might be subsidized, it should not be on a permanent basis. While financial institutions should run as enterprises, some are public enterprises and very successful ones. The principle of government non-involvement is a principle that has not won global acceptance. Indeed, public/private partnerships can be effective ways to draw on the strengths of both types of institutions, which is not to say they always work well.

3) Open Questions

a) What are the greatest challenges currently in terms of framing the regulatory environment? What are the regulatory issues emerging with regard to the increased integration of specialized institutions into financial markets? What political processes can be brought to bear in a country so that regulations that are adopted are appropriate, accepted and largely implemented?

b) What is the proper role of government as policy leader? Should government lead through legislation and regulation to shape the playing field, including seeking the entry of experienced foreign banks, on condition they agree to serve the poor? (Do such banks bring relevant experience in serving the poor?)

c) Is there a resurgence of government intervention to serve the poor? Is this a signal that "*laissez-faire*" policies failed or were never convincingly applied? Do policy experts need to devote more attention to finding better ways to intervene with greater benefit and less distortion of market signals? What is the nature of "smart subsidies"?

d) Can governments afford to be passive in the area of financial sector development? What if passivity leads to stagnation rather than private initiative in banking? Is there a role for governments in the ownership of institutions offering fully-priced financial services? There are a number of large government-owned banks that have used their infrastructure to reduce the cost of microfinance, including in partnerships with non-state entities. Is this a model? How should pressures or incentives be created for their efficient operation?

e) It appears that supervisory capacity lags behind the development of regulations, both in methodology and capacity? What are the greatest challenges in terms of applying supervisory tools to microfinance and SME finance as business lines?

Issues Cluster #6

International Cooperation and International Standards: Role of Donors and Elements of International Financial Architecture

The issues around donor support to micro and SME finance have been treated extensively by the Consultative Group to Assist the Poorest (CGAP). The recent CGAP publication, "Building Inclusive Financial Systems: Donors Guidelines on Good Practice in Microfinance" (the "Pink Book"), based on extensive consultations within and outside the donor community, provides practical operational guidance for donor staff. In addition, the core requirements of donor effectiveness were distilled from the extensive CGAP peer review process.

Another consideration on the international front is the role of international organizations in the setting of standards for financial system stability and the oversight of the international financial system. To what extent do these issues affect the market segments on which we are focusing? This includes the role of the committees associated with the Bank for International Settlements and other bodies in standard setting designed to improve accounting practices, banking supervision at the national level, as well as anti-money laundering measures, and the role of the World Bank and International Monetary Fund in oversight of their implementation through their Financial Sector Assessment Programme (FSAP) and Reviews of Standards and Codes (ROSCs).

1) Area of consensus

- Donor effectiveness can be enhanced by greater donor coordination, to which donor governments have committed themselves. In this regard, CGAP has functioned as an important donor forum working towards greater coherence in international assistance programmes. The reality is still that better cooperation and coordination is something for which donors have to continue to struggle.

- Government donors are aware that they need to help countries build an enabling environment for inclusive finance, which in part calls for them to position themselves in relation to private sector players. The distinct roles of external actors in microfinance — official donors, philanthropy, social investors, commercial interests — are now better understood. Despite the extensive work on sound donor practices, there is still concern that donors introduce distortions that are a constraint to private sector involvement.

- Some international regulatory standards should apply to all countries but not all of them. It is important for governments to choose the appropriate package of regulations to follow for their stage of financial sector development and national characteristics. International assistance can provide important support to this national reflection imperative.

2) Areas of Divergence

- Donors can support financial sector integration through the promotion of investment funds, credit enhancement such as guarantee mechanisms, lending as part of private-public sector consortiums, and under the right conditions, taking equity positions in financial institutions. Donors differ on the relative value to place on these different instruments. These interventions are also a challenge in terms of timing the entry and exit of public sector institutions into financial sector activities.

- The commercially oriented multilateral financing institutions have provided, directly or indirectly, about 75 per cent of all investment in specialized retail institutions by international funders. Regulated specialized institutions in the transition economies and Latin America have secured nearly 90 per cent of this money, leaving unregulated institutions largely without the benefit of this capital. This appears to be a misallocation of resources, although that might be debated. It may be argued in any case that public money should not displace local capital for retail institutions that can obtain it, and should instead take more risk by funding the emergence of a second layer of specialized institutions.

- Much attention has been given to international structures such as the new capital adequacy framework for commercial banks (Basel II), with fears expressed that these arrangements will cause developing country regulatory authorities to implement without adequate concern for national contexts and concerns. There is a sense in some developing countries that they should adopt Basel II standards to be “modern”, while the United States, for one, has decided to apply Basel II in only a limited way.

3) Open Questions

a) Donors have been moving away from funding financial institutions in developing countries to instead work more on financial sector policy issues. Yet all agree that the greatest challenges lie in the delivery of retail financial services for the poor. Has there been too much of a shift to focus on the policy framework? How can donors best contribute to increasing outreach in the most difficult market segments?

b) How can donors play the role of priming the pump as the commercial private sector gains experience in directly and indirectly providing financial services to the poor? How can donors position their involvement so as to leave room for the private sector to develop, rather than compete with the private sector with terms that in fact keep out the private sector?

c) To what extent do measures such as Basel II supervisory principles, international accounting standards and international money laundering measures affect the challenges of financial inclusion? What measures are required to make sure that the international financial architecture does not hinder inclusion, but rather incorporates financial inclusion as a fundamental objective?

d) How can regulators/supervisors from developing countries best discuss matters of common concern relating to extension of financial access to the poor? Does this warrant a one-time exercise or do these regulators need their own forum (or regional forums) in which to discuss common concerns, in the same way that the major developed countries created the Basle Committee to meet their needs in the area of supervising internationally active commercial banks?

e) More generally, should there be an international and multi-stakeholder forum in which to discuss policy issues in building inclusive financial sectors, not least to evaluate and update the Blue Book on a periodic basis?

Annex

BLUE BOOK ON BUILDING INCLUSIVE
FINANCIAL SECTORS FOR DEVELOPMENT

Main Consultations

October 2004:

- Middle East/North Africa Multi-stakeholder Dialogue, in association with Microcredit Summit Regional Meeting in Amman (October 12)

December 2004

- Africa Multi-stakeholder Dialogue, in collaboration with African Microfinance Network (AFMIN), Bamako (December 7-8)

February 2005- May 2005

- In-depth structured interviews and in-depth questionnaires with leading figures in inclusive finance (through mid-May)

March 2005

- Asia and Pacific Multi-stakeholder Dialogue, in collaboration with the Asian Development Bank, Manila (March 16, as part of "Microfinance Week")
- UK/Commonwealth Consultation organised by the UK National Committee for the International Year of Microcredit

March 2005 – April 2005

- On-line questionnaire response period
- E-Conference, in collaboration with World Bank Institute (March 28- April 8, extended to April 13)

April 2005

- Reconvening of the 1994 UN Experts Group on Women and Finance as a Blue Book event, Women's World Banking (April 6 – 8)
- Latin American Multi-stakeholder Dialogue, in collaboration with World Savings Banks Institute and Microcredit Summit Regional Meeting (April 19 and 20)

May 2005

- Final Multi-stakeholder Dialogue on Building Inclusive Financial Sectors, Geneva, hosted by ILO, to review draft findings/issues/observations for inclusion in Blue Book (May 4-5)

(A reference list will be available at the time of the meeting in Geneva)