EXECUTIVE SUMMARY

E-CONFERENCE ON BUILDING INCLUSIVE FINANCIAL SECTORS FOR DEVELOPMENT: WIDENING ACCESS, ENHANCING GROWTH, ALLEVIATING POVERTY

E-Conference organized by UNCDF and FFD in collaboration with the World Bank Institute

As part of the consultative process that serves as input to the Blue Book, the Financing for Development Office of the Department of Economic and Social Affairs, the United Nations Capital Development Fund and the World Bank Institute joined together[1] to organize an e-conference on "Building Inclusive Financial Sectors for Development: Widening Access, Enhancing Growth, Alleviating Poverty" from March 28th to April 13th. The three main objectives of this e-conference were:

1. Engage a wide range of constituencies from various professional and geographical backgrounds and solicit their expertise and opinions
2. Contribute to the Blue Book project by proposing innovative ideas and workable solutions to building inclusive financial sectors for development
3. Provide an introduction to the Global Meeting on Building Inclusive Financial Sectors for Development that will be held in Geneva May 4th - 5th 2005.

The e-conference was structured around a two-and-a-half-week discussion, moderated by two experts from the microfinance field, Deborah Burand (a law and finance specialist, most recently the Director of the Capital Markets Team of FINCA) and Bikram Duggal (previously with the ICICI Bank in India, currently working as a microfinance consultant). They provided guiding questions on the weekly topics and provoked a consistently high level of discussion.

During the first week, contributions focused on improving our understanding of the demand and supply barriers to increasing access of the bankable poor to financial services and products, both formal and informal. The discussion in the second week concentrated on integrating financial services for the poor into broader financial markets and creating an enabling policy environment for microfinance, focusing on the role of regulation and governments. The final half week allowed participants to share their vision of an inclusive financial sector and their views on required actions for achieving this vision.

With roughly 800 participants from 111 countries, encompassing microfinance practitioners, representatives from commercial banks, academics, members of non-governmental organizations, students, corporate executives, government representatives and staff from multilateral institutions, the e-conference provided a platform for a truly broad-based, constructive dialogue (see table 1). The broad participation in the e-conference drew a variety of perspectives and priorities.

[1] The e-conference team consisted of project leaders Kathryn Imboden (UNCDF), Barry Herman (UN DESA), and Djordjija Petkoski (WBI); project coordinators Stephanie Narquin (UNCDF) and Can Atacik (WBI) and project support staff Alys Wilman-Navarro, Wambui Chege, Danielle Leblanc (UNCDF), Silke Hermes (WBI) and Helen Toxopeus (UNDESA).

TABLE 1: REGIONAL DISTRIBUTION OF PARTICIPANTS IN E-CONFERENCE

Region	no. particip.	% of total
Europe	210	26.1
Central Asia	23	2.9
South and Middle America	47	5.8
Africa	130	16.1
North America	187	23.2
Middle East and Nothern Africa	24	3.0
East Asia	49	6.1
South Asia	70	8.7
Not specified	66	8.2
Total	**806**	**100.0**

Using the moderators guiding questions as a starting point, the following points came out of the debate as being particularly relevant in the process of building an inclusive financial sector.

WEEK 1 : EFFICIENT FINANCIAL INSTITUTIONS POSITIONED TO MEET CLIENTS' NEEDS

Both demand and supply barriers to increased access of the bankable poor to financial services were considered. It was questioned why the range of financial institutions engaged in finance for the poor is not able to expand the offer of such services more rapidly.

1. DEMAND SIDE BARRIERS

Five issues were highlighted in the debate on demand constraints and opportunities.

Cultural factors - The importance of cultural factors with respect to gender, religion and age was frequently mentioned. Women are often disadvantaged by credit requirements such as collateral since often property is registered under their husband's name. They also generally have less formal education and financial literacy. A participant from Iran specifically noted women's lack of access to formal financial services, but also that this has triggered creative, informal microfinance schemes. Due to women's changing role in a post-conflict society, the female demand for microfinance services also has a tendency to increase. Religion or other cultural norms may attach stigma to non-traditional income-generating activities, which would otherwise be good business opportunities. A participant mentioned that in Ethiopia, handicrafts are a non-traditional activity and therefore less popular to engage in than agriculture. Also, youth tend to have lower access to microfinance services in spite of their education, due to lack of collateral or other credit backing. Older participants on the other hand seem to be more reluctant to use microfinance services, preferring to invest in traditional manners (e.g. in livestock).

Mistrust of financial institutions – This demand side barrier was commonly mentioned, in particular as regards financial institutions involved in microfinance. Reluctance to put money in the formal system due to experience with hyperinflation, financial crises and corruption needs to be counteracted by government and financial institutions by "depoliticizing" microfinance and cultivating trust as a public good. Informal credit or saving schemes are often preferred by low-income clients looking for financial services. Views on this "shadow economy" were mixed: while some argued that the informal sector puts extra pressure on entrepreneurs (sometimes through criminal networks, as a participant from Russia mentioned), others believed that informal institutions are exemplary in meeting existing demand.

***Transaction costs* -** The role of transaction costs to the client (financial, time, etc.) as a demand barrier to financial services was debated. In spite of the recognition of the need for sustainability of microfinance institutions (MFIs), many felt that costly prudential requirements should be relaxed, considering the generally high repayment rates. A participant observed that transaction costs for the poor in Bulgaria are very high and the minimum requirements are a burden, however they are difficult to lower due to fixed costs involved for the bank. She observed that "even the socially engaged institutions cannot work below cost". Examples of too-stringent requirements were collateral, licensing requirements, high interest rates, bureaucratic procedures, and co-signers on loans. Two creative solutions to this were allowing work equipment to serve as collateral and including informal sources of income in the credit analysis. Overall however, the feeling was that the availability and consistency of access to credit are relatively more important than the transaction costs involved in facilitating access and use of microcredit.

Financial literacy and skills capacity –Developing financial literacy and skills capacity of the bankable poor is another factor that would build demand and lower the real and perceived risk of micro-lending. Some participants agreed that this would also make participants more price-sensitive. A Chinese participant stressed that financial literacy training needs to take into account the lack of a for-profit mentality in former communist countries.

***Access to basic infrastructure* –** Lack of access to infrastructure, including roads, equipment and supplies, was mentioned as a demand barrier also. A participant from Haiti mentioned that the lack of infrastructure available for energy access (specifically electricity) deters business development. An Ethiopian microfinance practitioner mentioned that where infrastructure is poor, credit tends to increase the scale of existing activities rather than moving clients into higher value added activities. A solution mentioned by some would be provision of subsidized or targeted loans for improving this infrastructure.

2. SUPPLY SIDE BARRIERS

Four main issues were addressed as important in providing an adequate supply of financial services to the currently unbanked.

***Financial viability of MFIs* –** Several MFI practitioners mentioned the difficulty in having a "double bottom line": at the same time aiming to be profitable and stimulating local economic development. Constraints include lack of steady capital, weak human resources capacity, lack of infrastructure, donor dependency and sometimes security concerns in servicing markets. Concerns were varied: some disproved of the profit-driven mentality of MFIs when they should be alleviating poverty; others worried about too much focus on repayment rates instead of on effectiveness in contribution to sustainable activities. Concerns were also raised about a tendency of MFIs to shift aw
ay from low-income clients to more profitable, commercial ventures (e.g. in Kenya and the Russian Federation). The opposite trend was also noted however: MFIs may be pushed "down market" by bank competitors moving into lower income segments, leaving MFIs to target the rural and urban poor.

***Real and perceived risk in micro-lending* –** The perceived risk of lending to the poor is higher than the real risk, creating a supply barrier by triggering higher than necessary transactions costs due to stricter than needed prudential requirements. The perceived risk is increased by lack of transparency of small enterprises, which are often informal. Participants noted different risk groups within the broad category of "bankable poor", which need to be addressed by different microfinance product designs. A professor from India made a distinction between "entrepreneurial poor," who are often engaged in small businesses already and could be scaled up

to participate more in the financial sector, and the "chronically poor," who are much more vulnerable to volatility in income flows, less able to engage in income generating activities and thus more in need of services in addition to micro-finance. One MFI practitioner suggested bundling insurance in with loans to hedge against risk from shocks (for example natural disasters or family health problems).

Institutions and linkage with the formal sector – It was pointed out repeatedly that the lack of linkages between MFIs and the overall banking sector limits access to additional capital to serve their clients' business, thereby hampering capacity growth. It also impedes clients' transition to larger banks. A participant explained that in Azerbaijan access to government funds for MFIs is only granted if they subsidize microfinance for clients, which he thought "unacceptable … and against best microfinance practices". Participants called for a stronger government role in creating an enabling policy environment and supporting microfinance. A participant from the Palestinian territories pointed out that most Palestinian capital is being invested abroad due to the unstable political and economic situation, which severely hinders the advance of micro and small business. Government efforts in combating corruption and ensuring political and economic stability were viewed as essential to expand microfinance, as well as actions to strengthen policy guidance, regulatory procedures and monitoring and enforcement institutions to deal with the microfinance sector.

Approaches and products – Supply of products by MFIs needs to be better adapted to meet diverse client demands, was the opinion of various participants. An important improvement would be for institutions to offer proximity services, especially in rural areas. In many countries financial services tend to be concentrated in urban areas, allowing rural clients little access to services and information for making well grounded decisions. One innovation that was mentioned was the "credit mobile" service to rural areas. Development and use of new technology was also discussed. The use of management information systems was mentioned as useful for expanding microfinance, as well as free tools like MicroFin. K-REP bank in Kenya was mentioned as an example where improving the management information system has increased their customer base and has expanded their clientele beyond the traditional MF sector. Group-based approaches received many supporting comments, and regular contact with communities was mentioned as a crucial aspect in successful lending. Many organizations reached out to clients through community leaders, who assisted in follow up and monitoring of loans. Others have direct regular meetings with clients, coaching them when problems arise and building trust levels in the process. Using cluster approaches to target rural communities was associated with lower transaction costs and marketing expenses.

WEEK 2: FINANCE FOR THE POOR ACROSS FINANCIAL MARKETS, WITHIN AN ENABLING POLICY ENVIRONMENT

Both different sources of capital for microfinance and possible improvements in the policy environment were discussed.

1. SOURCES OF CAPITAL FOR MICROFINANCE

There was a wide-ranging discussion on the various sources of funding for microfinance institutions and the costs and benefits of each. Some thought a reliance on private capital might lead to MFIs compromising their mission to provide services to the poor, while others thought accessing capital markets was the most useful vehicle to expand these services, and that avoiding private markets would further marginalize the microfinance sector. Several different sources of capital for MFIs were discussed.

Private domestic capital – Some participants felt that rather than relying on international private or donor funding, the microfinance sector should instead focus on creating and supporting cottage industries that can create surpluses to be reinvested in productive activities. This would require a supportive infrastructure for the microfinance sector to link it to the rest of the economy. Longer repayment periods would be needed, as investing in cottage industries would take more time to generate returns than other, standard investments. A participant from Central and Eastern Europe noted an increase in the availability of high-cost capital for microfinance from private microcredit funds. However, the high interest rates are passed on to clients, sometimes compromising social objectives by excluding the poorer end of the spectrum of microfinance clients.

International capital - Others advocated for linkages between microfinance and international financial markets. One participant wrote that his credit union in Ireland has accepted a share in the international Dexia Microcredit Fund in the name of credit union members, which he considers a promising experiment in mainstream banks linking with microfinance. It was suggested that developed country governments could create incentives for banks to invest in microfinance by offering preferential tax treatment, including a tax-free return and a tax-deductible investment. This method could be coupled with investor insurance to bring new actors (the public) and capital (from a diverse base) into microfinance.

Donor governments – Some argued that in line with their social objectives, MFIs should rely on low-cost government funding, e.g. funding programmes of the European Union. Another suggested model involved a global insurance vehicle, in which developed country governments could deduct a percentage of the return: "A reverse form of Tobin-tax, with beneficiaries paying from profit, not exchange." Using a consortium model, funds from several countries could be pooled in a common insurance fund, subject to independent monitoring. Yet another model would be government-to-government bonds issued on terms that would reflect financial stability, regulatory environment, and existence of national credit bureaux.

Donor organizations - The reliance of many MFIs on donor funding was debated. Some participants noted difficulties in securing consistent funding from donors, especially when MFIs must wait for rating agencies to release ratings before being considered for funds. In addition, donor agencies can be reluctant to provide a large percentage of the MFI borrowings, which can lead to MFIs keeping high idle cash balances to hedge against risk. Some felt that donor funding should be used primarily for training and marketing assistance to MFIs, rather than for extending credit. Developed country civil society could invest in human capital development through training and technical assistance, giving them a greater stake in development of poorer countries.

2. BUILDING AN ENABLING POLICY ENVIRONMENT

Many ideas were put forward on how to improve upon current financial systems and services to expand financial access to the poor. Focus was on managing and decreasing risk in microfinance, integration of microfinance with the mainstream financial sector, regulation for MFIs and the role of government and donors. Some other recommendations were mentioned also.

Managing risk in microfinance - Various participants felt the government has an important role in reducing risks of microcredit. Some policies mentioned to facilitate decreased overall risk include: deregulation of the microfinance market, offering loan guarantees to the poor, public-private partnerships, providing public services to reduce the cost of microfinance and identifying intermediate MFIs to serve as links between the larger commercial sector and the microfinance sector. Many participants noted the need for a solid and well-functioning legal system to enforce contracts and protect private property rights.

Participants discussed how MFIs can better manage foreign exchange risk to deliver consistent service to clients. One participant pointed out that some levels of foreign exchange risk are tolerable, but the focus should be on maintaining standards for managing risk and disseminating information about institutions that do not manage risk prudently. Since there are few strategies aimed at managing foreign exchange risks in unregulated institutions, it was suggested that donors could help monitor liabilities and assets of the institutions receiving their funds, encourage best practices and be more careful about the currencies they lend in. Risk raters could also play a role in disseminating information about performance of different MFIs. Others noted that for many MFIs, the cost of instruments to hedge risk eclipses the cost of the risk being mitigated and their access to hedging instruments is often limited. It was suggested that these risks could be better spread among different players with operational support from multilateral institutions such as the International Finance Corporation of the World Bank and regional development banks.

Integrating microfinance with the mainstream financial sector - Several themes were discussed on this topic. Some consensus existed that the integration of microfinance into the financial sector should take a different form depending on the financial landscape in a given country. In a market-based financial system, such as the United States, MFIs may access resources from capital markets and insurance funds. In a bank-based system like those found in Continental Europe and Japan, MFIs may be able to tap bank resources more easily. The need to formalize microfinance was a common theme, helping MFIs to be taken more seriously and get more capital access. The opportunity for the microfinance sector to serve as a link between the broader financial sector and low-income clients was also reiterated. Banks may be more willing to lend to MFIs than to the poor, and MFIs may deliver better services to low-income clients due to factors like proximity and knowledge of local context. In South Africa, banks have been mandated by the government to provide lower cost savings accounts for low-income clients; low interest rates may provide opportunities for coordination between commercial banks and MFIs. A legal consultant noted that in Ecuador, legislation is needed that provides incentives for financial institutions to offer services to the poor.

One opportunity to expand microfinance services that was mentioned was the increasing flow of remittance transfers. Using pension funds to raise capital for scaling up MFIs was also suggested, based on the experience of the United States and Peru. Furthermore, it was pointed out that the bankable poor have a strong demand for a safe place to deposit their savings, and do not just demand credit. Therefore this savings market should be attended to. Because of high reserve requirements and operation standards that limit access to these products, MFIs could partner with licensed deposit-taking institutions and simultaneously increase linkages with the broader financial sector. Finally, capacity building of MFI staff was noted by many as an important measure to scale up the microfinance sector; university degree programmes for microfinance practitioners in Sri Lanka and Kenya were mentioned.

Regulation for microfinance institutions - Several strategies for regulating the microfinance industry were debated. Successful examples were given of MFIs that proactively address issues of consumer protection and pro-client policies to increase accountability. Organizations such as the MicroFinance Network and the Action Network signed pro-consumer statements addressing issues of service quality, transparent and fair pricing, avoiding over-indebtedness, appropriate debt collection practices, respecting the privacy of customer information, ethical behaviour of staff, feedback mechanisms, and integrating of pro-consumer policies into operations.

Some of the discussion centred on the kind of institutions appropriate for regulating MFIs. Some believed that self-regulation would be the preferred option, since central bank regulation or

involvement of other institutions would politicize and possibly harm the relationship that MFIs have built up with their clients over time. Codes of conducts could be effective mechanisms to encourage transparency, efficiency and good performance. Examples were given from the Association of Microfinance Institutions in Uganda and the Association of Microfinance Institutions in East-Timor, where codes of conduct and performance monitoring systems were set up. The Council of Microfinance Equity Funds, a group of private funds investing in MFIs, is in the process of establishing governance guidelines for its members and the microfinance institutions in which they invest. However, self-monitoring is not without drawbacks, the largest being the lack of enforcement mechanisms. Some suggested that the market would discipline MFIs not following prudent standards; others advocated a state credit agency driven by for-profit logic to provide credit to unbanked small businesses and households. One participant noted that the role of the government in promoting access to microfinance was important, but it should not "mandate the business" by controlling interest rate offerings of MFIs.

Further policy suggestions - Various other policy suggestions were put forward. It was noted that governments should design a national financial sector strategy in which to place microfinance, possibly positioning it as a full-fledged economic sector. A regulatory and supervisory framework is necessary as a tool to ensure compliance with basic rules. Alliances across MFIs and policymakers and other sectors of society are needed to develop these strategies.

Other policy suggestions to expand microfinance included: building capital markets capable of arranging and issuing corporate bonds, education of capital market regulators in microfinance and its development role, local guarantee opportunities including tax incentives to institutions that guarantee MFI investments, pension funds as incentives to invest in MFI bonds, investment by wholesale funders in MFI bonds, a secondary stock market for MFI bonds and a regulatory framework that supports MFIs working together to set up special purpose vehicles to achieve economies of scale. Several participants shared information about legislation in their respective countries regarding microfinance. From India, we heard that the government has announced development of a MFI rating system by banks to improve information efficiency, the creation of a Microfinance Development and Equity Fund and the opening of an external commercial borrowing window for MFIs to assist them in tapping non-bank funds. In Kenya, the parliament is currently considering legislation that aims to establish a regulatory mechanism for MFIs and to give MFIs appropriate legal status.

Donor policies were also mentioned. Although donors can support local processes, they should not intervene as this can frustrate local efforts. Consortium-type arrangements among donors to ensure minimum standards and reporting requirements were perceived as an effective strategy to ensure good governance of MFIs, giving them an economic incentive to comply). Membership of national associations can include mandatory adoption of a code of conduct, regular reporting and an annual review of performance. If the information from these associations is well distributed, well-performing MFIs are rewarded by donors and clients.

Links:
Bluebook website: www.uncdf.org/bluebook
E-conference website: www.csrwbi.org/bluebook

APPENDIX 1: Number of participants per country

Europe	
Austria	1
Belgium	6
Bosnia-Herzegovina	1
Bulgaria	33
Croatia	3
France	9
Georgia	2
Germany	11
Ireland	1
Italy	11
Latvia	1
Luxembourg	1
Macedonia	6
Poland	1
Portugal	1
Romania	15
Serbia	18
Slovakia	1
Spain	1
Sweden	3
Switzerland	17
The Netherlands	12
Turkey	18
UK	35
Ukraine	2
Subtotal	***210***
Central Asia	
Albania	3
Azerbaijan	3
Kazakhstan	1
Russia	9
Tajikistan	2
Turkmenistan	1
Uzbekistan	4
Subtotal	***23***
Central and South America	
Argentina	2
Barbados	1
Bolivia	2
Brazil	15
Chile	1
Colombia	1
Costa Rica	1
El Salvador	1
Ecuador	3
Guatemala	1
Haiti	2
Honduras	2
Jamaica	1
Mexico	3
Panama	1
Peru	8
Venezuela	2
Subtotal	***47***
Africa	
Angola	1
Botswana	2
Burundi	1
Cameroon	4
Congo	2
Eritrea	1
Ethiopia	3
Gabon	1
Gambia	1
Ghana	7
Guinea	1
Ivory Coast	2
Kenya	24
Lesotho	2
Madagascar	1
Malawi	1
Mali	1
Mauritius	1
Mozambique	1
Namibia	1
Niger	1
Nigeria	37
Sierra Leone	1
South Africa	8
Tanzania	3
Togo	2
Uganda	18
Zambia	1
Africa (not specified)	1
Subtotal	***130***
North America	
Canada	7
USA	180
Subtotal	***187***
Middle East and North Africa	
Bahrain	1
Bhutan	1
Egypt	3
Iran	4
Iraq	1
Israel	1
Jordan	3
Lebanon	1
Palestine	1
Syria	1
Tunisia	1
United Arab Emirates	3
West Bank	2
Yemen	1
Subtotal	***24***
East Asia and Australia	
Australia	13
China	4
Hong Kong	1
Indonesia	4
Japan	4
Korea	1
Mongolia	1
New Zeeland	2
Papua New Guinea	1
Philippines	17
Vietnam	1
Subtotal	***49***
South Asia	
Bangladesh	3
India	48
Nepal	4
Pakistan	10
Sri Lanka	5
Subtotal	***70***
Not specified	***66***
Total	**806**