BUILDING INCLUSIVE FINANCIAL SYSTEMS

THE WORLD BANK GROUP

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This book is based on the seventh annual financial markets and development conference held May 30–31, 2006, in Washington, D.C. The conference was jointly sponsored by the World Bank Group and the Brookings Institution.

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BUILDING INCLUSIVE FINANCIAL SYSTEMS

A Framework for Financial Access

BROOKINGS INSTITUTION PRESS
Washington, D.C.

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1775 Massachusetts Avenue, N.W., Washington, D.C. 20036
www.brookings.edu

Library of Congress Cataloging-in-Publication data

Building inclusive financial systems : a framework for financial access / Michael S. Barr, Anjali Kumar, Robert E. Litan, editors.
p. cm. — (Emerging markets series)
"This book is based on the seventh annual financial markets and development conference held May 30–31, 2006, in Washington, D.C. The conference was cosponsored by the World Bank Group and Brookings Institution."
Includes bibliographical references and index.
ISBN-13: 978-0-8157-0839-1 (pbk. : alk. paper)
ISBN-10: 0-8157-0839-4 (pbk. : alk. paper)
1. Finance—Developing countries—Congresses. 2. Financial institutions—Developing countries—Congresses. 3. Microfinance—Developing countries—Congresses. 4. Credit—Developing countries—Congresses. 5. Financial services industry—Developing countries—Congresses. I. Barr, Michael S. II. Kumar, Anjali. III. Litan, Robert E., 1950– IV. World Bank. V. International Monetary Fund. VI. Title. VII. Series.
HG195.B84 2007
332.109172'4—dc22 2007027761

9 8 7 6 5 4 3 2 1

The paper used in this publication meets minimum requirements of the American National Standard for Information Sciences—Permanence of Paper for Printed Library Materials: ANSI Z39.48-1992.

Typeset in Adobe Garamond

Composition by Lynn Rivenbark
Macon, Georgia

Printed by R. R. Donnelley
Harrisonburg, Virginia

Contents

Acknowledgments

The editors wish to thank the World Bank Group and the Brookings Institution for making this conference possible. ABN AMRO, CGAP, Citigroup Foundation, Temenos, the United Nations Capital Development Fund, and the World Savings Banks Institute also were key sponsors of the conference. In addition, sponsorships, materials, and speakers were contributed by ACCION International, ICICI Bank, and KfW.

At the Brookings Institution Press, Eileen Hughes and Anthony Nathe ably guided the manuscript to completion, and Carlotta Ribar proofread the pages. Linda Wielfaert provided essential editorial support for Michael Barr.

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Introduction

Microfinance—the extension of loans of small sums and other financial services to the poor—is a hot topic. The founder of the field, Muhammad Yunus, won the Nobel Prize in 2006 for his pioneering work in launching Grameen Bank in Bangladesh. The United Nations designated the previous year, 2005, the International Year of Microcredit. More than $1 billion in microcredit loans, made to nearly 30 million people, are outstanding. For-profit lenders have discovered the potential profitability in microfinance, and they are now competing with the nonprofits that launched the field.

It is an opportune time, therefore, to take stock of what has been accomplished and learned so far and to identify what further challenges remain in expanding financial access, deepening markets for microfinance, and potentially linking microfinance provision more closely with conventional financial institutions. To that end, practitioners, academics, and policymakers convened in Washington May 30–31, 2006, to attend "Access to Finance: Building Inclusive Financial Systems," a conference sponsored by the World Bank and the Brookings Institution.

That conference and this volume represent the sixth in a series of collaborations on emerging markets finance between the World Bank Group and the Brookings Institution. The 2006 conference differed from the earlier conferences in some important respects. In previous conferences, authors presented completed drafts of the chapters that they had prepared for the volume based on the conference, and they received comments from designated discussants and other invited participants. At the 2006 conference, however, presentations included a range of approaches by practitioners, government officials, and academics, and the presentations for each conference session were summarized in a single chapter, which also draws on the prevailing literature, to present a thematic overview of the topic of the session. Each session had an average of three or four authored presentations. This volume presents, therefore, a series of original survey articles that include summaries of presentations by multiple experts.

In the balance of this introductory chapter, we preview the questions and issues taken up by the authors of the chapters that follow. We purposely avoid summarizing the key findings of the chapters, which are found instead in our concluding chapter.

It is natural to begin by asking how much access individuals and firms have to financial services—to payments facilities and credit and savings vehicles. That question is important because evolving research has documented the significance of financial access in economic growth; in particular, growing evidence suggests a link between financial development and the reduction of poverty and income inequality. How, then, should access to finance be measured?

That question is taken up in chapter 2 by Anjali Kumar, with colleagues from the World Bank, the U.K. Department for International Development, and FinMark Trust of South Africa. The authors wrestle with questions such as whether access should be measured by type of financial institution, of financial service, or of financial product used (they suggest using institutions and services as measures); whether distinctions should be made between voluntary and involuntary exclusion from financial markets and institutions (they suggest that measures based on actual usage are the most transparent); what unit should be employed to measure access (individuals, households, and/or firms); and what differences in access arise when the supplier of financial services is "formal" (legally recognized) rather than "informal" (operating outside the purview of financial regulation or supervision) In answering those questions the authors pay special attention to the particular circumstances of developing countries, which are the focus of the conference and of this book and are the primary object of attention of suppliers of microfinance services and those who study them. The authors also highlight the special efforts to measure access by the World Bank and other international organizations, point out some of the limitations of current efforts, and suggest future directions for measuring access.

Chapter 2 hints at why access to finance matters—its link to growth and poverty reduction. In chapter 3, Xavier Gine delves into this important subject in greater detail, providing a thorough review of what already is known about it and drawing on presentations at the conference by a number of different experts. The predicate for the discussion is that financial access indeed does facilitate growth and reduce poverty; the issue is how best to provide access. Among the topics that Gine addresses are the kinds of government intervention in this area that have proven most effective; the differences in provision of access by various types of microfinance providers; the strategies taken by different microlenders in particular; the form of lending (whether to groups, as in the original Grameen Bank model, or to individuals); and the mechanisms that microlenders have used to ensure repayment of loans.

Can financial access be expanded by microfinance institutions? How sustainable and how profitable are these institutions? How profitable can they be? It is natural to ask such questions since microfinance began with grants from nonprofit organizations and foundations that did not expect a return on their investments. Yet because the supply of donor-provided funds is limited, the viability of microfinance in the long run depends on whether it can offer a reasonable, risk-adjusted return to private investors.

In chapter 4, Stephen Peachey approaches the profitability question by addressing the "double bottom line" of microfinance providers—the social as well as the private returns to investors. Private returns are well understood: they consist of the profits of a private enterprise. The social returns of microfinance, in this context, represent the broader value to society as a whole of increasing access to finance among those who otherwise would not have it or could not afford it. Peachey addresses the issue by looking at a wide range of microfinance providers, including nongovernmental organizations, nonbank financial institutions, cooperatives, and government-run policy lending institutions as well as private banks and savings banks around the world.

Peachey summarizes the three papers presented at the conference that address profitability, reporting that except for government-operated microlenders, providers generally have been able to return a profit while also enhancing financial access.[1] Indeed, the evidence suggests that there need be no trade-off between providing access and earning a profit; the two can go hand in hand if institutions are managed properly. At the same time, however, there seem to be economies of scale in the microfinance business, since much of the access around the world is provided by a relatively small number of institutions.

1. That finding is consistent with more recent evidence of the profitability of some major microlenders. See Tom Easton, "Time to Take the Credit," *Economist*, March 17, 2007, p. 16.

As microfinance has become more successful, it has attracted more established, formal financial institutions. In chapter 5, Ajai Nair and J. D. von Pischke document efforts by commercial banks to offer financial services to low-income individuals. Those efforts are relatively recent, since historically commercial banks have viewed the low-income market as risky or costly to serve and have left it to government-sponsored financial institutions or special directed credit programs. The chapter discusses the changing paradigm, documenting the activities of specific banks in specific countries, and then discusses innovations that banks have developed to enable them to serve the low-income market. Nair concludes with lessons for other banks, donors, and governments that are interested in expanding access to credit to poor people in developing countries.

Financial institutions and services are not provided in a vacuum; they require a certain technical and legal infrastructure to survive and grow. In chapter 6, David Porteous summarizes presentations by experts on developments in retail banking in particular, paying special attention to the role that information and communications technology (ICT) has played in the delivery of banking services. ICT has had an especially significant impact on retail banking, and, as Porteous argues, on delivery of banking services to low-income residents of developing countries. The key has been the development of infrastructure for electronic point-of-sale and mobile means of payment, both of which benefit from economies of scale, which in turn make the delivery of banking services affordable for a much broader class of people than would be the case through traditional brick-and-mortar branch offices. At the same time, however, because of the high fixed cost of the new infrastructure the investment risk is high and payback to investors is possible only through widespread use of the services. Nonetheless, with mobile banking, or "m-banking," parts of the developing world have the potential to leapfrog more developed economies in which banking systems still rely heavily on branch offices.

In chapter 7, Michael Barr explores possible government policy applications of some of the lessons learned from the papers discussed in the chapters above. He draws on the analysis in chapter 4, which suggests that even if some microfinance institutions can turn a profit—that is, provide returns to private investors—the fact that they also can provide social benefits suggests, at least in theory, that their services are undersupplied in a purely market setting. That is, if the total returns—social and private—exceed the purely private returns, then a role presumably exists for nonprofit institutions and governments to further expand financial access.

Barr notes that in the past, however, governments have become involved in their economy's financial sector for other reasons, primarily to direct lending toward favored industries or sectors. Such policies generally have failed, largely because directed lending is not constrained by market forces. Barr suggests that governments should focus instead on policy measures that they can and should take to encourage conventional financial institutions to serve lower-income households and individuals. He draws on successful models and policies in developed countries to help lead the way in developing countries. Barr's framework for analyzing different modes of government policy helps clarify the theoretical and practical assumptions underlying different approaches and the trade-offs among them.

The foregoing chapters provide a broad overview of the state of knowledge about recent efforts to expand financial access. What are the key findings of this volume? Perhaps even more important, what are the key lessons from the experiences so far and what challenges lie ahead—for both microfinance institutions and individuals and firms that can benefit from enhanced access to financial services? We conclude this volume in chapter 8 by suggesting answers to those questions, drawing on the findings of the authors of the previous chapters as well as of those whose work is summarized in the chapters. We conclude that microfinance is here to stay, that it is increasingly profitable and therefore likely to grow in scale and scope, and that it should help foster economic growth while increasing the income of the very poor throughout the world. The challenge for governments and for the private sector is to facilitate this financial revolution.