

Building Inclusive Financial Sectors for Development



Executive Summary

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INTRODUCTION

Why are so many people and firms in developing countries excluded from full participation in the financial sector? That is the fundamental question that claims the attention of *Building Inclusive Financial Sectors for Development*.

The Monterrey Consensus that Heads of State and Government adopted at the International Conference on Financing for Development in 2002 explicitly recognized that “microfinance and credit for micro, small and medium enterprises...as well as national savings schemes are important for enhancing the social and economic impact of the financial sector.” The United Nations General Assembly designated 2005 as the International Year of Microcredit to “address the constraints that exclude people from full participation in the financial sector.” In this context, the UN Department of Economic and Social Affairs (DESA) and the UN Capital Development Fund (UNCDF) undertook a project to analyse the obstacles to financial inclusion and to report on efforts to overcome those obstacles in a variety of countries.

A multilateral agency group representing the World Bank, the International Monetary Fund, the International Fund for Agricultural Development and the International Labour Organization supported the DESA and UNCDF staff team. This team was further supported by the Consultative Group to Assist the Poor, the Advisors Group of the International Year of Microcredit, the Group of Friends of the Year of Microcredit, the African Microfinance Network, the African Development Bank, the Asian Development Bank, the Inter-American Development Bank, the Economic Commission for Latin America and the Caribbean, Women’s World Banking, the World Savings Banks Institute and the Microcredit Summit Campaign.

As an additional process, a series of regional “multi-stakeholder consultations” was organized in the Middle East, Africa, Asia and Latin America. The views of governments, international organizations, financial institutions, the private sector and civil society were gathered in informal roundtable discussions at these meetings. A global e-conference in the spring of 2005 mobilized over 800 participants. Material was also gathered from an on-line questionnaire, in-depth interviews with experts in the field and seminars organized by partner organizations. This consultative process culminated in a May 2005 Global Meeting on Building Inclusive Financial Sectors in Geneva.

The result of these extensive collaborations is this book. It offers a vision of what inclusive finance could be. It does not dictate policy prescriptions to realize that

vision. Even before publication, the book has gained some notoriety in the microfinance industry where it has become known as the “Blue Book” after the colour of the United Nations flag. It is indeed a blue book, but it is not a “blueprint.”

While there are areas of consensus, there are also many issues on which there are diverging views and different solutions proposed and implemented in different countries. The Blue Book is intended to be a guide and companion to national dialogues among relevant stakeholders that individual countries may wish to convoke to develop their own national strategies.

Chapter I

SETTING THE STAGE FOR BUILDING INCLUSIVE FINANCIAL SECTORS

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

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

In most developing countries, financial services are only available to a minority of the population. The majority have no savings accounts, do not receive credit from formal financial institutions and have no insurance policies. They seldom make or receive payments through financial institutions. The limited use of financial services in developing countries has become an international policy concern.

The reason for concern about widespread financial “exclusion” in developing countries is straightforward: access to a well-functioning financial system can economically and socially empower individuals, in particular poor people, allowing them to better integrate into the economy of their countries, actively contribute to their development and protect themselves against economic shocks.

The central question asked by this book is how to bring access to these fundamental services to all people in developing countries and thus accelerate their economic development and that of their countries. Inclusive finance — safe savings, appropriately designed loans for poor and low-income households and for micro, small and medium-sized enterprises, and appropriate insurance and payments services — can help people help themselves to increase incomes, acquire capital, manage risk and work their way out of poverty.

The starting point for discussion regarding building inclusive financial sectors is the recognition that mainstream for-profit financial institutions have largely ignored

the lower segment of the market. The emergence of microcredit, microsavings and microinsurance industries in various developing countries over the past quarter century indicates that poor clients can be served despite the higher cost of small-scale transactions. In addition, the cost differential of serving poor customers has fallen as advances in information and communications technology have pushed down the costs of many transactions.

A Range of Financial Service Providers

Today, most developing countries already have a range of retail financial service providers with different ownership structures and legal charters. These institutions provide financial services to a portion of the low-income population, although outreach is uneven, notably with regard to rural areas. Financial service providers include some private commercial banks that have special microfinance operations, but primarily they comprise public or non-governmental institutions that pursue a social purpose. They include state-owned commercial banks and savings banks, postal banks, private and state-owned rural banks and banks that specialize in providing services to poor and low-income people or SMEs of varying degrees of quality. There is also a wide variety of non-bank financial intermediaries, including organizations that offer some but not all the services of a bank, such as the *fondos financieros privados* in Bolivia, microfinance deposit-taking institutions in Uganda and licensed MFIs in Cambodia. Credit unions, cooperatives and member-owned mutual banks, generally established under distinct regulatory and supervisory frameworks, also provide financial services to poor and low-income households in rural and urban areas. In addition to these formal institutions, there are a number of financial service providers, including very large non-governmental organizations that are not regulated by the banking or other financial authorities.

Vision of Inclusive Finance

With a view to significantly increase outreach to unserved and underserved enterprises and households, the vision of inclusive finance begins with this general goal: supported by a sound policy, legal and regulatory framework, each developing country should have a continuum of financial institutions that, together, offer appropriate products and services to all segments of the population. This would be characterized by:

- (a) access at a reasonable cost of all households and enterprises to the range of financial services for which they are “bankable,” including savings, credit,

- leasing and factoring, mortgages, insurance, pensions, payments and local and international transfers;
- (b) sound institutions, guided by appropriate internal management systems, industry performance standards and performance monitoring by the market, as well as by sound prudential regulation where required;
 - (c) financial and institutional sustainability as a means of providing access to financial services over time; and
 - (d) multiple providers of financial services, so as to bring cost-effective and a wide variety of alternatives to customers.

A number of important considerations need to be taken into account to realize this vision of inclusive financial sector development: the right to fair treatment of the individual in his or her society; the degree of financial literacy of customers; the recognition of the need for some civic or government intervention to open access; the need for financial policy interventions to take a long-run view on access, regardless of short-run exigencies; and the recognition that the vision is dynamic and eclectic, allowing for the possibility of new forms of service provision arising through social, policy, technological and financial innovation.

There are a number of overall policies that support or impede financial inclusion. Growth with equity policies seeks to foster economic growth and strengthen opportunities for poor and low-income people to raise their incomes and build assets. A macroeconomic policy framework with excessive government deficits too often crowds out credit to the private sector just as an excessively tight macroeconomic policy too often chokes off economic growth and private demand for credit. General institutional weaknesses in a country can impede its development, including poor public sector governance, limited effectiveness of the courts and excessive or corrupt bureaucratic procedures. On some occasions, governments intervene directly in the economy to protect the public. At other times, they can be most effective in protecting the public by promoting competition and transparency among private entities. Policies to assure that the buyer has options from which to choose are necessary in market economies as a general proposition. This means promoting competition by facilitating entry of new competitors and maintaining a diversity of types of financial service providers.

To realize the vision of financial inclusion, financial services for poor and low-income people should be seen as an important and integral component of the financial

sector. This sector should include a continuum of financial institutions, each with its own comparative advantages and each presenting the market with an emerging business opportunity. Inclusive finance should be part of any financial sector development strategy.

Chapter II

WHAT LIMITS ACCESS TO FORMAL FINANCIAL SERVICES?

There is no question that poor and low-income people use basic services from financial institutions when they are available, accessible and appealing. What people “demand” is very much shaped by what the market offers to them, and the market is often not very friendly to potential poor and low-income customers. A central question about use of financial services is how much this use is limited due to customer reluctance to seek services and how much these limits result from the reluctance of financial institutions to provide services.

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

Who you are and where you live matters

Personal and cultural characteristics of potential customers have a large role in shaping — and often discouraging — the use of financial services by poor and low-income people, as do education and location. Cultural factors are routinely mentioned in surveys and interviews as constraints on usage of financial services. While some cultural barriers are reinforced by the legal system, others are based on deeply rooted social traditions that influence how people treat each other in society. Access to credit is frequently limited for women who do not have or cannot hold title to assets such as land and property or must seek male guarantees to borrow. Women often do not control cash flows from their family’s economic activities or from their own work. In addition, women’s literacy rates are generally lower, compounding the constraints on their demand for and access to financial services. Further, financial service providers

usually target the middle of the economically active population, often overlooking the design of appropriate products for older or younger potential customers.

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

Limited literacy, particularly financial literacy, is often cited as a significant constraint on demand. People with limited literacy skills are also generally unaware of their rights and can be intimidated by banking systems and procedures that include complex contracts and documentation they cannot read and do not understand.

Whether potential customers are located near a branch outlet of a formal financial institution can be an important determinant of access, although effective distance can be as much about transportation infrastructure as physical distance. Large urban neighbourhoods and densely populated areas have more access while rural populations generally have a harder time accessing financial services. Remote areas are the most poorly served. Highly mobile populations that have no fixed or formal address can find significant legal and service delivery constraints on accessing financial services. Insurgency can also constrain demand for financial services, although demand is often high in areas affected by conflict.

How you make your living matters

People who are not economically active express limited demand for formal financial services. Extremely poor people find difficulty in accessing financial services even when the services are tailored for them. But if lack of economic opportunity limits demand for formal financial services, it does not eliminate this demand. While destitute people are a less likely market for microcredit, they may wish to draw on microsavings services. Formal financial institutions and microcredit lenders frequently face difficulties in extending credit to newly established enterprises, regardless of size, which are higher risk for the creditor and the borrower. Agricultural lending remains a great challenge.

Compromised confidence in financial institutions

A customer's prior experience with financial services from institutions and informal sources can have important effects on willingness to utilize such institutions again. Previous exposure to institutional financial services generally has a positive influence on demand for additional services. Previous negative experience, however, can have a negative impact. The reasons fall roughly into two broad areas — behaviours of the providers of financial services and the economic environment in which they operate. Customers will limit their use of formal financial institutions for a variety of reasons that include knowledge of corruption, theft and mismanagement in the institution, how their staffs treat clients and the clarity of rules and procedures customers are asked to follow. They can also limit their use when they anticipate political influence in decision making by the financial institution or when they are wary of the organization's attitude toward confidentiality. Customers' central fear with saving in a financial institution is losing their funds. Customers limit their use of formal financial institutions when there are frequent or lingering crises in individual institutions, within the broader financial sector or in the economy as a whole.

Chapter III

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

A fundamental challenge in building inclusive financial sectors remains adequately expanding retail capacity to serve the unbanked and underbanked. Experience and research suggest that demand from poor and low-income customers in developing countries for financial services grows when financial service providers understand what customers use and value and then offer products and services customers want to buy. When these providers function with appropriate pricing, with efficient, streamlined institutional structures and with solid risk management systems, they can become profitable business ventures that reach the scale necessary to be significant players within a very large market.

Which institutions will best serve this market? Legal form and ownership structure are not necessarily related to scale of operations or to organizational efficiency, effectiveness or sustainability. Different types of retail providers have different strengths and weaknesses and different challenges and advantages, including with respect to the range of products and services they can offer. The commercial orientation of an organization does not prevent it from serving poor clients with quality financial services; by the same token, an organization's social mission or mandate does not assure that the organization will serve the poor well or efficiently. There is a direct relationship between profitability and scale of operations: profitable institutions have shown that they can most effectively reach out to poor clients on a sustainable basis.

Profitability, risk and incentive structures

The profitability of serving poor households and firms is a main concern for many retail financial institutions — those with a “double bottom line” as well as those that seek to maximize profits. There are two ways to assess the profitability of serving the low-income end of the retail market. The first is whether serving poor and low income customers can be a profitable business enterprise, and the second is whether it is relatively profitable when compared to other possible lines of the business that may compete for scarce resources.

While pricing strategies in microcredit have gained considerable attention, particularly with respect to interest rates, cost reduction, particularly through strong risk

management, is the main driver of sustainability. Sustainable organizations frequently pass on increasing efficiencies to their customers. Achieving economies of scale in this high-volume business of small-sized transactions is important from the business perspective, as well as from economic and social development perspectives. Scale of operations was and continues to be a concern of policymakers, in part because the number of people without access to financial services is so great that serving a small customer base appears to be an insignificant activity and an ineffective use of national and international subsidies. From the business perspective, reaching scale is also of critical importance. The basic ability to spread fixed costs over more transactions is the basis for achieving economies of scale. There are also important economies of scope so that offering more than one product or service can lower average costs, improve income streams for the institution and provide a wider variety of choices to the customer.

There are advances in information technology and new innovations that build on past experiences and alliances. Successful models of operation emphasize multiple sales points, standard yet accessible products and technological and operational innovations that increase efficiency and lower costs. Alliances with specialized providers present opportunities to overcome the limits on the products and services that one institution can offer on its own.

Private financial institutions can provide financial services to some segments of the low end of the market in a profitable manner. They may, however, choose not to provide these services if this line of business competes for managerial talent and investment from other more profitable opportunities. Factors internal to the firm can also influence decisions on market entry, staying power and ability to expand and succeed. These factors include corporate culture, core business models and growth strategies.

“Small is beautiful, but large is necessary”

The economics of retail financial services drives managers of retail financial institutions toward choosing a set of standardized products and services and seeking to expand the volume of sales and lower average costs. A large number of institutions have done exactly that. But an even greater number have not. They start small and remain small; or they start large and stagnate; or they fail and go out of business. One argument that is sometimes offered is that the less dynamic providers have an especially difficult operating environment and this environment precludes thinking

about growth strategies. In many cases, there are difficulties in the way the institution operates, including internal systems and management practices that make successful performance a challenge. Even when good management practices are present and operations run smoothly and efficiently, some managers of retail financial institutions are less open to innovation than others. There are individual and institutional factors making one management team dynamic and inspired and another static and unimaginative.

Governance of financial institutions is of special importance given the crucial financial intermediation role of financial institutions in the economy, the need to safeguard depositor funds and the high degree of sensitivity to potential difficulties arising from ineffective management. The functions of a board of directors and senior management with regard to setting policies, implementing policies and monitoring compliance are key elements in the control function of a financial institution. In addition, governing bodies play a critical role in establishing the values and “culture” of an institution, including its ability to make sound technical decisions on products and pricing, manage risk, innovate, adapt, change and grow.

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

Chapter IV

ACCESS TO FINANCIAL MARKETS: A CHALLENGE FOR MICROFINANCE INSTITUTIONS

Broad-based financial development includes the ability of financial service providers to access capital. Just as financial intermediation between individual savers and borrowers benefits accumulation of assets and investment, intermediation across the financial sector benefits retail financial institutions broadly, including those that serve poor and low-income customers. There is, however, fragmentation in financial markets serving poor households and firms

In particular, microfinance institutions frequently lack access to mainstream financial sources. The progressive inclusion of microfinance institutions into domestic and international financial markets generally occurs when these institutions begin to mobilize savings as a source of funds and when they begin to access debt and short-term funds, utilizing capital market instruments such as bond issues, securitization and equity finance. It is also a critical step for these institutions to be included in national and international transfer, clearing and settlement systems.

Inclusion of MFIs in financial market development will continue to be a function of the broadening and deepening of financial markets, the capacity of these institutions to access domestic and international financial markets, and the development of the financial infrastructure to increase the flow of information and link institutions. When a variety of financial institutions provide a variety of microfinance products and services and when these institutions fund the liability side of the balance sheet in increasingly sophisticated ways, this is a sign that inclusive finance is becoming a more important part of the financial sector as a whole.

Impact of weak financial sectors on MFIs

The intermediation of private funds on competitive terms to the institutions that serve poor people requires some degree of financial sector strength, including the capacity to assess and manage risk. When the financial sector is weak, microcredit institutions will have limited opportunities to tap into domestic or international funds and credit for households and small firms is likely to develop more slowly and on a more limited basis. The less robust the domestic financial sector and the more fragmented its sup-

portive infrastructure, the more likely it is that microfinance institutions will rely on government and international donors and the credit enhancements they offer.

Limited access of MFIs to financial markets

Institutional factors limit the ability of MFIs to access financial markets: weak management and operational capacity at the institutional level; higher cost of funds for new entrants to the private funding market, assuming they gain acceptance at all; and the lack of skills to manage their assets and liabilities for market risk — the risk of loss owing to changes in market rates and prices, including liquidity risk, interest rate risk and foreign exchange risk. Special hurdles are faced by young institutions in accessing financial markets. These include their lack of experience with financial market participants, their lack of experience with many financial instruments and their limited negotiating power.

Beyond the general concerns regarding the track record of many MFIs, banks and other financial institutions have been slow to show confidence in MFIs. This is largely because microfinance institutions operate very differently from more traditional financial institutions. First, the status of many MFIs as non-profit institutions makes it difficult for them to secure loans. NGOs that are not legally established as corporations may have no clear ownership and no capital base that is formally the property of the owners that can be leveraged to raise debt. Second, risk assessments of MFIs are often unfavourable, in part because there is inadequate knowledge in the rating agencies about microfinance operations. Third, commercial banks may believe that MFI portfolios are inadequately secured and thus that regulatory authorities will require the bank to take additional provisions. Potential lenders may also be concerned that they cannot depend on the legal system to recover defaulted loans. Finally, most commercial lending institutions are not willing to accept a lower return on lending as part of a “socially responsible investment” programme.

There are a number of instruments and relationships that have enhanced the ability of MFIs to access financial markets.

- There are continuing calls for guarantee funds and other guarantee mechanisms as a means of bolstering access of MFIs to capital markets. It is argued that guarantees are warranted to correct “market failure,” such as inaccurate market evaluation of risk. Proper structuring of guarantee schemes is required, however, to address misperceived risks in lending without undermining the risk management of the lending institutions.

- It is more unusual for an MFI to successfully sell a bond issue than to borrow from a bank. Successfully borrowing through a bond issue involves selling the bond to a large number of mostly institutional investors. For this broader investor group, more information must be made available to produce adequate confidence in the borrower. These instruments are sparking increased interest in financial markets. Local equity investment for MFIs is, however, still a major challenge in most developing countries; many constraints that apply to debt and bond transactions also apply to accessing shareholder capital.
- Agency relationships, strategic alliances and other partnerships are increasing as ways in which MFIs can engage with a wide variety of financial market participants. These include “strategic alliances,” mergers and acquisitions, joint ventures and contractual arrangements. As these arrangements capitalize on the comparative advantages of vastly different institutions, they can take many different forms.

There is increasing concern that donors are continuing to fund the most successful microfinance institutions even when these institutions are ready and able to access funding on commercial terms. This type of donor support can serve as a disincentive to the MFI to seek commercial funding.

Donor provision of loans at concessional rates can be critically important for launching microfinance operations and providing a demonstration effect. Donors can also pave the way for private sector finance. They can do this by lending, either alone or as part of private-public sector consortiums, by brokering new banking relationships, by offering incentives for the entry of commercial institutions, by taking equity positions in MFIs, by providing credit enhancement on capital market transactions and by promoting international investment funds.

International borrowing: opportunity and risk

There is an ongoing debate about the role of international financial market resources in inclusive finance. Some express concern that resources provided by international investment funds distract attention from the development of the domestic market for MFI financing. There is also concern about the foreign exchange risks to which MFIs may be exposed if these external resources are not made available in the currencies of the countries where the MFIs operate. But these international funds frequently provide resources to institutions in countries where domestic financial markets are

not yet prepared to finance microfinance institutions. By providing a “stamp of approval,” international investors can raise the profile and acceptability of lending to MFIs. This can be helpful for diversifying the MFI’s funding base and may prompt domestic market lenders to view the borrowing institutions (and microfinance generally) with less aversion.

As MFIs turn to international sources to access capital, the issue of foreign exchange risk issue has become increasingly visible. The serious concern about MFIs taking on unmanageable foreign exchange risk has led to increasing pressure to encourage the development of mechanisms to lend in local currency or for the international funds to help cover the risk and to appropriately match investor risk/return targets with the funding requirements of MFIs.

Savings as a funding source

This last issue treats financial intermediation in its basic form: offering deposit services to savers and intermediating those savings to borrowers. Savings mobilization serves dual objectives – offering a valuable service to depositors and providing a source of funds for lending for regulated MFIs that can accept deposits. Many contend that savings are lower cost funds to fuel loan portfolio growth than domestic and international borrowing. But this may not always be the case. Mobilizing savings requires considerable institutional development, and the actual cost of funds can be higher than borrowing, notably in markets where subsidized wholesale funds are available. Whether savings are lower cost funds also depends heavily on the nature of the savings instrument. It also requires staff skills and systems that are different than those required by organizations engaged only in lending. Finally, the ability to mobilize savings can depend significantly on the macroeconomic conditions in the country and on the regulatory environment.

Chapter V

THE POLICY FRAMEWORK AND PUBLIC SECTOR ROLE IN INCLUSIVE FINANCE

Government has an important role to play in building an inclusive financial sector. Experience has shown that this role can be largely supportive, but that government intervention can also impede financial sector development. The issues regarding the appropriate role for government in building inclusive financial sectors revolve around what to do and how to do it in a specific country setting, not around whether to engage at all.

Country level policy frameworks: From vision to strategy

A key constraint to the development of inclusive financial sectors is the lack of a coherent government policy stance fostering a competitive and fair financial sector. Most countries have taken a fragmented approach, one that does not aim specifically and coherently to increase the access of all people to appropriate financial services. This means that there has rarely been a clear articulation of how the social policy objective of outreach and the financial policy objective of stability should interact with and balance each other.

While good policy and a participatory political process are at the heart of pro-poor financial sector development, the improper politicization of financial sector development provoked passionate responses during the consultations associated with the preparation of the Blue Book. In short, political focus on short-term expediency can undo years of development efforts, create significant frustration among various stakeholders, and seriously impede long-term efforts toward financial inclusion.

There is still no consensus on the liberalization of interest rates

Interest rate ceilings continue to exist and have been reintroduced in several countries. It can be politically appealing and expedient to “protect the poor” by re-imposing interest rate caps. But these caps can have negative market development consequences, and they frequently offer few benefits to the many of the very people they are intended to protect. The difficulty is that interest rate ceilings, by making it impossible to cover costs, undermine the ability of many microfinance institutions to become

sustainable. This can cause many potential financial service providers to be unwilling to enter the market or to withdraw existing services from the most difficult populations to serve. This can force many poor people to rely on much more expensive and limited informal alternatives.

At the same time, legitimate concerns are expressed that high interest rates are not acceptable in the market segment that serves poor and low-income people. They may reduce profitable business opportunities for the poor, and they may reduce their ability to accumulate assets. High interest rates may also lead inexperienced or financially unsophisticated poor or low-income borrowers into debt traps. These factors together lead to concerns that very high rates are neither socially nor economically acceptable and thus to an ongoing and important policy debate.

A critical argument in the case for liberalized interest rates is the promise of competition, increasingly efficient institutions, and ultimately as much better informed group of customers. The practical dilemma is that simply calling for competition to drive down decontrolled interest rates does not create the market or spur entry of new, more efficient institutions when the conditions are not propitious. Consideration needs to be given to a range of measures, many at the institutional level, that lead to the lowering of interest rates over time.

Whether governments or donors should intervene in interest rate markets by providing subsidies to reduce costs of microcredit providers, which reduced costs can be passed on to borrowers through lower interest rates, is a widely and vigorously debated issue. In this regard, the term “smart subsidies,” as discussed below, may sometimes come into play.

The issue of government involvement in financial intermediation

Despite calls for indirect rather than direct involvement of government in financial services provision, there is a renewed interest in developing countries in direct government involvement in financial intermediation. This interest has developed from the intention to better serve underserved market segments.

Concerns about government ownership of financial institutions are based on negative experiences in a number of countries and focus in particular on faulty risk management in direct lending to retail customers. A large body of evidence suggests that direct government lending to poor people has not always been effective or achieved stated governmental objectives. Regulators are particularly outspoken about

the problems posed by government-controlled banks given their inability to apply the same supervisory standards to these institutions as to private ones.

Yet, there are also some examples of state-owned banks that are very successful in operating commercially. Some of these banks focus extensively on extending financial services, particularly savings, to the poorer segments of the population. In general, state-owned financial institutions have been more successful in offering savings to poor people than in managing the risks associated with credit services. In any case, publicly owned banks and other state-owned financial institutions are the major providers of financial services to the poor people in developing countries.

The success of state-owned banks depends on: a well-defined mandate; clear accounting of subsidies; sound governance; transparency in delivering audited financial statements; and, most importantly, government commitment to the protection of the institution's operational independence from political concerns and pressures.

Governments sometimes mandate commercial financial institutions to allocate a percentage of their lending to certain economic sectors or to the less advantaged segments of society in an effort to broaden access. Historically, directed lending programmes were applied in many countries in a way that distorted market signals and did not achieve intended purposes. Recently, some better-designed programmes have resulted in increased commercial bank involvement in finance for micro, small and medium enterprises.

The role of subsidies and taxation

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

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

social benefits and incentives for strong institutional performance while minimizing distortions and mistargeting. Costs that are “smart” to subsidize are, for example, start-up, research and development costs, those of high-risk/significant impact products, costs for capacity and customer building, and costs of developing adequate channels for accessing capital. Addressing issues of purpose, efficiency, and market distortion best focus the debate on whether a subsidy is valuable or counterproductive.

Participants in the multi-stakeholder consultations expressed concerns about unfair treatment of alternative financial institutions by tax regimes on the one hand and the lack of sufficient tax incentives on the other. Concerns were expressed about important differences in how tax regulations are applied to different financial institutions (e.g., whether loan-loss provisions are treated as an expense, or whether sales tax is collected on interest payments) and about the inconsistent application of the rules across institutions within the financial sector.

Policies to broaden and strengthen financial infrastructure

Financial infrastructure covers the range of support mechanisms provided by the public and private sectors to promote financial market development, competition and access of the poor to financial services.

- **Infrastructure that enhances risk mitigation:** This type of infrastructure includes credit bureaux and identification numbers that facilitate information sharing. It also includes an effective property registry. More attention is now being given to assuring that adequate credit history information is available across the financial sectors and to strengthening property rights and the functioning and adequacy of the legal and judicial system.
- **Infrastructure that enhances transparency:** This type of financial sector infrastructure includes financial standards, disclosure requirements and codes of practice of trade associations; accounting standards and external audit requirements; disclosure requirements; consumer protection laws, ratings performed by specialized, neutral and internationally recognized agencies. It is aimed at assuring financial sector transparency and accountability.
- **Infrastructure that increases efficiency and reduces costs:** These important elements of financial infrastructure include primarily clearing and settlements systems able to process an increasing number of transactions. The parameters

of these systems need to be such that smaller financial institutions can benefit directly or through linkages with larger financial institutions.

- **Infrastructure that enhances innovation:** This type of infrastructure consists of technology and communication infrastructure, capacity-building initiatives, and research and development activities.

Chapter VI

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

Traditional regulatory and supervisory regimes focused on the fundamentals of protecting depositors and the stability of the financial system. It is timely to consider integrating the objective of increasing access of the poor and micro and small enterprises to financial services into regulatory and supervisory schemes. Policymakers and regulators are challenged as they seek to redefine the opportunities for inclusion and to respect the fundamental principles of protecting the customer and the financial system.

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

It is not clear to many stakeholders, including regulatory authorities, to what extent government should oversee microfinance operations and how much to set forth appropriate roles and responsibilities in legislation and regulatory frameworks. This uncertainty is largely attributed to a lack of understanding of the risk profile of portfolios of microcredit loans to poor and low-income borrowers and to micro and small enterprises. As a result, policymakers and regulatory authorities frequently too easily conclude that general prudential regulations must apply. This can lead to limitations on market entry, over-regulation, or under-regulation.

Policymakers are challenged to consider the trade-offs between openness of entry to new market participants and concerns regarding the soundness of these institutions. Moreover, decision makers must carefully evaluate the adequacy of existing legal models and the design of new institutional models that support the expansion of microfinance activities. They also need to consider the advantages and disadvantages of strategic partnerships and consolidations that may occur among the increasing variety of market participants.

The decision of when to regulate is critical for the protection of customers and for the soundness of microfinance portfolios, either in specialized regulated institutions or as a specialized unit or activity in a larger financial institution. The protection of depositors is the one clear and compelling case for prudential regulation.

There is a continuing call from many quarters for “self-regulation.” This is sometimes deemed to be an appropriate substitute for direct governmental regulation and

supervision. The essential point is not to confuse the state regulation required when public savings are involved with “self-regulation” at the industry level, which cannot be a substitute for government supervisory oversight.

The challenges of applying tiered regulation and risk-based supervision to microfinance

The establishment of tiered regulatory structures can foster diversity in institutional models. This can also help calibrate and tailor regulation and supervision to the specific products and services offered and their associated risks. This can allow the authorities to take into account the different types of institutions offering microfinance services, the different products and services they offer, and the different markets and populations they serve.

Introducing risk-based regulation and supervision is a current challenge worldwide. This approach gives more weight to requiring financial institutions to strengthen internal risk analysis and management and internal control capabilities. Applied to microfinance, risk-based supervision would result in an increased emphasis on risk management in MFIs and a fundamental shift of emphasis among managers and regulators to better anticipate and manage risks, rather than just react to them.

The need to focus on the adequacy of supervision

A crucial question with regard to all financial supervision is whether the supervisory authority has the tools and capacity to supervise the regulated institutions and to monitor compliance with regulatory requirements. It is unsafe to promote market entry without the necessary supervisory tools and the capacity to apply them to monitor new (and old) market participants.

Until recently, most central banks and supervisory authorities have not seen the importance of understanding the nature and nuances of microfinance institutions. Often, legislation and regulatory measures have been drafted without due consideration of the actual burdens of supervising many small, unconventional MFIs. Supervisors, who may be absorbed by a formal banking sector in transition or one in crisis, may not be prepared to supervise a large number of small institutions, particularly in rural areas.

Given that the range of corrective action that can be imposed by supervisory authorities is far more limited for deposit-taking MFIs than what can be applied to

more conventional banking activities, it is important that supervisors see and respond to problems sooner rather than later and prepare for the consequences if deposit-taking MFIs experience financial difficulties.

Access to financial services as a policy goal

There is increasing interest in including access to finance and, more specifically, access to microfinance, in banking regulations and supervisory practices. We suggest in this book that access to finance should be a central objective of prudential regulation and supervision. This means that the two traditional goals of prudential regulation — safety of funds deposited in regulated financial institutions and the stability of the financial system as a whole — should be supplemented by a third goal: achieving universal access to financial services.

Incorporating access considerations into banking regulations and supervision would require: changing policy and regulatory views about the market segment; facilitating market entry; treating microfinance as a business line across the full range of financial institutions and supervising it as a separate asset class; allowing for greater innovation in products and delivery systems; and, overall, adjusting supervisory practices on the basis of a better understanding of risk profiles and the operating systems and methodology of financial service providers in the microfinance market segment.

Experience with the regulatory treatment of microfinance institutions suggests that access has not yet been generally made part of regulation and supervision. As more information about microfinance is accumulated, it serves to increase the ability of policymakers and regulators to assess the true risk in this line of business. A more sophisticated approach to regulation that takes into account the experience of lending to poor people and their enterprises is required. At the same time, the risk profile of the financial institutions concerned and the products and services offered require the strict application of regulatory parameters in key areas to ensure financial soundness.

New regulatory issues

As microfinance service providers grow and microfinance products and services become more sophisticated, market participants are beginning to express concern about a number of new issues.

Managers of deposit-taking institutions have expressed the need for some form of deposit insurance. There is thus far limited experience in establishing deposit insur-

ance schemes for deposit-taking MFIs. There are a number of issues that have been raised, including how the coverage can extend to many tiny accounts and whether MFIs should be insured through a separate deposit insurance mechanism.

Concerns about the ability of financial institutions to manage currency mismatches have led to some regulatory restrictions on foreign exchange exposures. Such restrictions can take the form of prohibitions on holding uncovered net liabilities in foreign currencies or changes in the provisioning regime to take into account foreign exchange risk. This issue is likely to become increasingly important for MFIs as borrowing in hard currency increases and regulators are called upon to be more vigilant about such risks. Regulators and policymakers should be encouraged to develop suitable frameworks or even prohibitions within their own country context.

International standards do not consider access to financial services at the present time. Three areas in particular have been flagged for their potential impact on access:

- The revision of the Basel Core Principles on Banking Supervision is underway. These principles have not thus far explicitly included access considerations.
- Developing countries should not rush to apply “Basel II”, and certainly not in relation to small financial institutions. Changes in the determination of regulatory capital require sophisticated systems designed for large internationally active banks that entail costly compliance. These systems may risk raising capital requirements in institutions in developing countries.
- The international framework for anti-money laundering and combating the financing of terrorism (AML/CFT) (e.g. customer due diligence, keeping records of transactions) should be carefully analyzed to guarantee that it does not unnecessarily restrict formal financial institutions from reaching poor and low-income people.

Chapter VII

POLICY ISSUES AND STRATEGIC OPTIONS

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

Manager, regional network organization

The book outlines a number of policy options which the relevant stakeholders in policy formulation at the country level may wish to consider. A consideration of these options should facilitate discussion and debate and help policymakers develop stronger policies. Seven areas are highlighted, each of which gives rise to a range of policy options. These options are based on the experience of many different countries. Policy choices in one area may have a profound influence on those in another area, strengthening or diminishing the intended effect. It is the responsibility of the policymakers in each country to determine whether one set of choices is superior to another in any given economic, social or political setting.

Option Set 1.

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

Governments have been widely concerned that access to financial services is not equitable and have sought to improve the way the market functions through a variety of policy interventions. Interventions should be adjusted according to the dynamic reality of evolving financial sectors and judged by how they facilitate or hinder innovations in the business decisions, products, services and technologies needed to increase access. This option set considers the range of policy instruments governments have used, with varying degrees of success.

Policymakers can opt to...

...remove barriers to the entry of competent firms that wish to provide financial services for the poor. Many policymakers who wish to create a competitive environ-

ment suggest lowering barriers to entry for a wide variety of financial institutions. Barriers to entry protect some types of firms and discourage others.

...treat all service providers the same way or allow preferential treatment. In order to correct some failures that may occur in financial markets, policymakers need to determine to what extent and how policy objectives call for the introduction of incentives, subsidies and directives that may affect the way financial service providers compete.

...consider which subsidies are valuable and which are counterproductive. Most financial systems have some sort of subsidies, whether they are transparent or hidden, temporary or permanent. This policy option involves an examination of who gets subsidies and whether they are efficient and sustainable.

...intervene more, or less, in financial markets through mandates. Governments often seek to encourage and shape retail financial services through additional policies, including interest rate ceilings on loans, portfolio quotas and directed lending programmes for banks. The question is whether the policies have their intended effect to serve and protect the consumer and encourage financial institutions to provide these services over the long term.

...engage directly in providing financial services, or disengage from such activities. There are many state-owned banking institutions that provide retail services. Some of these institutions are extensively engaged in serving the lower segment of the market, particularly on the savings side and in rural areas. Experience suggests that if a government chooses to provide financial services directly, policymakers need to be certain that these institutions have a well-defined mandate, work on commercial principles, have a clear accounting of subsidies, and demonstrate sound governance and professional and transparently hired management. Governments also need to commit to the protection of the institution's operational independence from political interference and to comply with the general legal and regulatory framework governing financial institutions.

Option Set 2.

How can we achieve affordable and sustainable interest rates?

No global consensus exists on what constitutes reasonable and fair interest rates or how to bring them about. There is solid evidence, however, that low interest rate ceil-

ings have led to the rationing of credit to the benefit of better-off and more powerful segments of the population and have discouraged financial service providers from mobilizing savings. The basic question is whether it is possible to support the growth of the financial sector so that financial institutions serving poor households and enterprises can charge interest rates that are simultaneously affordable and sustainable.

Policymakers can opt to...

...apply interest rate ceilings or liberalize interest rates. The basic argument opposing interest rate ceilings is that the higher cost of offering microloans warrants a higher interest rate for lending, with evidence showing that borrowers are frequently willing to pay the higher interest because it is lower than in informal markets and because they need the credit and liquidity. A common counterargument is that high rates reduce the prospects of success for microenterprises and adversely affect poor households, no matter to whom they are paid. In addition, higher interest rates could also hide a low level of efficiency. The liberalization of interest rates is designed to attract competition from new entrants in an effort to drive down costs and, consequently, interest rates.

...require full transparency of interest rates, fees and other obligations of the borrower and full reporting on the efficiency of financial institutions' operations. Truth-in-lending laws or voluntary measures with the same purpose allow customers to appreciate the full cost of borrowing, strengthening their bargaining positions. Reporting on the efficiency of operations permits comparison and benchmarking among institutions, thereby reinforcing the incentive to lower operating costs if indeed there are inefficiencies that can be corrected and passed on to customers.

...support the careful design of subsidies, in such a way as to minimize distortions and to assure transparency and the achievement of desired results. The debate around the issue of whether indefinite subsidies to lower interest rates in microcredit is a wise use of subsidy is far from settled. One use of subsidies that is considered "smart" and can help reduce the costs of microcredit is to focus them on funding the start-up of new institutions to cover capitalization, innovations and expansion to new areas, and initial operating short-falls.

...recognize that a complex set of measures is required to lower market-based interest rates. Policymakers need to recognize that interest rates are interconnected with other measures, particularly at the institutional and operational levels. These

include: issues of competition (market entry and regulations), access to and cost of funds (financial market development), the high costs of poor communications infrastructure, and increasing efficiency at the institutional level (through, for example, simplification of loan appraisals, new technology for management information systems and payments transfers, training, etc.).

Option Set 3.

How to fashion financial infrastructure for inclusive finance?

Building a strong and efficient financial infrastructure is an essential part of financial sector development in developing countries, and it applies *ipso facto* to those parts of the financial sector providing services to poor and low-income households and to micro, small and medium-sized enterprises.

Policymakers can opt to...

...give priority to those elements of the financial infrastructure that are essential in managing risk and in reducing transaction costs. Strengthening credit bureaux and information technology are key focus areas. Information and communication technology are of constantly increasing importance and their development and evolution are radically changing the financial sector landscape.

...support the establishment of guarantee funds. To the extent that they adjust for an unfair market evaluation of risk, guarantee funds can be considered as a correction for market failure. Credit guarantee schemes can be effective in promoting sustainable changes in lender behaviour. This can lead to financial sector deepening, in particular where necessary conditions for success are present such as an open, competitive banking environment, a dynamic and expanding business sector, and a high degree of transparency among market participants.

...provide avenues for MFIs to link into the infrastructure serving the major financial institutions. This opens an opportunity for joint public-private initiatives to upgrade and to adopt compatible systems of information and communications technology. It includes access to the payments and settlements system.

...focus more attention on the development of accounting principles and guidelines, public disclosure of information and transparency, and audit standards. These are an important foundation for better internal management and for external

assessment. In addition, the assessments of independent rating agencies and credit bureaux are important tools that lenders and investors rely on to provide credible assessments of risk.

...set the standards for service provision through the private sector or provide the service through the public sector. Given the range and complexity of financial industry infrastructure, some services are better provided by the public sector and others are more efficiently handled by the private sector or through private-public partnerships where private sector providers follow standards set by the government.

Option Set 4. What should regulators and supervisors do to foster financial inclusion?

Regulation and supervision affect the extent to which the financial system as a whole is more or less inclusive. Traditionally, regulations have not tracked the status of access to financial services of different population groups nor sought to increase access as one of their policy goals. This could be made part of the mandate of regulators and supervisors.

Policymakers can opt to...

...integrate access into the objectives of regulations and supervision and into supervisory practices. Governments and policymakers should ask their regulators and supervisory authorities to play a proactive role in increasing access over time through an explicit assessment of the impact of regulations on increasing or limiting access and, beyond that, through the application of pro-inclusion regulations and supervisory practices.

...instruct all supervised financial institutions to collect and report data on usage of financial services. The authorities could use this data to monitor and encourage the expansion of financial services for underserved groups. A more controversial policy would be to target a minimum percentage of bank lending towards underserved customers, a practice that some countries follow.

...treat microfinance as a business line across the full range of financial institutions and supervise microfinance as an emerging asset class. This means allowing the full range of financial institutions to offer microfinance services, thereby treating

microfinance portfolios as an asset class in terms of products allowed, risk categorization, reserves and provisioning requirements.

...reassess the risk in extending credit to the underserved and the institutions that serve them. Regulators might re-examine the risk profile of microcredit and small enterprise finance in light of experiences and in contexts comparable to those in their countries. With the expectation that regulators have often judged the risk to be greater than it actually is, a corrected assessment would allow the reduction of risk-weighting for capital adequacy requirements and the relaxation of other regulatory constraints, both with a view toward expanding the availability of microcredit.

...differentiate between where regulatory constraints can be relaxed and where they need to be tougher because of risk. Regulations and supervisory practices may sometimes unnecessarily discourage the supply of credit to poor people in the name of protecting depositors. Nevertheless, strict application of regulations in key areas is essential to ensure financial soundness.

...adjust supervisory practices and reinforce supervisory capacity. Reporting requirements can be simplified to align with the methodologies of the particular financial institution being supervised and with audit procedures that reflect the nature of the supervised institution's financial structure. Supervisory capacity, although weak overall in many countries, can be reinforced.

...exercise national prerogatives in applying international standards. Policymakers can opt to focus on what international standards can do to strengthen their financial sectors and on their pragmatic implementation.

Option Set 5.

How to promote consumer protection?

The choices about the level of consumer education and protection within the financial sector are important because they can help make markets work better or they can undermine them. Fair treatment embodies the absence of personal discrimination and also entails honest dealing between the service provider and the customer. It includes provision of appropriate information by both sides of a financial transaction with each side having the capacity to arrive at an informed financial decision.

Policymakers can opt to...

...**“let the buyer beware.”** This minimalist option is often considered anti-consumer. It provides little consumer protection unless combined with effective and widespread financial literacy initiatives.

...**increase consumer information.** This includes establishing a truth-in-lending law or transparency standards for publishing interest rates and other charges.

...**invest in financial literacy initiatives.** The ability of individuals and enterprises to use finance safely and effectively depends in part on their degree of financial literacy.

...**insist that the retail financial industry take steps to protect customers.** Financial institutions may be required to design their own pro-consumer codes of conduct and practices or develop them in an industry association and pledge to follow them.

...**encourage the establishment of an independent oversight authority.** Such oversight would involve monitoring, reviewing, publishing and making widely available annual ratings of financial institution good business practices, as well as information on consumer complaints and how they were addressed.

Option Set 6.

How many financial institutions and of what types?

The case for a high degree of diversity in types of financial institutions is based on two primary considerations: the institutions should extend access to “unbanked” populations, and they should also give customers alternatives. Diversity in financial institutions contributes to competition in terms of service and pricing and increases the variety and quality of products and services available to the poor and low-income people and to micro and small enterprises.

Policymakers can opt to...

...**ensure there are no barriers to entry of new institutions or to the expansion of sound institutions that can add financial services to a broader segment of the population.** This option requires authorities to be open to the idea of new types of providers entering their market area. It also encourages openness to innovative strategic alliances and other new relationships among existing providers.

...design new legal forms to increase outreach. The need for a diverse set of institutions, structures, and approaches requires policymakers to examine existing legal, regulatory and policy frameworks to determine whether the diversity of the organizations permitted by law adequately serves the market. One strategy for permitting retail financial institutions to change their formal structure is to introduce “tiered” licensing and regulation.

...consolidate the number or type of institutions. The advantages of consolidation are that larger institutions can take better advantage of economies of scale and scope. In addition, they may be a better match between the number of institutions to be supervised and supervisory capacity. The disadvantage is that if one legal option is closed off without another being put in place, or if one bank is closed without others entering the market, access and competition may actually decrease.

Option Set 7.

How should governments be organized to promote financial inclusion?

Not only do developing countries need to design appropriate strategies for increasing access to financial services by all segments of the population, but they must also be able to turn their strategies into effective policy and implementations. This requires that governments determine the best ways to organize themselves for actual implementation. This involves both the efficient clustering of financial access programmes and activities within the government administration and ensuring adequate political attention is focused on financial inclusion. It entails the cooperation of a full range of financial institutions and effective cooperation from development partners over the long term.

Policy-makers can opt to...

...arrange various programmes in multiple ministries. This is the most common arrangement, as different policy focuses in government can independently introduce financial initiatives as part of their sectoral mandates.

...bring together all inclusive finance initiatives under the authority of one ministry or office. Such a ministry or office can focus on economic development and poverty alleviation. This approach allows a focused political champion of inclusive finance to emerge in government while also enabling the consolidation of different programmes.

...develop a comprehensive financial sector development strategy assigning responsibility for policy implementation to the ministry or office responsible for financial sector development. This option views microfinance as “finance” and credit and savings as part of banking activities. This option argues for strengthening the coherence in financial policy development, notably creating an enabling policy environment with appropriate roles attributed to the finance ministry and regulatory and supervisory authorities. It has the disadvantage of diluting specific concerns related to microfinance and related poverty alleviation concerns.

Chapter VIII

DIALOGUE AS A PRELUDE TO ACTION

A broad range of stakeholders — with important roles for government and regulatory authorities — can contribute to building a shared vision for developing and implementing national strategies to build an inclusive financial sector. Strategies backed by research undertaken within the national context enable the design of relevant policies that fit a country's particular state of financial sector development, the promotion of its inclusiveness, and ensuring that attention is focused on financial inclusion over the long term.

Setting the stage for dialogue at the national level

The previous material is based on international experience in a broad range of countries and institutional settings. It is provided to help national stakeholders build their own understanding of what is required to build an inclusive financial sector. Yet, this material serves only as a prelude for a national multi-stakeholder consultation. In a particular national context, processes to build inclusive financial sectors could be shaped in consideration of the following elements:

Assessment

- **Taking stock of the state of financial sector development and access.** An assessment of the current state of financial sector development and the nature of financial markets is the starting point for the discussion. This includes the degree of inclusiveness and the current state of access and usage of financial services. It should also include an expert appraisal of the degree of conduciveness of the legal and regulatory framework, the strength of financial markets and the performance of the range of institutions. Understanding the nature and extent of demand for financial products within poor and low-income populations is a fundamental piece of information that enables the consideration of what products and services the market may require. This may also suggest the type of organization that can best provide these products and services.
- **Analysis of constraints.** Obtaining a thorough understanding of the constraints to and opportunities for realizing an inclusive financial sector is a fundamental step in crafting a national strategy. These constraints may be found at the levels of policy, legislation, regulations, and guidelines. There

may also be infrastructure, communications, and technology constraints. Furthermore, institutional and human capacity limitations may seriously constrain financial sector development. These areas can each be shaped by the development of the mainstream financial sector and its infrastructure, general institutional and human development in a country, and the ability of the customers to exercise demand for financial services.

- **Collaboration with external partners.** This collaboration can be an important means of reinforcing analytical capacity and testing policy options against international views and experiences and sound practice. Financial Sector Assessment Programmes of the International Monetary Fund and the World Bank are increasingly becoming vehicles to assess the “development” dimensions of the financial sector.
- **Mobilizing technical and financial support from development partners.** This mobilization allows for additional analytical work and capacity building. It can introduce innovation and help provide financing for infrastructure and institutions. It cannot, however, replace the vision and commitment of national authorities.

Building a shared vision, policy and strategy

- **Mobilizing policymakers and the broad range of stakeholders and fostering their ownership of a dialogue process.** A national dialogue should include: ministers and senior government officials; regulators and supervisors; key parliamentarians; local government associations and leaders; microfinance networks and other professional associations; the full range of public and private sector financial institutions that seek to provide inclusive financial services; academics and independent experts; institutions that provide financial infrastructure services; and representatives of institutions speaking for small enterprises and household users of financial services. Finally, international financial institutions and donor agencies should also be involved. Each of these groups has different perspectives and expertise on the subjects at hand, which should enable an informed dialogue backed by facts and knowledge of the financial sector.
- **Building a shared vision.** This should be a vision of what a competitive, diversified and inclusive domestic financial sector would be like in 10 years and beyond. Stakeholders at the national level should define what the country’s financial sector should look like compared to where it is today.

- **Analysis of policy options and policy formulation.** National strategy should be built upon a clear evaluation and analysis of policy options specifically tailored to a particular national context. These options should be based on global experience and best practices and should be based on the fundamental consideration of the appropriate role envisaged for the State. The strategy should set forth the actions needed to resolve policy issues, establish appropriate policy frameworks, and put effective policies in place.
- **Recognition of variation in policy options among countries.** Policy options shift over time within a country. This may be due to shifts in the degree of financial sector development or to changes in circumstances, governments, or policy objectives. In some settings with less developed financial sectors, the issues for debate begin with broad policy considerations. In other country settings, policy may focus more quickly on detailed measures, such as specific legislation and regulations.

Implementation

- **Implementation and on-going review.** Governments require commitment, energy, skills and political space to implement policy. Policy change takes place over years, not months, and it requires stakeholder monitoring for achievements and corrections as the process advances. Mechanisms and processes that assume regular review, monitoring, and evaluation of national implementation plans are therefore critical to their long-term success.

Important process considerations

No one party can develop an effective national strategy in isolation. Multi-stakeholder dialogues that bring together government, central bank, regulatory and supervisory authorities, the full range of financial institutions, associations, academic experts, civil society, donors, investors and the private sector can facilitate the understanding of constraints and the development of a national strategy. This multi-stakeholder dimension cannot be overemphasized: policy change is most likely to occur when there is a critical mass of institutions and interests with the same concerns that are willing to act together.

At the same time, ministries of finance and central banks have to be centre stage. National leadership and championship at the highest levels of the process are vital.

There needs to be extensive involvement and ownership at both the political and technical levels of ministries of finance, line ministries, central banks and banking supervisors. As such, the process recognizes more than a technical perspective; it accepts that the political policy agenda must often first be established and then revised and even rejected when appropriate. Many different individuals need to be involved, and a forum for open interaction and debate is always required.

In support of this process, it would be very valuable to acquire a comprehensive picture of financial inclusion and to track statistical indicators of changes in the degree of inclusion over time. Most countries have not systematically collected this type of data, which generally requires a substantial and expensive household survey for the initial stocktaking, complemented by the collection of data for compiling selected statistical indicators.

Donor support is most valuable when it works on the basis of priorities set by national stakeholders. This is indeed a good basis for effective partnership for development in general and for building inclusive financial sectors in particular.

Dialogue at all levels needs to be ongoing. A periodic review of progress and adjustments in strategy based on experiences gained will raise confidence that the strategy remains on sound footing and will help to achieve a genuinely inclusive financial sector.

Conclusion

Developing countries need to design appropriate strategies for increasing access to financial services by all segments of the population. They must also turn their strategies into effective policy measures and implementation plans. This means that multiple stakeholders must work together to design these strategies and determine the best ways to organize their implementation. Such an effort entails the cooperation of the range of governments, financial institutions, civil society organizations, development partners, and the private sector. And it requires all stakeholders to ensure that adequate attention is focused on financial inclusion over the long term.

We believe the payoff to a focus on financial inclusion in developing countries is very high. It will enrich the overall financial sector. By increasing the economic opportunities of poor and low-income people, it will help make economic development itself broader, deeper and more inclusive. Shared and sustained economic growth helps support political stability and social progress. But most of all, inclusive development of the financial sector will increase incomes, build financial assets, and empower and enrich the lives of millions of households currently excluded from economic opportunity. This is the ultimate objective of this endeavour.

