Shamshad Akhtar: Financial inclusion

Keynote address by Dr Shamshad Akhtar, Governor of the State Bank of Pakistan, at the Expanding Access to Finance USAID and SHOREBANK INTERNATIONAL WHAM Project 2005-08, Islamabad, 28 March 2008.

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1. Asia is home to nearly 650 million of poor (defined as 1 dollar a day[1]) representing 65% world poor. Population growth and economic cyclical factors however add annually to the ranks of poor. Notwithstanding there has been a reduction in poverty incidence in Asia from 27% in 1990 to 20% by 2006, though East Asia managed to achieve steeper and swifter reduction in poverty relative to South Asia.[2] East Asia lifted around 630 million people from extreme poverty in under a quarter of a century and the region's share in total poverty declined from 58% in 1981 to just 9% in 2004. In South Asia poverty fell from 52% in 1981 to 32% in 2004, but absolute number of poor has been high close to 470 million. Along with poverty reduction, there has been a gradual move to attainment of Millennium Development Goals (MDGs).

2. Several factors have contributed to improvements in these indicators ranging from higher economic growth and liberalization to concrete affirmative and targeted anti-poverty programs. Among these, Global microfinance campaign and domestic initiatives helped in changing lives of poor and extended them finance that contributed to their economic empowerment. In Asia, the number of microfinance beneficiaries has now reached 113 million: 74% of who were poor and 65% women. Including families of the beneficiary clients, microfinance services reached close to 465 million across the world – almost 85% of these are Asian clients. Dealing with "poverty" is complex given its dimensions and multiple causative factors. Global and regional challenges of reducing poverty and MDGs are daunting but attainable provided there is accelerated, aggressive, brutal and frontal attack through well coordinated and cohesive economic and social policies.

3. Recognizing this dilemma, the evolution of financial inclusion that aims to broaden and deepen access to development finance for all, of which microfinance is a subset, is timely. Ultimately it is a well functioning and efficient financial market which can deal holistically with provision of financial services to the economy and population. Building financial inclusive system is, however, an integral and core pillar of financial sector reforms. As growth and development of finance alone does not address question of "access." Direct intervention to build financially inclusive system is critical as one recognizes fully (i) financial markets failures and imperfections such as information asymmetries, lack of sensitivity to gender and redistributive dimensions of resources and wealth and high transaction costs etc.; (ii) high price and non-price barriers such as lack of credit history and collateral and connection; and (iii) other constraints such as lack of literacy and entrepreneurial skills, etc.

4. Over the years, there has been substantive development in the architecture and thinking on financial inclusion. While there is no "one-size fits all" financial inclusion strategy or approach but it is important to recognize few core or necessary and sufficient conditions that are needed to maximize the benefits derived from such strategy.

5. At the outset, it is critical to understand the size and dimension of financial exclusion. Despite complexities of estimation, a recent study[3] concluded that average level of financial

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[1] An alternative definition of poverty ($2 a day) gives an estimate of 2 billion poor in Asia. However, for monitoring progress of MDGs, World Bank uses the $1/day definition as it reflects extreme poverty.

[2] The World Bank, *Global Monitoring Report*, 2007.

[3] Beck, Thorsten, Asli Demirgç-Kunt, and Maria Soledad Martinez Peria (2007) *"Reaching Out: Access to and Use of Banking Services across Countries*." Journal of Financial Economics 85 (1).

exclusion, as measured by the percentage of the adult population with access to an account with a financial intermediary, in poor developing countries is as high as the level of financial inclusion in advanced industrialized countries where it is rare not to have at least some access to basic financial services in remote parts. In developing countries, level of financial exclusion is steepest in Sub-Saharan Africa (a reflection of extreme poverty and difficult economic condition). Situation in Asia, present a mixed picture. South Asia (average access rate being 31 percent) lags behind in expanding financial access relative to South East Asia (average access rate being 47 percent). Advanced transition economies of Central Europe have progressed well in rebuilding access. There has been relatively little progress made in Central and South America despite a relatively robust economic base, particularly among larger countries.

6. To design strategy and policies, there is further need to understand what the reasons for exclusion are? Is it voluntary or pure denial of services and what the barriers of access to finance are? General evidence does suggest that in developing countries financial penetration is quite low because of (i) geographical exclusion since physically banks coverage of population is low (18,000 persons per bank branch in South Asia and 12,000 in South East Asia), the limited reach in rural areas where larger proportion of population resides, (ii) cash based economy given issues surrounding disclosure, identification, and taxation etc., (iii) low financial literacy, and (iv) lack of collateral and credit history of micro borrowers and micro-entrepreneurs.

7. Conceptually, financial inclusion should focus on

- Provision of full range of financial services i.e. going beyond credit to deposit and payment services;
- Meet requirements of individuals ranging from consumption to basic education, health and other services,
- Cater to the requirements of small and new firms, and
- Markets excluded by gender or remoteness

8. Evidence confirms that degree of financial inclusiveness is high where there is high degree of competition in the financial system that encourages financial institutions to go beyond the saturated and right in the corner markets to the excluded and far flung markets and offers appropriate products to clients with different requirements.

9. Commercialization of microfinance business has a massive impact on enhancing scale of outreach. For instance, in Latin America, the Non-Governmental Organizations (NGOs) opted to transform themselves into licensed financial institutions, together with specially licensed financial institutions that they were able to provide almost 45% of the microfinance services.

10. Donor support can be useful provided it paves the way for commercialization and private sector involvement in microfinance, 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.

11. Financial inclusion based on private sector involvement and solutions for extending reach to poor yields better and sustainable results. In the UK, South Africa and other Commonwealth countries, private sector with supportive government environment, played an instrumental role in promoting financial inclusion. Government or donor sponsored subsidized or directed lending programs have now proven to limit growth and encourage dependency since they induce price distortions that deter effective competition.

12. Subsidies can work for microfinance borrowers and institutions in certain circumstances. For example, subsidies may be necessary during the start-up stage of an

MFI, but they are best used to cover operating costs and to build MFI systems and staff capacity. It can take some years for an MFI to reach the scale and efficiency needed to cover its costs from interest income. During this period donors can support to build the capital base of efficient MFIs, enabling them to grow more quickly, increase their leverage, and serve larger numbers of clients on a sustainable basis. Subsidies may well be used to correct market failures; such as, to increase efficiency, transparency in financial reporting, and supporting industry infrastructure.

13. Within South Asia, Pakistan is actively pursuing a broad based financial inclusion strategy in conformity with the best practices through a public-private partnership model. In order to speed-up the process of financial inclusion, the State Bank of Pakistan has developed an ambitious plan to scale up outreach of microfinance services to 3.0 million users by the end of 2010, scale number of small agriculture borrowers to 2.0 million and SME borrowers 300,000 by 2010. The DFID, and other donors, will be providing substantial financial and technical support to Pakistan's financial inclusion programs.

14. Based on experience and research, critical conditions for financial sustainability of financial inclusion programs are:

(i) *Economies of scale*: Given direct relationship between profitability and scale of operations, larger banks/MFIs are able to evolve business models and growth strategies to reach out to poor clients on a sustainable basis. Such institutions have inherent ability to spread fixed cost over more transactions, promote multiple sales points, adopt innovation and technology which together offer ease and efficiency in service delivery. These factors enhance ability of firms to expand and compete to stay in power.

(ii) *Proper Funding Mechanism*: Sustainability requires that MFIs largely rely on deposit mobilization to finance their businesses. In initial stages of development however MFIs end up developing alliances with the commercial financial institutions. These arrangements offer opportunities for foreign and/or local currency funds. Setting aside moral hazard of generating protracted dependency, foreign exchange risks in absence of the natural hedge raises the end pricing to clients that inadvertently results in dampening demand or magnifies probability of defaults. It is usually easier for MFIs to successfully borrow from a bank than to sell a bond which involves disclosure of information to produce adequate confidence in the borrower. However, profitable MFI have successfully issued bonds sparking interest in financial markets such as Compartamos bond issue in Mexico. Alternatively, a number of instruments and relationships can enhance the ability of MFIs to access financial markets. For example, use of guarantee funds and other guarantee mechanisms can correct "market failure," such as inaccurate market evaluation of risk, as a means of bolstering access of MFIs to capital markets. Proper structuring of guarantee schemes, however, require minimizing misperceived risks in lending without undermining the risk management of the lending institutions.

(iii) *Transformation of NGOs into MFIs*: NGOs need to be encouraged to restructure into themselves into legally established companies, licensed preferably by central bank, so that they can operate under effective and transparent ownership with adequate capital base. Backing such MFIs by supportive prudential regulatory framework helps in proper leveraging funding, while providing comfort to depositors and borrowers. To encourage transformation of NGOs into MFI, Pakistan in June 2007 allowed a five year income tax holiday to such institutions and now few large NGOs (such as Kashf Foundation and the National Rural Support Program) are in process of structuring their transformation.

(iv) *Strategic Alliances of MFIs with financial markets*: Developing strategic alliances and other partnerships are increasingly becoming the ways in which MFIs can engage with a wide variety of financial market participants. As these arrangements

capitalize on the comparative advantages of vastly different institutions, they can take many different forms. Where MFI cannot achieve organic growth they have two options: (i) these include "strategic alliances," mergers and acquisitions, joint ventures and contractual arrangements, or (ii) alliance with commercial banks to set up and launch MF operations.

(v) *Developing supportive infrastructure for nurturing financially healthy MFIs/MFBs*: It is critical that countries work towards developing proper rating agencies and credit information bureaus to assess risks associated with microfinance operations and their clients.

(vi) *Greater diversification and sales volume*: The economics of retail financial services drives managers to evolve a set of standardized products and services to expand the volume of sales and lower average costs.

(vii) *Governance of financial institutions*: Proper governance of banks/MFIs is essential to safeguard stakeholder interest in particular depositor funds. 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.

(viii) *Role of small, locally-oriented financial service providers*: 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. Small financial service providers can be expected to penetrate their markets, seeking alliances with others and through networks to offer a greater range of products and services.

15. Though financial sustainability is essential for massive and swift expansion of services, to maximize client-level benefits it is essential to ensure social sustainability of financial inclusion programs. While intertwined with financial sustainability, social sustainability demands that:

(i) *Effective community and social mobilization* is critical to success of financial inclusion strategy. It involves using participatory process to raise awareness, mobilize and involve local leadership, institutions and communities to organize for collective action for common goals and objectives to reach poor, women and the disadvantaged. Community Investment Fund (CIF) provides a useful tool to reach the poorest decile of population. The experience of successful CIFs demonstrate that savings-based and Self Help Groups (SHG) based CIFs are some of the most successful models for achieving better social outcomes on sustainable basis. Externally funded CIFs have lower odds of success as they have to swim against the stream of natural incentives of group members. It is prudent for external funders to provide support services to CIF instead of injecting loan capital.

(ii) *Targeted support programs.* Most pertinent in this context would be the Community and Rural Support programs which catalyze employment opportunities. Whether they are by way of subsidized lending program MFIs (or those who support them) should be able to report on how (or whether) the stated goals they have promised (i.e., improved earnings, reduced vulnerability, increased empowerment, etc.) are being realized.

(iii) *Properly structured credit enhancements:* Design credit enhancement in a way that MFIs use of the facility is subject to fulfilling social sustainability criteria to yield better social outcomes.

(iv) *Social performance* demands keeping a close watch on the financial bottom line through better retention of clients and reduction of costs, quality of services,

improvements in client lives through proper economic empowerment which could be through business opportunities, education, health, or agricultural extension, with additional appropriate funding.

16. In a nutshell, evidence suggests that poverty reduction strategies are successful if countries adopt inclusive policies. Building inclusive financial systems that are both financially and socially sustainable is a fundamental requirement of any poverty reduction strategy.