Financial Sector Development and Expanded Access to Credit

R. Michael Barth and Cesare Calari | January 2006

1. Introduction

If the private sector can be considered the engine of development, the financial sector is surely its brain. The financial sector is the nerve center that mobilizes savings and allocates them to economic uses. It is also a critical source of information and discipline for economic agents as well as a mechanism for the allocation and management of risks. When a financial sector is relatively healthy and strong, it supports and catalyzes economic activity. When not, it dampens economic and social development and entrenches poverty. Deep financial sectors that intermediate efficiently between savers and investment projects improve choices and productivity in the "real" economy. Shallow financial sectors restrict choice and retard productivity.

In richer countries, even in those where the financial sector is not as well developed as it should be, most people have access to savings accounts, mortgages, consumer credit, insurance, and money transfers, while businesses can obtain working capital and long term financing. In many developing economies, however, this kind of critical access and support is severely constrained; and, for large groups of poor people it is largely absent. As a rule, the poor cannot safely store their possessions, access payments and money transfers, leverage their assets, fund entrepreneurial activity, nor obtain elementary risk mitigation instruments, such as life insurance and catastrophic insurance. In other words, they cannot fully participate in the mainstream economy, nor readily access important markets for goods and services.

In the past, it was often assumed that the poor were badly served because they were neither of interest nor suitable as clients for sophisticated service providers. Recently, however—especially as a result of the strong emergence of microfinance—many of the myths surrounding the importance and reliability of the poor as users of financial services have been effectively challenged. The inadequate availability of financial services to large segments of the population is viewed essentially as the result of massive market failure, institutional shortcomings, and policy neglect.

There are many factors - both macro and micro—that explain the low level of financial sector development and performance in poorer countries. These include distortionary macroeconomic policies, weak institutions, and inefficient markets characterized by poor business practice. High rates of inflation, government deficits which "crowd out" private borrowers, weak governance and institutional capacity, and an inadequate contracting and information environment lead to a lack of resilience, balance and variety, and discourage serving nontraditional segments. All these contribute to "broken" financial sectors in many poorer developing countries, and they are at the very root of why informality is still dominant there.

When a financial sector is dysfunctional, the poor must go elsewhere to find means of finance. Instead of using banks, people who need money will rely on various other types of informal or "curb" finance, family or friends. Poor people who wish to transfer money may also be discouraged from using formal channels, because of a

variety of physical, legal, cultural, or other barriers, or simply because lack of competition impacts the quality and costs of services. In these cases they may resort to using informal networks. While informal finance may flourish in countries where formal finance is limited or inaccessible, it is nevertheless generally inefficient and prone to abuse. The longer people are relegated to an informal sector, the longer they remain poor.

The indirect costs of a deficient financial system—i.e. the opportunity costs of slower growth—are often hidden, but nonetheless high and increasingly unaffordable in a global environment. For example, according to World Bank estimates, a doubling of the ratio of private sector credit to GDP can add two percentage points to long term growth. The direct costs of a weak financial sector can also be high and are most evident when they manifest themselves in a financial crisis. Financial crises invariably lead to high fiscal costs and slower growth or even a decline in GDP over a protracted period of time. The World Bank estimates that the fiscal costs alone of financial crises in developing countries in the past 20 years have averaged 14% of GDP and have amounted to over $1 trillion, roughly equivalent to the total amount of external aid provided to these countries!

2. Access to finance, poverty and informality

Access

Available data, though far from perfect, shows that access of households to financial services varies widely. While socioeconomic characteristics such as income, wealth, and education play the largest roles in explaining access, there is clear evidence of two sets of barriers that have a pronounced negative impact.

First, fundamental flaws in the institutional setting can substantially curtail access to finance. The absence of transparency (certainly as manifested in the lack of credit information systems), difficulty in securing and recovering collateral, and flaws in contract design and enforcement can make lending especially difficult. Banking system regulations such as interest rate caps, directed lending, and onerous administrative regulations can also hinder access.

Other constraints impair the operational capacity and incentives of financial intermediaries. Many financial institutions—especially those in the public sector—in poorer countries lack incentives to innovate or take risks in areas that are unfamiliar to them. Often, their assets consist largely of government debt, government-directed credits and related party lending, and they are subject to high reserve requirements. All of these dampen their capacity to innovate. Favoring "low risk" assets, these banks often find servicing poor households too risky and unprofitable. Further, lack of competition from foreign institutions and from viable domestic securities markets may also discourage banks from seeking new markets and engaging SME's and other non-traditional customers, including the poor. Their high minimum deposit balances and transaction fees, and slow internal processes make the process of obtaining a loan expensive and cumbersome. This frequently increases "thresholds" for poor people—who are naturally hesitant to approach formal institutions—when in fact they should be lowered. Furthermore, industrial elites and other incumbents are often politically powerful in developing countries and may use their influence to discourage reforms that would facilitate access to finance and, hence, the emergence of new competitors.

Although the room for improving the financial sector is huge, notably in terms of broadening access to the poor, it should be acknowledged that substantial improvements have been made in the institutional framework of many countries. There are also cases where—mostly with the impetus of foreign competition—the scope and quality of financial services has improved dramatically. The development of consumer and mortgage finance and of various forms of SME and micro lending in Central and Eastern Europe, in Mexico, in

South Africa and, increasingly in various parts of Asia and the Middle East, is a recent and powerful example of this trend...

Informality

Whether it applies to households or businesses, whenever entry or access is difficult and expensive, the informal economy thrives. Reducing entry barriers—through legal or institutional reform or other measures—is crucial to improving the prospects of economic growth and development. This also applies to finance; when barriers to formal financial access are steep, the poor use informal financial systems, such as moneylenders, savings and credit clubs, and mutual insurance societies to acquire financial assistance.

In developing countries, the poor accumulate assets, such as livestock or building materials, or cash, as stores of value. For many, the objective is to build a basic asset base by saving, borrowing, or in some combination that enables them to pay school fees, meet medical expenses, host life-cycle ceremonies, improve their dwellings, and invest in their small businesses. Although there are many poor people that have access to credit cooperatives or government-owned postal or development banks, and to commercial vendors that can finance certain modest acquisitions, such as fertilizer, on the whole the costs and risks of financial services are high, their availability and flexibility limited, and collateral requirements ineffectual or unduly onerous.

The emergence of microfinance has shown that lending to the poor is feasible and can be profitable. These small loans to poor people who often lack collateral have been shown to have the potential to improve household welfare, stimulate enterprise, and make the financial sector more efficient. However, microfinance resources still remain limited; both in terms of the relative amount of funds available and also in the reach to household savings by the poor (see section 3 below).

The major part of poor people's wealth is tied up in assets—notably land and housing—that can only be unlocked through efficient collateralized lending arrangements. Growing urbanization in the developing world has created a strong demand for mortgage finance. In poorer countries, however, notably in Sub-Saharan Africa, this is still very scarce. Experience has shown that this type of finance requires a number of key building blocks. First, a certain degree of macroeconomic stability is required to create a measure of long term confidence in the value of money. Next, there must be good titling and land registration systems that establish and enforce rights. This includes encouragement for formal tenure, as well as an efficient foreclosure process and other judicial procedures, good risk assessment tools, and an adequate payment system.

3. The micro finance sector – achievements and challenges

Starting in the 70's, some well known pioneers like Accion in Latin America, and Grameen, BRAC, and ASA, in Bangladesh, demonstrated that when suitable delivery mechanisms are created, poor people can be creditworthy. Since then, microfinance providers and other institutions catering to lower-income groups have broadened the scope of their services well beyond micro credit (including savings, remittances, insurance, leasing, etc.) and enabled growing numbers of the poor to build assets, diversify and increase their incomes, and reduce their vulnerability to economic volatility. Perhaps most significantly, however, microfinance has produced a growing appreciation of the empowerment dimension of finance, providing widespread access to opportunity even in extremely difficult environments.

Increases in the size and scope of microfinance have led to an improvement in its quality and effectiveness. In the past, microfinance depended primarily on donor-driven, subsidized programs. Today, the donor com-

munity still actively supports the sector ($1-2 billion p.a. directly and through IFIs) but funds increasingly come from the mobilization of local savings. Long term sustainability has become a key objective. Industry leaders now adhere to key principles and guidelines developed by CGAP and its donors, which include sustainability, transparency, clear financial and social performance guidelines, and regular audits. Concerns about governance have hastened the emergence of microfinance institutions that are becoming integrated into the mainstream of the financial system.

Against these positive developments and contributions, microfinance still has substantive limitations. Only a limited number of microfinance institutions have reached what can be considered a "critical mass", which would allow them to be fully sustainable and subject to market discipline, provide efficient services, and mainstream their operations. Also, microfinance providers that started as not-for-profit NGOs often face major transitional challenges, such as ensuring adequate governance, the inability to offer deposit services, and the difficulty in scaling up. According to CGAP, the best microfinance intermediaries (the top 25%) are profitable, have an average expense ratio of 11%, and an average client base of some 150,000. The rest, however, barely break even with cost ratios that are 4 or 5 times as high, and an average client base of less than 5000.

Many countries, moreover, have inadequate resources to provide proper supervision of the sector, partly because it did not grow up as part of the mainstream financial system. This supervisory lag is compounded by the fact that financial regulatory practice is becoming more demanding and complex, in effect creating a moving target for best practice in countries that have to catch up. This presents significant issues of consumer protection and, in a limited number of countries, could possibly contribute to systemic risk.

More importantly for the future, while the microfinance sector can be a catalyst to stronger, more inclusive financial systems, it cannot by itself resolve the fundamental structural issues outlined above. This may also explain why microfinance has clearly demonstrated its usefulness for the poor, but has not yet been shown to have produced a large impact on poverty rates. This last point is very important in that it implies that microfinance cannot, and should not, be considered a panacea for financial sector development or poverty alleviation.

4. Building inclusive financial systems-an agenda for follow-up

The roles of the financial sector and the relationship between access to finance and poverty alleviation have come to be seen as important aspects of the development agenda. Much insight has been garnered, but much remains to be done in this complex area. In the past decade, several seminal studies—mainly sponsored by the World Bank—have clearly shown that a sound, well-developed, and inclusive financial system boosts economic growth and that improved financial depth has an additional "pro-poor" effect. Financial sector development correlates with both the reduction of poverty and the mitigation of inequality, and there is also a strong correlation between lack of access to financial access and low income. These basic findings have been supported by numerous case studies which illustrate the poverty-reducing potential of direct access to financial services.

But a number of important open questions remain: findings that show that financial depth does not necessarily correlate with financial reach or access, and household access varies widely among developing countries in ways that are not correlated with income. It is increasingly recognized that additional data should be collected and that more research is in order to determine whether and to what extent the poor actually benefit directly from financial services. The research agenda has recently gathered momentum under the aegis of the UN International Year of Microcredit; ideally it should explore impact not only through the formal financial

system but also by semi-formal and informal financial intermediaries. The World Bank has recently noted that better data is required to address such questions as:

- How well does the financial system in a given country actually serve the poor, their micro enterprises, and other enterprises that employ them?
- Who are the excluded or poorly served?
- Which types of direct access produce the greatest impact on reducing poverty and lifting growth rates?
- How does financial sector access affect the efficiency of micro- and small-scale enterprises?
- What are the chief obstacles to access?
- What policy interventions and institutional arrangements can best improve access?
- How should financial sector development be sequenced to serve the poor? For example, credit evaluation capabilities, regulatory oversight capacity, and a sound basic legal and accounting infrastructure must be in place as credit deepening occurs.

The answers to these questions are relevant for policy makers, and also for market participants, in determining which organizational and product strategies are most effective in opening up new business opportunities. They would lead to a better "policy roadmap", and would be a catalyst toward building stronger and more inclusive financial systems.

WASHINGTON D.C. JANUARY, 2006

THIS PAPER WAS AUTHORED BY:

R. MICHAEL BARTH
Interim Executive Director
HLCLEP

CESARE CALARI
Vice President, Financial Sector
The World Bank