Ann Orr and Krishnan Sharma

Promoting Inclusive Finance for Development*

Lack of access to finance

In most developing countries, financial services are only available to a minority of the population. Mainstream for-profit financial institutions have largely ignored the segment of the market that includes the low-income and poor households, as well as small and medium-sized enterprises, often called the "missing middle". This is because smaller transactions tend to be less profitable, and assuring the creditworthiness of lower-income borrowers and smaller firms, with little collateral, is believed to be more difficult.

This limited access to finance for large segments of the population is a concern since this prevents them from integrating into the economy, actively contributing to its development and protecting themselves against economic shocks. Indeed, 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 serve to increase production and employment and help people help themselves to increase incomes, acquire capital, manage risk, and work their way out of poverty.

The central question then is how to promote inclusive finance in developing countries. *Building Inclusive Financial Sectors for Development*, also known as the 'Blue Book', attempted to address this critical issue and underscored some key findings and policy considerations.

Challenges to building inclusive financial sectors

The vision of inclusive finance is to significantly increase outreach to un-served and underserved enterprises and households. Supported by a sound policy, legal and regulatory framework, each developing country should have a continuum of financial institutions that collectively offer appropriate products and services to all segments of the population. This would be characterized by access - at reasonable cost - of all households and enterprises to a range of financial services and sound financial institutions that provide access in a sustainable manner and to a wide array of providers and cost-effective services for customers. Building inclusive financial sectors includes, but is not limited to, strengthening microfinance.

The profitability of serving low-income and poor households and small firms is a main concern for many financial service providers. Achieving economies of scale is of critical importance in order to reduce cost due to the small transaction size and operating cost in remote rural areas. Moreover, while private financial institutions can provide financial services profitably to some segments of the low end of the market, this has to be compared to the profitability of alternative ventures.

Fragmentation in financial markets limits the ability of financial providers serving poor households and small firms to access capital. Guarantee mechanisms, which require proper structuring to address risks in lending, have been used to enhance access to financial markets. Savings mobilization by financial providers can provide a major source of funds but requires a certain level of institutional capacity.

Policy framework and the public sector

Experience has shown that governments have an important role to play in building an inclusive financial sector. It is important to articulate clearly how the policy objective of outreach balances and interacts with the objective of financial stability; inclusive finance should be part of any financial sector development strategy. 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. These include:

Interest rate liberalization

There is still no consensus on the desirability of interest rate liberalization for the development of inclusive finance. Interest rate caps can have negative market development consequences, by making it impossible to cover costs, undermining the ability of many microfinance institutions to become sustainable. On the other hand, high interest rates in the market segment that serves poor and low-income people are often considered not acceptable. While the argument for liberalized interest rates is the promise of more efficient financial intermediation and resource allocation driven by market forces, this may not be feasible in many cases and financial liberalization may need to be coherently implemented with a range of policy and institutional reforms.

Government involvement in financial intermediation

There is a renewed interest in developing countries in direct government involvement in financial intermediation in order to better serve underserved market segments. While concerns about government ownership of financial institutions are based on negative experiences in some countries, owing in particular to faulty risk management arising from direct lending to retail customers, many state-owned banks have been very successful in operating commercially.

Some of these banks focus extensively on extending financial services, particularly savings, to the poorer segments of the population. 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.

In addition, governments sometimes mandate commercial financial institutions to allocate a percentage of their lending to certain economic sectors, small firms or to the less advantaged segments of society in efforts to broaden access. While directed lending programs in many countries did distort market signals and have not achieved intended purposes, some better-designed program have recently resulted in increased commercial bank involvement in finance for micro, small and medium enterprises.

Subsidies and taxation

Subsidies have many drawbacks when they are misused, politicized or applied without the necessary transparency and care, but when appropriately applied, they can help to pursue social objectives and to correct for "market failures." The key issue is whether the specific subsidies are well-designed and maximize social benefits and incentives for strong performance while minimizing distortions and "leakages". For example, subsidies may go to costs relating to start-up, research and development, and the development of adequate channels for accessing capital. Addressing issues of purpose, efficiency, and negative externalities best focus the debate on whether a subsidy is valuable or counterproductive. Pertinent taxation issues centre on unfair treatment of alternative financial institutions and the lack of sufficient tax incentives for them.

Broadening and strengthening financial infrastructure

There is the need for policies to broaden and strengthen financial infrastructure provided by the public and private sectors to promote financial market development, competition and access to financial services. This includes infrastructure to mitigate risk, including setting up credit bureaus, facilitating the enforcement of contracts and strengthening the legal and judicial system; infrastructure to enhance transparency, including financial, accounting and auditing standards, disclosure requirements, consumer protection laws and independent credit ratings; infrastructure that increases efficiency and reduces costs, consisting primarily of improving clearing and settlements systems; and infrastructure that enhances innovation, comprising technology and communication, capacity-building initiatives and research and development activities.

Regulation and supervision

Policy-makers and regulators face the challenge of balancing the fundamental principle of protecting the customer and the financial system with expanding and actualizing opportunities for financial inclusion. The following considerations may guide regulatory and supervisory practices in inclusive finance:

- Including access to finance in banking regulations and supervisory practices means that the two traditional goals of prudential regulation — safety of funds deposited in regulated financial institutions and the stability of the financial system — need to be supplemented by a third goal of achieving universal access to financial services.
- The establishment of tiered regulatory structures can help calibrate and tailor regulation and supervision to the specific products and services offered and their associated risks, fostering diversity in institutional models. Introduction of risk-based regulation is currently a challenge worldwide.
- A crucial question is whether there is the supervisory capacity for adequate supervision of a large number of small institutions. 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.
- Since international standards, such as the revised Basel Core Principles on Banking Supervision principles, have not explicitly addressed access to finance considerations, developing countries need to give due thought before adopting them. Similarly, the international frameworks to curb money laundering and terrorism financing warrant careful review.

---

*This brief is based on *Building Inclusive Financial Sectors for Development*, United Nations, New York, May 2006.

Ann Orr and Krishnan Sharma are with the Financing for Development Office,United Nations Department of Economic and Social Affairs (UNDESA).