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Microfinance for Development*

Microfinance has been defined as the provision of diverse financial services (credit, savings, insurance, remittances, money transfers, leasing) to poor and low-income people. The past quarter century has seen the emergence of a range of microfinance providers but outreach has been uneven. The higher cost of small transactions and the higher risk perceived by lenders to lower income clients limits the provision of financial services.

At the same time, certain characteristics of potential clients also constrain demand for services. Limited literacy, particularly financial literacy, is a significant factor. Access to finance is frequently limited for women who do not have or cannot hold title to assets such as land and property or must seek male guarantors to borrow. Lack of legal identity most often affects women and indigenous minorities. Rural populations generally have a harder time accessing financial services, with remote areas the most poorly served. Moreover, customers tend to limit their use of formal financial institutions if they have negative information about operations of the institutions.

The profitability of serving low-income and poor households is a main concern for many retail financial institutions. Achieving economies of scale is of critical importance due to the small transactions associated with poorer households, micro-enterprises, and remote rural areas. It is also a concern of policymakers, in part because of the need to provide financial services to great numbers of people in order to make a meaningful impact in access to finance. One may expect that microfinance will increasingly be provided through larger entities, ones that will be more likely to offer a broader range of financial products and services.

Moreover, microfinance institutions (MFIs) frequently lack access to mainstream financial sources and are also excluded from national and international transfer, clearing and settlement systems. Some instruments, such as guarantee mechanisms have, to a degree, enhanced the ability of MFIs to access financial markets. MFIs have also been increasingly engaging with a wide variety of financial market participants through strategic partnerships.

Donors have, on occasion, assisted by providing loans to MFIs at concessional rates. At the same time, there is increasing concern that donors are continuing to fund the most successful microfinance institutions, creating a disincentive to the MFI to seek commercial funding. Donor provision of these loans, however, can be critically important for launching microfinance operations and providing a demonstration effect and can also pave the way for private sector finance.

Some institutions have also turned to international sources to access capital, leading to a parallel set of concerns about taking on unmanageable levels of foreign exchange risk. This in turn has led to growing pressure to encourage the development of mechanisms to lend to MFIs in local currency.

A suggested method of increasing financing for MFIs is mobilizing savings through deposit-taking. This may offer a valuable service to depositors as well. However, the mobilization of savings by MFIs would in many instances need to be preceded by considerable institutional development. The actual cost of funds can be higher than borrowing, notably in markets where subsidized wholesale funds are available. In addition, the ability to mobilize savings can depend significantly on the macroeconomic conditions in the country and on the regulatory environment.

Regulation and Supervision

On the regulatory and supervisory front, the following considerations may serve to guide policy makers in support of the development of microfinance:

- 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, thus taking into account the different types of institutions offering microfinance services, the products and services they offer, and the markets and populations they serve. 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.
- There is increasing interest in including access to finance, and in particular access to microfinance, in banking regulations and supervisory practices. 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. This would require changing policy and regulatory views about the market segment, facilitating market entry, treating microfinance as a business line across financial institutions and supervising it as a separate asset class and allowing for

greater innovation in products and delivery systems. Overall, supervisory practices would have to be adjusted on the basis of a better understanding of risk profiles and the operating systems and methodology of microfinance providers. 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.

- As the microfinance industry grows, a number of new issues have emerged. Managers of deposit-taking institutions have expressed the need for some form of deposit insurance, raising a number of issues, including how the coverage can be extended 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.

Policy issues and strategic options

The Blue Book highlights a range of policy options, based on many different country experiences. The final decisions rest with policymakers to determine which set of choices is best, considering the context.

1. Government intervention in financial services. Options available to policy makers include removing barriers to the entry of firms that wish to provide financial services for the poor; treating all service providers the same way or preferential treatment; determining which subsidies are valuable and which are counterproductive; intervening more, or less, in financial markets; or engaging directly in providing financial services, or disengaging from such activities.
2. Achieving affordable and sustainable interest rates. Options available include applying to policy makers comprise applying interest rate ceilings or liberalizing interest rates; requiring full transparency of interest rates, fees and other obligations of the borrower and full reporting on financial institutions' operations; supporting the careful design of subsidies to minimize negative externalities, assure transparency and the achievement of desired results; while recognizing that a complex set of measures may be required to lower market-based interest rates
3. Financial infrastructure for inclusive finance. Options available include giving priority to elements of the financial infrastructure for managing risk and reducing transaction costs; supporting the establishment of guarantee funds; providing avenues for MFIs to link into the infrastructure serving the major financial institutions; and focusing more attention on the development of accounting principles and guidelines, public disclosure of information and transparency, and audit standards.
4. What should regulation and supervision do to foster financial inclusion? Options available include integrating access into the objectives of regulations and supervision and into supervisory practices; instructing all supervised financial institutions to collect and report data on usage of financial services; treating microfinance as a business line across the full range of financial institutions and supervising microfinance as an emerging asset class; reassessing risk in extending credit to the underserved and the institutions that serve them; determining where regulatory constraints can be relaxed and where they need to be tougher because of risk; adjusting supervisory practices and reinforcing supervisory capacity; and exercising national prerogatives in applying international standards.
5. Promoting consumer protection. Options available include not implementing consumer protection measures; increasing consumer information; investing in financial literacy initiatives; insisting that retail finance take steps to protect customers; and encouraging the establishment of an independent oversight authority.
6. How many financial institutions and of what types? Options available include ensuring there are no barriers to entry of new institutions or to the expansion of sound institutions that can provide financial services to a broader segment of the population; designing new legal forms to increase outreach; and consolidating the number or type of institutions.
7. How should governments promote financial inclusion? Options available include arranging various programs in multiple ministries; bringing together all inclusive finance initiatives under the authority of one ministry or office; and developing a comprehensive financial sector development strategy, assigning responsibility for policy implementation to the ministry or office responsible for financial sector development.

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