International Year of **Microcredit** 2005

Statement of the Advisors Group to the United Nations International Year of Microcredit 2005

United Nations Forum to Build Inclusive Financial Sectors
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1. The United Nations International Year of Microcredit has exceeded even our expectations as the Advisors Group to the Year. The UN Year has raised the profile of microcredit and of microfinance in general. It has generated a great deal of enthusiasm, among microfinance users and providers, suppliers of capital, commercial businesses and the public of many nations, developed and developing: a record number of national committees - most of which are impressively diverse and actively engaged - have been formed to promote the goals of the UN Year. The critical role that access for poor people to financial services plays in reducing poverty is now much better understood by policymakers. Promoting greater access has become a key part of the international development agenda, including achieving the Millennium Development Goals.

2. As an Advisors Group, we are confident that, although microfinance remains very far from its potential, significant progress can be made in overcoming the remaining obstacles to the spread of financial services that can meet the needs of poor people. We have seen encouraging evidence that microfinance works. We applaud the efforts of thousands of people who have brought it this far. In this note, we make a number of key observations arising from the UN Year, and set out our recommendations for further action. This note contains the collective view of the 20 members of the Advisors Group alone, the result of our meetings and other conversations during the UN Year. It is intended to complement other important work produced as part of the UN Year, such as the "Blue Book" on "Building Inclusive Financial Sectors for Development".

3. The focus of the UN Year quickly expanded from microcredit to the whole of microfinance, including services such as savings, insurance and money transfer, as well as lending. With good reason, the main message of the UN Year became: there is a vital, pressing need to build inclusive financial sectors in which the billions of poor people around the world have access to affordable financial services.

4. At its launch last November, we said that the overarching goal of the UN Year was to "secure a global commitment to develop inclusive financial sectors in which all people have access to the financial services they need to make the best possible use of their human potential". Specifically, we agreed that the UN Year would be a success if it achieved three goals. First, if it increased awareness of microfinance and the conditions in which it can flourish. Second, if it contributed to filling the information gaps about who has access to what financial services, at what cost, what impact this access has, and why access is currently limited. Third, if it secured the commitment of governments to ensure that their fiscal, macroeconomic, regulatory and supervisory policies support rather than stunt the availability of microfinance, and of multilaterals, donors, NGOs and private-sector institutions to treat microfinance as a serious part of the financial sector and as a business concern, not an act of charity.

5. Given these demanding goals, our aim as an Advisors Group has not been to cheerlead but to focus attention on the many difficult questions that arise regarding financial access for poor people. From the start, we have been particularly concerned about the lack of reliable data (except in a few cases) about what financial services are available to poor people, and what

services are actually used by them. This lack of data has made it hard to move beyond a general observation that, in sharp contrast to rich countries, a large majority of the populations of poor countries is essentially ignored by the mainstream financial sector. In our view, the lack of good data has made it hard for governments and others to make well-designed policy, hard for potential providers of financial services to poor people to accurately judge the need/opportunity, hard for multilaterals and donors to judge if their actions are helping or hindering the financial sectors in which they intervene, hard for investors to assess the market opportunities, and hard even to reach empirically sound conclusions about the relationship between financial access, poverty and economic growth.

6. The generation of good data has therefore been one of our priorities during the UN Year. Specifically, the Advisors Group has brought together central bankers, leading economists and statisticians, including from the UN, World Bank, IMF, Britain's Department for International Development (DFID), the Central Bank of West Africa (BCEAO) and the private and non-government sectors, to develop common measures of financial sector inclusion and to answer the central question of how many poor people have access to what kinds of financial services and what is the quality and impact of those services.

7. In September, the International Monetary and Financial Committee of the Board of Governors of the IMF observed in the official communiqué at its annual meeting that "2005 is the International Year of Microcredit. The Committee notes the IMF's role in improving data availability on microcredit and in addressing microcredit issues in the Financial Sector Assessment Program". Following on this, we urge the IMF and the World Bank to include more of an analysis of the financial services targeted at poor people in the various statistics it collects. We expect that financial access will increasingly be recognised as a key indicator of the efficiency of a country's financial sector.

8. Although much work remains to be done, we are delighted that the process of gathering good data about the access of poor people to financial services has begun. Already it has yielded two notable achievements. The first is a window into the current state of microfinance. The second is that it has provided a foundation on which multi-year comparisons between nations can be built. We strongly recommend that this work continue, so that inadequate data will soon cease to be a factor slowing the spread of microfinance.

9. We are particularly hopeful that countries will soon employ common measures of financial inclusion developed during the UN Year by the World Bank and DFID as an indicator of progress in reducing poverty. We recommend that national governments (and their regulators and supervisory institutions) adopt common indicators and methodologies and work with the IMF, the World Bank and others in using these data to assess the breadth, depth and inclusiveness of their financial sectors. We also recommend that multilaterals and other donors support governments in this effort and help them to strengthen their statistical collection systems and that the UNDP Human Development Reports, amongst other publications, include this data.

10. We note recent empirical analysis by the World Bank, which for the first time shows that increased access to finance helps to reduce poverty (rather than, as is sometimes argued, that greater financial access is merely a consequence of reductions in poverty). The results support the view that building an inclusive financial sector should be considered a driving force of economic development and poverty reduction, and we hope that the increased availability of data about microfinance will encourage further research into its potential role.

11. The World Bank analysis is noteworthy in two other respects. First, it confirms that access to financial services remains extremely limited in most poor countries. Although throughout the UN Year we have been encouraged by numerous examples of how microfinance can transform the lives of poor people, it is clear that the biggest challenge for the next few years is to provide microfinance on a significantly greater scale than anything we see in poor countries today. A particular challenge is in rural areas that can be especially costly to reach.

12. Second, the World Bank analysis also finds that government ownership of the financial sector is inversely correlated with access. This underlines a crucial lesson for policymakers as they consider how to "scale up" microfinance: the private sector will play a critical role in enabling poor people to receive financial services.

13. This does not mean that governments should ignore microfinance. On the contrary, we believe that governments have a crucial enabling role to play in increasing access to financial services.

14. In general, financial services are more likely to be available to poor people in countries which are essentially well-governed: with sensible macroeconomic policies aimed at keeping inflation and interest rates low, a competitive economy with strong antitrust laws, limited red tape, clear enforceable property rights (for poor people as well as rich, for men as well as women) and effective law enforcement, including against corruption.

15. In addition, there are several crucial areas of government policy that specifically relate to microfinance. One common temptation is for governments to impose ceilings (caps) on the rate of interest that can be charged on micro-loans. Such ceilings have a simplistic political appeal, by appearing to ensure cheap credit for poor people, but in practice interest-rate ceilings tend to reduce the supply of credit, especially to the poorest would-be borrowers, who are driven instead to borrow from illegal money-lenders whose rates are not capped, and whose collection methods are notorious. Interest-rate ceilings can also reduce the transparency of the cost of credit to borrowers, as lenders seek to evade the caps by adding various service charges and application fees. We strongly recommend that governments do not impose interest-rate ceilings on micro-lenders. The evidence shows that a far more effective way for governments to ensure that interest rates are not excessive is to foster healthy competition within the financial sector.

16. Government regulations on the collection of deposits often prevent, or impose a significant cost on, micro-lenders providing other financial services, in particular savings accounts. These

regulations are often intended to protect savers from bank failure, which is clearly a desirable goal. However, they raise the cost of capital to micro-lenders, which are prevented from operating as normal banks that lend money that has been deposited with them. Moreover, these regulations can mean that poor people are denied access to savings accounts, and thus have to save by methods that involve far greater risks than that of bank failure. We recommend that financial sector authorities should devise prudent and appropriate means to make it possible for microfinance providers to qualify to accept deposits.

17. Finding the appropriate balance between consumer protection and a light regulatory burden is not easy, but getting it right should be a priority for governments everywhere, and particularly in poor countries. We believe that too often well-run microfinance institutions are being overly constrained by regulations (particularly with regard to restrictions on what services they can provide) as they look to increase the scale and scope of their operations. We recommend that governments, assisted by the relevant multilaterals, urgently review their regulations to ensure that they encourage prudent and sound provision of financial services to poor people. We also recommend that priority is given to training competent bank regulators, accountants and auditors, lawyers and credit-raters, who are often in short supply in poor countries. This may be a fruitful area for international assistance, from multilaterals and national governments, and from private donors. We commend the Bank for International Settlements, the Federal Reserve Bank of New York, the Banking Superintendent of New York, Citigroup and the Central Bank of West Africa (BCEAO), leading trainers of central bankers and other regulators and supervisors in developing countries, for including issues pertaining to microfinance in their training programmes. We recommend that others follow their example.

18. Regarding consumer protection, there are at least three areas in which government can play a helpful, enabling role. First, we recommend that lenders be required to inform borrowers clearly of the full cost of their borrowing, including interest rates and any other fees. Such a requirement ought not to impose significant costs on either lenders or regulators.

19. Secondly, we are concerned that, in some countries, laws to protect privacy are preventing the emergence of credit bureaus. Such credit bureaus can greatly reduce the cost of lending – and thus increase the overall supply of loans - by giving lenders better information about the creditworthiness of borrowers. Some rich countries have managed to combine strong, effective privacy protection with sufficient freedom to share financial information to enable viable credit bureaus, and we recommend that poor countries follow their example and take measures to facilitate and encourage the establishment of credit bureaus. Furthermore, we encourage efforts to help microfinance providers improve their information systems, not least so that these bureaus can receive relevant information.

20. Third, deposit protection is often woefully inadequate in poor countries. Although deposit protection schemes, such as insurance, can have some downsides, including a heavy regulatory burden and the creation of a moral hazard that can make savers careless of who they entrust with their money, combined with effective but light regulation such schemes can greatly

increase consumer confidence in the financial system. A lack of such confidence is often – and not unreasonably – a serious constraint on the growth of financial systems. We recommend that governments explore whether they can sensibly and cost-effectively introduce deposit insurance or other protection scheme for savings accounts provided to poor people.

21. A difficult issue for suppliers of capital for microfinance is how or if they should subsidize the provision of financial services to poor people. Here there is no simple answer. We observe that even at current levels of subsidy, many microfinance institutions find themselves constrained by a lack of funds. Increasingly, they are looking to find other sources of capital, not least by focusing more on generating profits from their activities, which in turn makes them attractive to private-sector investors. We welcome this increasingly commercial approach to serving poor people, not least because we believe that only the private sector will have the ability to provide the organization, expertise and capital that can drive a rapid increase in access to financial services.

22. Whether it would even be desirable for more subsidized capital to be made available is debatable. In practice, government or other donor subsidy of microfinance has often gone hand-in-hand with a lack of transparency, significant corruption and general inefficiency, which in turn has distorted the provision of financial services in ways that have hindered their long-run development. Whilst there may be poor people to whom it will never be commercially viable to provide financial services – in which specific circumstances, a case can arguably be made for subsidy (but perhaps a better case for social safety nets) – we believe that the best hope for a rapid increase in access to financial services lies in the provision of these services to poor people becoming more commercially-driven. We therefore recommend that governments and others are restrained in their provision of subsidized capital to microfinance, and aim to deploy it in ways that encourage, not discourage, commercially-driven capital into the sector. For instance, governments and other donors might more usefully invest in the development of the regulatory infrastructure within which microfinance can thrive, in seeding new microfinance institutions and new technologies that speed the increase in financial access, and in providing relevant education and training to users and providers of microfinance.

23. We also welcome the increasing enthusiasm of many providers of microfinance – old and new – for delivering financial services to poor people on a commercially sustainable basis. Though many established microfinance institutions are rightly proud of their charitable roots, a growing number of them are willing to talk about possible partnerships with established commercial financial institutions, about scrutinizing loan portfolios, retailing insurance policies underwritten by commercial insurers, and even of making profits and perhaps becoming listed public companies. Some of the best institutions are now reducing their dependence on donor financing, exposing their operations to critical ratings agencies, and hunting out private capital. We also welcome the growing interest of commercial financial institutions in serving poor people, who until recently they often avoided as customers. Encouraging examples of commercial institutions entering microfinance include large banks in Latin America, Asia and

Eastern Europe, and some of the major international banks based in rich areas of the world including America, Western Europe, and Australia.

24. Nevertheless, rhetoric is certainly running ahead of action. Although a growing number of institutions and governments talk about treating people who are poor as clients and not beneficiaries, they often continue to ghettoize microfinance within the philanthropic arms of their organizations, where resources and accountability are typically limited, or otherwise evaluate them in non-commercial ways. A culture change is still required in many of the established institutions that provide financial services to poor people. In particular, we recommend that providers of microfinance become more transparent, especially about their loan problems and about the degree to which they depend on subsidized capital, and we recommend that they subject their performance data and accounts to independent audit. Likewise, whilst we wholeheartedly welcome the growing interest in microfinance of established mainstream national and international financial institutions and even some industrial firms, we urge them to back up their rhetoric with more substantial action.

25. We note with some concern the fact that much of the commercial capital available to microfinance providers is foreign, and therefore carries significant exchange-rate risk. This risk has been sufficiently large to bankrupt some microfinance providers in the past. We recommend that foreign suppliers of capital to microfinance institutions develop ways of providing such funding in local currency. We further recommend that governments examine whether their own policies are constraining the supply of local capital to microfinance.

26. We are also concerned about those multilaterals and other donors who, through their actions, appear wedded to microfinance remaining an activity subsidized directly through cash contributions or indirectly through technical assistance and subsidized financing. We recommend that multilateral institutions and other donors give serious thought to how they can use their resources more effectively to develop commercially sustainable microfinance.

27. We have been greatly encouraged by the growing interest in microfinance of a new generation of philanthropists, many of whom made their fortunes as entrepreneurs during the recent wave of technological innovation. We recommend that they bring that entrepreneurial mindset to microfinance, not least so that they avoid replicating existing subsidy-based microfinance.

28. We are also greatly encouraged by various attempts now underway to use technology such as mobile telephony to dramatically lower the cost of providing financial services to poor people. This may offer large economies of scale and reduce the need to deploy traditional high-cost bank branch networks. We recommend that donors do what they can to spur this technological innovation in the early stages where it may not be able to generate an economic return. We also recommend that regulators have an open mind to such technological innovation, which may challenge traditional approaches to providing, and regulating, financial services.

29. Throughout the UN Year, we have been greatly encouraged by the active role played by clients, and aspiring clients, of microfinance institutions. It is their demand, more than anything, that is driving the growth of microfinance, and their insights have been invaluable. We recommend that providers of microfinance continue to actively consult and otherwise involve microfinance clients to ensure that the financial services they offer truly meet their needs.

30. With the International Year of Microcredit, the UN has exemplified its role as a neutral broker, bringing together disparate parties to address an issue of critical importance. We commend the UN for the seriousness with which it has undertaken this task. In the light of this, we note that much of our work as an Advisors Group has been to initiate activities that will not be completed until after the end of the UN Year. Although our role concludes with the UN Year, and we do not wish to extend our mandate, we recommend that the UN should appoint a group of experts, for a limited period not exceeding two years, to see the work we have begun through to completion.

31. All that remains is to congratulate the UN for dedicating this year to such an important subject, and to thank all the many people involved in making the UN International Year of Microcredit such a success.