

CGAP's Review of 2010

Globally, an estimated 2.7 billion working age adults do not have a formal sector savings, transaction, or credit account. Even more have no access to formal insurance. This is a problem because poorer households in the informal economies of the developing world need financial services as much as wealthier families—actually more so, for two reasons. First, their income streams and bigger outlays tend to be irregular and unpredictable, and their income and expenses do not sync up as neatly as wealthier peoples' monthly pay checks and mortgage payments. Second, poor people obviously have less of a cushion to absorb economic shocks to begin with.

As a result, poor households live astonishingly active financial lives, using a large number of mainly informal sector mechanisms. They tolerate negative returns on deposits to have their short-term cash guarded by doorstep collectors; they go to the moneylender for credit and the pawnbroker for liquidity; they send money through informal networks; they enter costly social obligations, hoping that in their time of need, some form of “mutual insurance” will pay off; they invest in livestock that can die or be stolen as a means of longer term savings.

These informal mechanisms are less reliable and often far more expensive than similar services in the formal economy. Poor households are doubly penalized. They are more vulnerable, and when they try to use financial mechanisms to improve their lives, accumulate assets, cope with shocks, and protect themselves from risk, they must do so without access to reliable instruments, and they have to pay far more than we would be willing to pay.

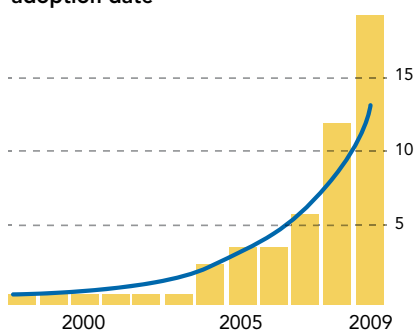
DEVELOPMENTS LAST YEAR

The shared mission of CGAP and its members is to advance access to financial services for the poor so as to eliminate this double injustice. Against that mission, last year was characterized by two major, seemingly contradictory, developments.

On the one hand, more global leaders embraced access to financial services as an important policy objective. The CGAP/World Bank Group *Financial Access* survey showed an exponential increase in the number of countries adopting explicit financial inclusion mandates or strategies. It also showed that even during the global financial crisis, access for poor households improved in terms of number of accounts, albeit not volume. The Basel Committee on Banking Supervision—the blue-chip central bankers’ club—for the first time developed guidance for the regulation and supervision of depository microfinance. And at their 2010 summits in Toronto and Seoul, the leaders of the G-20 countries elevated financial inclusion to a central priority of their economic development agenda. This global recognition boosts national-level efforts toward financial inclusion.

On the other hand, the narrower idea of microcredit came under scrutiny. The dominant impact narrative for microcredit rests on loans to capital-constrained microentrepreneurs who earn a steep return on marginal capital and thus can repay the relatively high interest rate associated with the labor-intensive microcredit model and reinvest to grow out of poverty.

Number of countries with national financial inclusion strategies (64 of 142 countries surveyed), by strategy adoption date



Source: CGAP/World Bank Group 2010 Financial Access

G-20 AND FINANCIAL INCLUSION

During the height of the global financial crisis, when the G-20 stepped in to harmonize interventions to restore stability to the world’s financial system, some observers saw a big risk for the financial inclusion agenda: Would this powerful new force take the wrong lessons from the U.S. and U.K. subprime lending crises and view increased financial inclusion simplistically as the enemy of global financial stability?

The opposite happened. The G-20 took a very positive stance on financial inclusion in 2010. Recognizing that the goal of financial inclusion when pursued responsibly complements the goal of stable financial markets, a newly convened G-20 Financial Inclusion Experts Group worked with CGAP and the Alliance for Financial Inclusion to develop Nine Principles on Innovative Financial Inclusion. These principles were adopted by the G-20 leaders at their Toronto Summit in June. At the Seoul Summit in November, the G-20 leaders took important further steps:

- Endorsing a concrete **Financial Inclusion Action Plan** to promote implementation of G-20 Principles
- Establishing a **Global Partnership for Financial Inclusion** (GPFI) to ensure buy-in from G-20 governments, non-G-20 governments, the private sector, and civil society alike

- Embedding financial inclusion as a **key pillar** in the G-20’s multi-year global development agenda

Getting the important political backing of the new global financial system architect for the notion that financial inclusion, financial stability, financial integrity, and financial consumer protection are mutually reinforcing policy objectives has already borne fruit. Joint outreach by the UN Special Advocate for Inclusive Finance in Development, Princess Maxima of the Netherlands, and the G-20 to the five global standard setting bodies most relevant to financial inclusion (the Financial Action Task Force, the Basel Committee on Banking Supervision, the Committee on Payment and Settlement Systems, the International Association of Insurance Supervisors, and the International Association of Deposit Insurers) has helped solidify their commitment to embedding access to financial services for the world’s poor in their guidance to country-level policy makers, regulators, and supervisors.

CGAP is serving as one implementing partner for GPFI to achieve the goal with which the G-20 started the year: “the safe and sound spread of new modes of financial service delivery capable of reaching the poor.”



WHAT WORKS FOR WHOM AND WHY

The dominant impact narrative for microcredit rests on loans to capital-constrained microentrepreneurs who earn a steep return on marginal capital and thus can repay a relatively high interest rate and reinvest to grow out of poverty. Access to credit for this segment remains an important development tool. But not every borrower is a microentrepreneur, and poor households clearly have other financial services needs beyond credit.

To assess the impact of access to financial services, the key questions are, therefore, what are the underlying financial services needs of clients, and, what impact is achieved when the appropriate financial instrument is used?

Several researchers are studying the various new ways access to financial services might positively impact poor households' welfare, leveraging insights from the field of behavioral economics. In parallel, a new body of empirical evidence is emerging using methodologies similar to medical trials where access to specific new services is randomly assigned, and the impact of a change in access on one customer group is compared to a second group without that same access. Such randomized controlled trials need a certain sample size and timeframe to be meaningful, and only a handful has been completed to date in access to finance.

Across various financial services, here are some of the highlights of this new thinking and the new evidence from randomized controlled trials.

Credit. Beyond providing working capital loans to microentrepreneurs, borrowing money can help households manage cash flow spikes and smooth consumption. Cutting-edge behavioral research also suggests that the mere peace of mind associated with the knowledge that credit is available can help households make better decisions that improve welfare in the long run. New

empirical impact studies have shown positive effects on the income of existing microbusinesses (in India and the Philippines), diversification of livestock (in Morocco), and reduction in the spending on temptation goods, such as tobacco (in India and Morocco). These studies, which had one- to two-year time horizons, however, did not find evidence for a direct effect of higher spending on health or education relative to the control group.

Savings. Accumulating savings also helps households manage cash flow spikes. Researchers think that saving small amounts at home is difficult for poor households given multiple, immediate demands of various household members. When mechanisms for high-frequency, low-balance deposit services are available, results could be strong. A recent randomized controlled impact study found that access to a new savings service to women in Kenya enabled them to mitigate the effect of health shocks, increase food expenditure for the family, and increase micro-business investments by 40% relative to the control group.

Insurance. Insurance helps poor households mitigate risk and manage shocks. By definition, insurance seeks to broaden and diversify risk pools and is hence inherently inclusive. Challenges so far have been to find mechanisms that are helpful to poor households, yet manageable from an actuarial and operational insurance perspective. A recent randomized controlled study of weather-based index insurance showed strong positive impact on farmers as the assurance of better returns encouraged them to substitute away from subsistence to cash crops (in India and Ghana). In Ghana, insured farmers bought more fertilizers, planted more acreage, hired more labor, and had higher yields and income, which led to fewer missed meals and fewer missed school days for the children.

This narrative remains true and access to credit critical for this segment, but not every borrower is a microentrepreneur, nor does every poor person necessarily need credit. A financial services offer that doesn't meet the real need of many clients is, at best, less likely to have the hoped for impact, and at worst, can actually harm clients. Fresh thinking and an emerging body of new impact evidence suggest different dynamics of how access to a broader range of financial services could improve household welfare and highlight the importance of better understanding what services and product designs might work for which customers' needs and why.

At the same time, rapid growth of competing microfinance institutions (MFIs), often fueled by the ready availability of debt capital, has led to periods of oversupply and over-indebtedness in some local markets. The microfinance industry must learn from this and evolve. Our analysis of these recent crises points to a particular vulnerability of credit-only MFIs and reaffirms the importance of developing local, deposit-driven institutions that are more in tune with the broader needs of their customer base and less dependent on the demands of wholesale capital.

At CGAP, we believe that the global policy momentum for financial access, the required evolution of the specialized credit industry, a sharper understanding of the underlying customer needs, and new business models will move us powerfully toward what we ultimately need: a formal financial ecosystem that gives the poor at the base of the economic pyramid the full range of services they demand, delivered responsibly and at dramatically lower costs.

LESSONS FROM LOCAL MICROCREDIT CRISES

Over the past two years, microcredit crises erupted in several markets, and the financial inclusion priority shifted from promoting access to ensuring the responsible provision of services. CGAP's analysis of the domestic market situations that led to the delinquency crises in Andhra Pradesh, Bosnia-Herzegovina, Morocco, Nicaragua, and Pakistan points to important local factors, including political ones, but also highlights a number of commonalities.

These markets were typically characterized by

- Very rapid growth, in several markets well in excess of 50% per annum
- Largely credit-led MFI models, with low deposit-to-loan ratios or no deposit-taking whatsoever because of regulatory constraints
- Ready availability of wholesale debt-funding, fueling the growth and increasing leverage ratios

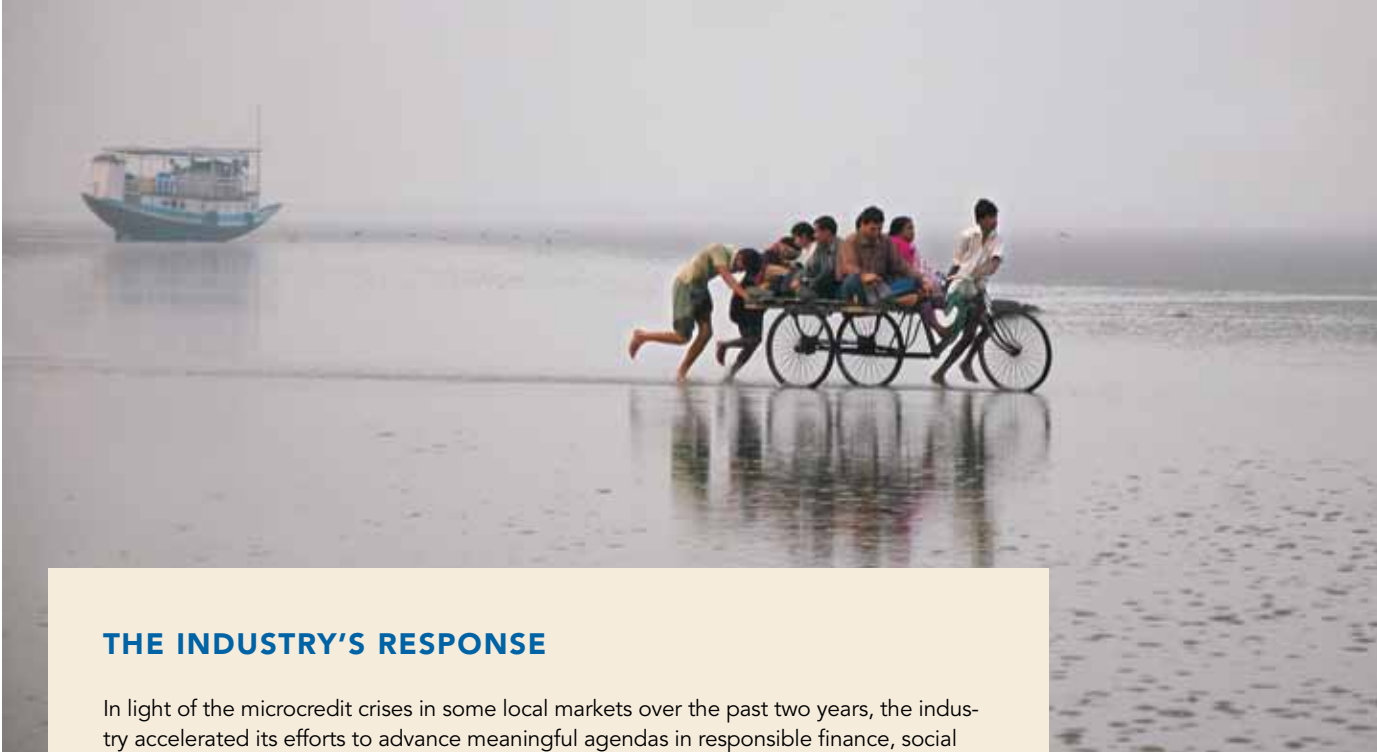
The outcomes of rapid growth were similarly common. In all markets, individual MFIs stretched their systems and controls, evidenced for example by very high staff turnover, and let their credit discipline erode. Competition often concentrated

on the same attractive localities and customer segments. Multiple borrowing on the part of clients ensued.

The microfinance field is learning from these lessons. Shareholders and their boards need to set appropriate targets, align management incentives with a lasting mission and changing market realities, and ensure appropriate controls. Socially motivated equity investors in particular have an opportunity and responsibility to exercise stronger oversight. Management needs to develop a better understanding of customer needs and tailor their offerings accordingly.

At the market level, the sector needs better credit information-sharing mechanisms and practical early warning indicators to prevent unsustainable overlending. From a regulatory perspective, consumer protection and MFI supervision become more important, but the overarching consideration might be to encourage and allow more transformations to deposit-taking institutions, which are inherently more attuned to their customers and more stable.

These lessons have set a new agenda for the field that CGAP is helping to advance.



THE INDUSTRY'S RESPONSE

In light of the microcredit crises in some local markets over the past two years, the industry accelerated its efforts to advance meaningful agendas in responsible finance, social performance, and responsible investing. These efforts complement each other, with responsible finance at the retail level as the cornerstone. They are also at different stages in their journey from initial development of guiding principles, to application of commonly accepted standards to transparent, universal reporting and ultimately improved practices.

Responsible finance practices for retail financial services providers ensure that their products, processes, and policies avoid harmful or unfair treatment of clients and appropriately balance customers' interests with their own. The Smart Campaign, as the broadest industry effort, continued to gain momentum last year with the endorsement of over 460 microfinance service providers, 200 networks and support organizations, and 100 funders. The six Client Protection Principles that form the basis of the Smart Campaign are increasingly considered to be the universal minimum standards for any financial services provider serving poor clients. The Campaign is now focused on identifying acceptable standards for each of its core principles—including transparency, avoidance of over-indebtedness, responsible pricing, and effective complaints resolution—and on developing implementation tools for retail providers and supporting microfinance networks.

Social performance efforts go beyond these minimum “doing no harm” standards and translate institutions' social mission into practice in line with their stated goals, such as serving larger numbers of poor and excluded people; improving the quality and appropriateness of financial services; or creating specific benefits for clients. The Social Performance Task Force supported by 650 global leaders across the broad spectrum of microfinance stakeholders, continued last year to drive its work on indicators that assess the entire business process of an institution against the objective of having positive changes in the lives of clients. Through increased transparency and management of social performance, financial institutions with a double or triple bottom line, and their donors and investors, are striving to improve practices and achieve better results at the client level.

Responsible investment translates responsible finance and social performance concerns into action at the investor level. Initiatives focus on investor performance related to environment, social, and governance (ESG) issues and encompass a commitment of investors to be more responsible toward their investees and the community at large. In the course of last year, a consultative process across the microfinance investment sector produced a consensus around a new set of seven Principles for Investors in Inclusive Finance. At the recent launch, the 40+ signatories committed to supporting and investing in those financial service institutions that offer responsible microfinance in a transparent and sustainable manner. They also committed to address ESG concerns in their investment decisions, to fairly treat investees, and to strive for balanced returns. These Principles have become a work stream of the broader UN-backed Principles for Responsible Investment.

OUR WORK OVER THE YEAR

CGAP focused its efforts across our various teams on helping a broader set of providers reach more people with a fuller range of services at lower costs, and helping the industry develop a real responsible finance agenda.

In terms of broadening the range of providers and services, CGAP continued to help test new business models, often enabled by technology, that may produce the low transaction costs required for payments and higher frequency, low-balance savings. This work has deepened industry knowledge and informed enabling regulation. In parallel, the CGAP–Ford graduation program continued its work on better understanding how safety nets, livelihoods, and access to finance programs can be best sequenced to create pathways for the poorest to graduate out of extreme poverty.

CGAP's work on transparency, social performance reporting, and consumer protection helped advance the broader responsible finance agenda the industry had started developing. CGAP also helped drive significant developments at a national level in making financial inclusion a policy imperative, including progress on regulation and supervision in many countries and improving the industry infrastructure.

In all these areas, we engaged with a broad range of donors and investors in efforts to ensure that their interventions are as effective as possible and complementary to each others' actions and priorities on the ground.

OUR THANKS

As the landscape has grown more complex, opportunities and partnerships continue to proliferate. As an organization, and as a broader network of partners working to improve access to financial services for poor people in developing countries, we are guided by the wisdom, experience, and shared mission of our members, and we are grateful for their support.

Working toward full financial access for poor households remains an important goal in and of itself, because we know that access to formal services helps them better manage their financial lives. It also remains a good development strategy, because we know from research that economies with deeper financial sectors and less informality tend to perform better.

It is humbling to be part of this critical endeavor, and CGAP remains dedicated to helping achieve full financial inclusion.

Tilman Ehrbeck
CGAP CEO