

Q: We talk variously about microfinance, financial access, and more recently financial inclusion. What's the issue we're trying to solve here?

We know that poor people, poor families in the informal economy need financial services as much as everybody else. Actually they need them more, for two reasons. Their income streams and expense outlays are very erratic and not as neatly aligned as ours—I get a monthly pay check and then I pay my rent or my mortgage a few days later, so very nice synchronization, if you will, of my income stream and my expense stream. Poor people don't have that in the informal economy. And on top they have less of an economic cushion to begin with. So we know conceptually they need financial intermediation arguably more so than their richer counterparts in the developed world. And we know empirically that they use a lot of financial services. They live astonishingly rich financial lives—that's what the entire financial diary literature tells us—and what they have to do because they don't have access to formal services they use informal financial services. And those tend to be unreliable and more expensive. So there's a double injustice, if you will. If you are poor you are more vulnerable to begin with, and if you want to use financial services to protect yourself a little bit against those vulnerabilities, to improve your income-generating potential by building assets, or to mitigate risks, or to smooth consumption, if you want to try to do that in the informal economy, you pay far more than most people in the rich world would be willing to for financial services.

Q: What products will be needed to reach those needs?

The starting point is to understand a household and its aspirations, and therefore the financial services needs to meet those aspirations, also understanding their current obligations, etc. And if you look at—again from the financial diaries literature, or from our own experience in our graduation programs where we ask households to first start with what do you want to achieve?, then you will notice they need the broad range of financial products. They need some credit to build assets, buy the cows or the guinea pigs and then build the stable for the livestock, so they need credit for that. They should protect that investment, so they need insurance, cattle insurance, or some such thing. They often care a lot—not often, *all* parents care a lot about the education of their children, so they often have to pay for school fees—school fees are a cash flow spike but not an unanticipated one, so how come people borrow and pay interest to pay school fees, rather than saving and earn interest while they are saving? Maybe it has to do with the fact we didn't provide the right product, which is a commitment savings product, or we didn't provide the business model that can deliver those savings at low enough cost. So, poor households they do need credit; they do need savings; they need to make payments—often they have a family member in the city who would love to remit money home—so they need remittances; they definitely need insurance for the productive assets for the home. So they do need, not surprisingly if you think about it, the full range of financial services.

Q: There's 2.7 billion without access to formal financial services—what's going to meet that need?

The starting point is that 2.7 billion working age adults don't have access to formal financial services—that's more than half of the world's working-age adults—and this is financial access defined as either having a loan or a savings account. If you throw in insurance actually the number of excluded working age adults is even higher than that 2.7 billion. So that's the starting point. We know from the financial diaries literature that poor families need all services. If you now switch over to the provider side, the supply side, if you will, the provider economics per product is very different, and the economic challenge is very different. As a result you cannot expect one set of institutions to provide all these services. What you need is an ecosystem of a variety of financial services providers that all work together.

Let me juxtapose the examples of credit and insurance. So in credit the real challenge is how do I stand credit and manage the credit risk and ensure repayment when I lend—from the provider perspective—to poor families in the informal economy, who by definition don't have collateral, etc. And that challenge is in the community at the point of origination, so to speak. And the genius of the microcredit revolution was the idea of social collateral, that allowed to overcome what otherwise would have otherwise been an information asymmetry, if you will, that traditional banks just had not been able to overcome. So microcredit figured out the economic crux of credit, and then you have to refinance your balance sheet—either collect savings, which would be preferable, or refinance yourself in the wholesale markets, etc. But the economic crux was managing credit risk at the front end.

Insurance by contrast is the inherently inclusive product. If you are a provider you want everybody to sign up. You want big risk pools. Sometimes we mandate risk pools because we want the young and healthy to buy health insurance because if only the elderly and sick come, then insurance is not viable. Insurance is the inherently inclusive product. It has to be provided by big institutions that are deeply capitalized who can take on risk, aggregate risk, manage risk, and lay it off, reinsure, even in the international markets —there's no such thing as small is beautiful in insurance. If you just insure a group of farmers in one region that all grow the same crops and they are subject to the same weather conditions, and you do this locally, you are bound to go bust. You have to have at least a national if not a global insurance pool. So the economic challenge, and therefore who can provide insurance, is very, very different from credit. Microfinance institutions could be very important in all this because they could be the agent, if you will, of the insurance company, but they should not underwrite the risk at the local level.

Q: We've heard a lot of hype recently around mobile banking—what actually is the opportunity here?

The starting point is to understand that the provider economics by product are very very different. When it comes to high frequency, low balance, low denomination savings, the big challenge are transaction costs. If you want people to save 20 cents at a time, the transaction costs can't be 25 cents. The transaction costs have to be 0.2 or ideally even 0.02 cents—very, very low. The promise of technology, and in particular cellphone-enabled new business models is to bring down transaction costs to this incredibly low level so that payment services, and short term high frequency saving services

become economically viable from a provider perspective. But it's very important to distinguish what we exactly are talking about. So we are talking about payments here, mobile money, but not necessarily banking. Banking includes obviously importantly the extension of credit—and that you would never do over the mobile phone, you need to assess the credit risk and make sure you know the borrower very well—again I am speaking from a provider perspective—and you do that either through social collateral or through individual underwriting, but you don't do that over the cellphone.

Q: What's the appropriate role of donors in this space given that we are looking at private actors coming in, private investment?

The field of access to finance, it is a market development exercise which is different from some other development interventions, and that means ultimately we need the private sector to take this on—whether they are purely commercially-oriented or non for profit, that is a secondary consideration. We need a large number of private sector players. And the role of public money against that is really only twofold: first there is the notion of demonstration projects. We probably need subsidies or grant money to establish the viability, prove the concept of new ideas, new products, in new areas, new circumstances. So the notion of demonstration projects is important—that's a dynamic notion that changes over time and the frontier is shifting and donor money needs to follow that changing frontier. And then the other role of public money in market development is really providing the public goods that the private sector simply cannot co-ordinate around—some infrastructure, some knowledge as well, some regulation. So it's the broader notion of infrastructure, and public goods, and the enabling environment for the private sector development to happen.

Q: We've seen in India, Bosnia, Morocco concerns around too much credit and a potential for overindebtedness. How do you interpret the issues and what needs to be done?

Too much of a good thing can be bad. I think there are two or three underlying issues. The first one was that we did not as an industry and MFIs individually fully understand the real underlying demand and market potential, which is probably smaller globally than we might have thought in the past. I'll give the example of borrowing for school fees again. So maybe people borrow for school fees and take out a loan, but that does not really meet the need because it's a cashflow spike, but not an unanticipated one: a commitment savings product would have been a better product. So one underlying foundational issue is that we don't fully understand demand, and we need to all do more to understand it better. That's the first.

The second is we had very rapid growth in a number of markets that led to saturation. And what happened in that context is that we did not realize as an industry and the individual MFIs did not realize that the underlying challenge shifted on them from providing access to responsible delivery. And it happened faster because we probably overestimated demand. Some of the characteristics of the fast growth was losing of credit discipline, maybe not perfect functioning of the risk controls, if you will,

competition for the same segments, often the same geographies, which leads me to the third underlying reason which is that we didn't have the industry infrastructure in place to prevent some of this from happening, most importantly credit information sharing so that we, or individual MFIs, get the sense that they are not the only provider, but that there are a number of competing providers. [16'35]

So between not understanding fully the demand, fast growth that sort of eroded institutional discipline and a lack of market infrastructure, that combined to these local market episodes of overlending and multiple borrowing and overindebtedness. But it's very important to stress that these are early cases, and we will see probably more of those. But I just was in the Middle East where a regulator, a central bank governor told me, he said "listen, microfinance as an asset is 0.03% of total assets in the economy, and penetration might be 3%." So this is a situation where we still have a white space and need access, so let's not kill that budding little thing called microfinance by overlaying too much of a regulatory infrastructure, if you will, that prevents it from going in the first place. What would be good is to immediately start at the same time building the market infrastructure so that it is in place when the underlying challenge changes from providing access into white space to responsible delivery.

Q: What's the role of regulation?

Regulation absolutely plays a role, but probably more importantly supervisory capacity, if you will. Take India as an example, Andhra Pradesh which is obviously on people's minds. The MFIs were all Reserve Bank of India regulated NBFCs, non bank finance companies. They all were also subject to the Indian Fairness Act, etc. So it's not that the regulatory environment was not in place. It was just because of the fast growth, and the lack information, and conceivably the lack of supervisory capacity that we collectively as a system did not realize fast enough what was happening, i.e. this notion of the challenge has shifted from providing access to responsible delivery, and everybody needs to contribute to that. At the institution level—because we control growth and how we set incentives, and how we monitor discipline. At the institutional level, at an industry level, because we can share credit information and we can agree codes of conduct, and at the regulatory, supervisory level, because obviously there's an obligation to provide the nudge, and to watch the developments on the ground.

Q: You've referred to responsible lending. CGAP is playing a leading role among others in the movement around responsible finance—how do you see that movement?

The starting point is that we want to provide formal financial services to poor families in the informal economy. And what we provide to them better be better than the informal sector alternatives that are unreliable and more expensive. If what we do is not better then we miss the bigger picture and the bigger point.

So to deliver services across the board in a responsible fashion is a minimum starting point, and that holds true for the broader financial services industry, not just for microfinance. It has several

components. There is a regulatory supervisory component, which is consumer protection, which means transparency in pricing, these types of things. Then there is importantly an industry self regulation code of conduct because at the end of the day the supervisory capacity will always be too limited to follow all the MFIs in all parts of the country. At the end of the day a regulator, particularly if it's the central bank, has to worry about the stability of the broader system and the systemic risk that big commercial banks inherently have, not microfinance institutions. So there is a big onus on self regulation in all of this. And in a number of countries that is happening that the industry agrees on a code of conduct and agrees on a code of conduct, and agrees on industry level measures, such as credit information sharing. And then there's a consumer component around financial capabilities, capacity, financial literacy that sort of complements these other two dimensions.

Q: There has been lots of discussion about profit-maximizing institutions—are they a good thing or a bad thing?

Access to finance is a market development exercise. We need the private sector to provide these services. The notion of commercial versus non-commercial is a bit of a red herring in all of this. In order for this to be scalable and sustainable all institutions have to make some type of profit, whether they maximize and dividend out to shareholders, or whether they make profit and reinvest is a secondary issue. Even for non for profits no margin no mission, as they say. So the clear notion is that it has to be sustainable and profitable within the realms of consumer protection, do no harm, and if you attract subsidized money maybe also with the promise to do specific good, with respect to some social performance indicators. But the starting point is sustainability, which means profitability, and then what you do with the profits that is a decision that any institution can take and it depends on who the owners and shareholders are, and what they are willing to do in terms of either profit distribution or non-distribution.

Q: Are you concerned if we proceed down this path that the very poor will be left out? [24'16]

When it comes to income segments and the poorest of the poor I think we have to pursue two paths. One is more accepted and established, and the other we are discovering. The more accepted and established path is to say that also the very poorest ultimately have aspirations, dreams, and a variety of activities and therefore need access to financial services. But they might need to start with what we call a graduation program that's been pioneered by BRAC and others around the world where we start with an intervention that starts with livelihoods that establishes the viability of the household, if you will. And the successes of these programs are actually very, very encouraging. They are called graduation because the idea is that once some basic nutrition has been provided and maybe some health or other problems have been taken care of, and means for livelihoods have been created, then these families become if you will clients of microfinance. So that is an approach that is well accepted, and CGAP is working on it as well in co-operation with a number of partners around the world, always with our objective of

learning, codifying those learnings, making them available to everyone so it can be replicated in large numbers. So that's the graduation approach to the poorest.

The other is what we find is that some of these financial services are reaching so large numbers that it does include the poor and the very poorest. So M-PESA which is the first by now most famous in Kenya by now, these numbers increase by the day--by now reach 80% of the population. By definition that means it also reaches large numbers of the poor--which are actually the majority of the Kenyan population--and it also reaches some of the poorest. What's interesting is that it started as a pure payment, money transfer mechanism. But increasingly the poor and conceivably also the poorest use it to store money. So send themselves money before they go on a trip, because it's very unsafe to carry cash with you, and to withdraw the money at the end. And we have studies now that show there is a welfare impact, a statistically significant demonstrable welfare impact that M-PESA users have, largely because they have access to money and remittances sent from relatives in urban areas in moments of need when they for example need to make sure they can actually buy a meal for the family or buy medicine for medical reasons. And in the past it would have taken two or three weeks with a risk of loss to get money from relatives who could help. And now there is an immediate access that helps with what economists call consumption smoothing or other expenditures, and it's shown to have had a welfare impact.

Q: We've had some soul searching around the question of impact, following the publication of some studies a couple of years ago. What are your thoughts today on where that discussion stands? [28'33]

The impact discussion is important. At the end of the day while access to finance is a market development exercise, it needs to be to a higher purpose. So, why are we doing all this? It needs to do something good for either families or communities, or an economy as a whole. My read of the debate and the evidence to date is actually very hopeful and quite optimistic. There are really three levels of impact that we should think about and where the evidence is coming together. First is impact at the household level directly. The first set of studies asked this question of does microfinance work or not? And that debate has really evolved within only a few years to "when does what product work for what segment, and why?", which is the far more appropriate question, because this is saying let's improve and make sure that access to the appropriate product is actually welfare enhancing. And the evidence that's coming in from the more recent set of studies is quite encouraging. So there are studies that show that savings allow for higher business inventory and therefore higher incomes for female market vendors in Kenya. There's evidence that crop insurance helps farmers shift from subsistence to cash crops, use more fertilizers, use more land, have higher incomes and have impact on the family all the way to fewer schooldays skipped, and fewer meals missed for the children. So the evidence is coming together quite nicely. That's at the household level. [30'29]

Then there are two more levels that are often of interest for policymakers in the global arena. The first of those two additional levels is that a financial system that reaches all its citizens allows for more effective other policy interventions, for example in health or education. In Brazil the Bolsa Familia

program shifted a number of its social welfare payments onto one electronic benefit pay card. And as a result of that effort, the pure transaction cost of these programs reduced from 14.8% of total volume to 2.1%—that's a 12.7 point drop—that's huge because that's a 12.7 percentage savings on billions. And when you make that calculation, finance ministers start listening. One such finance minister is Pranab Mukherjee in India who in his budget speech in March announced that India is going to shift as many of its social welfare payments onto electronic platforms, and that's combined with an Indian effort to provide every Indian with a unique biometrically-verified identity card, and therefore easy access to financial services. So that's the second level of impact. [32'07]

And then the third is at the macroeconomic level that goes beyond the base of the pyramid, but we know that the depth of financial intermediation is positively correlated with growth, and negatively correlated with inequality as measured by the GINI coefficient. And that is actually pretty well established economic, both through theoretical and empirical literature. 32'34

So between direct impact on households, if it is the appropriate product for the correctly understood underlying need, enhancing the policy effectiveness of other interventions, and then at the macroeconomic level, there's quite a bit of development or growth impact to be had, and that's what we are very excited about.

Q: Where do you see the biggest opportunities?

The starting point is the 2.7 billion working age adults excluded from financial services, even more with insurance.

We have a lot to do. And I think what's coming together is, between a better understanding of what the underlying consumer need is, what the latent demand is, if you will, the experimentation with new business models that can reach at far lower costs, and a better understanding of what's the pragmatically enabling environment that's required—the right regulation, the right infrastructure, the right public goods— there's a body of knowledge coming together that actually allows us I believe in our lifetime to reach something like full financial inclusion. That's not what we can say in other fields of development—this is actually doable to some degree. There are always some people who might not want to be included, and certainly it doesn't mean that everybody needs access to all products, it just means that everybody has if they need to, access to the appropriate products. We can achieve this in our lifetimes. Not in two years, but it also won't take 20 years. ENDS