Focus

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The Missing Links:
Financial Systems That Work for the Majority

CGAP

The Focus Series is CGAP's primary vehicle for dissemination to governments, donors, and private and financial institutions on best practices in microenterprise finance.

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In April 1995, ninety leaders of finance ministries, central banks, financial institutions, international development agencies, and Women's World Banking (WWB) participated in the WWB Global Policy Forum in India, to build actions that would open financial systems to the world's poor majority. The purpose was to pull together public and private financial leaders with the power to transform local and global financial systems in ways that will open access to millions of low income entrepreneurs. During the Policy Forum, leaders arrived at consensus on the approaches and actions needed, and committed to moving the recommendations into practice.

This Global Policy Forum was both the culmination and the beginning of a movement to transform development paradigms, policies and financial flows in favor of the world's poor majority. In January 1994, WWB convened a United Nations Expert Group on Transforming Financial Systems. Forty of the world's leading microfinance practitioners created a report and set of action recommendations. In September 1994, these recommendations were adopted by the Donors Committees on Small and Medium Enterprises and Financial Sector Development, as the guiding principles for funding. The paradigms, approaches, and recommended actions outlined in this report represent a strong consensus among the world's financial leaders who participated, the world's leading microfinancing institutions, and the world's low income entrepreneurs.

The Challenge

Over 500 million of the world's economically active poor people run profitable micro and small businesses. Microentrepreneurs have shown that they repay market-based loans, and use the proceeds to increase their assets, their living standards and their roles in shaping societies. NGOs, other specialized financial institutions and some banks have shown that microlending can be a profitable business. Financial services to low income entrepreneurs may be the single most effective way to reduce poverty and achieve broad-based economic growth. Yet fewer than 2 percent of low income entrepreneurs and producers have access to financial services from sources other than money lenders. To fill this gap, policy makers need to move beyond the pendulum swings between structural adjustment and social expenditures. Economic participation of the bottom 50 percent needs to be placed front and center in the development agenda. Governments, financial intermediaries and funders need to adopt new paradigms and take on new roles in building financial systems that work for the majority.

Finance and enterprise systems that serve the majority can be the pivotal links and the levers, enabling the poor to share in economic growth and giving poor people the means to use social services. Macro reforms in financial systems need to be complemented by measures that encourage the institutions, instruments, relationships and financing arrangements geared to providing sound, responsive financial services to the majority of enterprises that have not had access.

If 10 percent of all low income entrepreneurs are to gain access to institutional finance by the year 2005, and 30 percent by 2025, financial systems will need to be transformed. Financial intermediaries' total portfolios in microloans, now about US$2.5 billion, would need to be about US$12.5 billion by 2005, and about US$90 billion by 2025, serving about 180 million low income entrepreneurs. These rapid increases in lending levels are reasonable, and reflect growth rates that are lower than actual growth rates in the last five years. The main challenges will be in expanding the capacity and resources of those retail intermediaries committed to providing financial services to low income entrepreneurs.

How to Meet the Challenge:

Action Recommendations to Governments, Financial Institutions and International Funders

If these challenges are to be met, all major actors need to share the objective of providing sound, responsive, market-based financial services to the majority, in ways that are advantageous to both the clients and the institutions that serve them. The goal should be to provide access, not subsidies, to low income entrepreneurs. A wide range of retail-level financial intermediaries should be encouraged, not forced to provide these financial services. Intermediaries receiving financial incentives and support should meet high incremental and absolute standards on financial performance, client reach and business practices. Those institutions that meet the standards should have access to capitalization, loan funds, and effective capacity building support to help organizations at different stages move to sustainable scales of operation. Such support should be structured as a catalyst and complement to savings and other domestic resource mobilization measures by retail institutions. Legal frameworks, second-tier institutions and financing arrangements that balance promotion and prudence will be needed to encourage the development of sound, responsive retail institutions that serve the majority.

Build Dynamic Performance Standards

Incremental and absolute standards need to be established on financial performance, client reach, and business practices as eligibility criteria for accessing support. It is important that all actors, funders, second-tier institutions, retail intermediaries and clients understand, endorse and adopt the same principles, objectives, and bases for determining best practice and accessing resources. The system should establish different thresholds as the bases for accessing different types and levels of support.

Financial Performance

- Excellent repayments with arrears under 10 percent of principle due and bad debts under 4 percent.
- Interest rates and fees that are high enough to cover finance and operating costs of an efficient microlender.
- Substantial progress and credible plans to cover operating and finance costs from internal revenues in a three to seven year period from the outset of operations. Diversity in portfolio by size and sector, to spread risks. A growing capital structure that can be used to generate investment income, can be lent, and can be used to leverage domestic resources.

Client Reach

- Market penetration for significant outreach to low income entrepreneurs.
- Strong savings mobilization directly or through other institutions.

Business Practices

- Sound governance and accountability structure, freedom from political interference.
- Competent staff, responsive loan systems.
- Sound institutional operations, effective management information systems, financial accountability.

Provide Access Not Subsidies to Clients

Experience around the world has shown that microentrepreneurs do not need subsidies and that microlenders cannot afford to subsidize borrowers. Low income entrepreneurs want rapid and continued access to financial services, rather than subsidies. Most microenterprise clients see the "market interest rate" as the rate charged by the money lender or curb market, which is often double the interest rate charged by microlending institutions. Subsidies often send the signal to borrowers that the money comes from government or donors who regard the poor as objects of charity, and borrowers see this as a signal not to repay. Few low income entrepreneurs end up benefiting from subsidized programs, because these programs fail before they reach significant numbers.

Efficient financial intermediaries need to charge high rates to cover the costs of making small loans. Microenterprise financial intermediaries have learned that they cannot depend on governments and donors as reliable, long-term sources of subsidized funding. Commercial banks that are forced to make small loans at rates that do not allow them to cover their costs and make some profit will devise ways to circumvent mandatory allocations, or will lend and then ask government to cover losses by claiming on loan guarantees.

Support Institutions Not Projects

All actors need to find effective means to support the build-up of local intermediaries that have the commitment and competence to lend to micro and small businesses. If financial intermediaries are to move to the significant volumes in microfinancing that are needed to make these programs sustainable, early operations will need to be subsidized. NGOs and other specialized financial intermediaries, which are not in the position to cross-subsidize microenterprise lending while they build lending volumes, will need some form of institutional subsidy for a period of five to seven years. Specialized institutions that meet performance standards need capitalization and low cost, long-term loan funds, preferably repayable in local currency, while they expand their volumes to sustainable levels. Those commercial banks that see microfinance as a potentially profitable market will make a significant commitment to this sector only if, at early stages, they: get access to funds at lower than their average costs of funds; get some guarantee coverage; and are able to charge interest rates that enable a profit once volumes are reached. As institutions expand their microfinancing operations, they will need access to effective capacity building services. The main means will be practitioner training, institution-specific technical services, and benchmarking against best practice. The main sources of capacity building support will be practitioner networks.

Emphasize Savings and Domestic Resource Mobilization

Client-friendly savings mobilization services can be as important as loan services to microenterprises. Deposit mobilization can be one of the most effective means for intermediaries to mobilize resources. Savings mobilization makes financial institutions accountable to local shareholders. All financial intermediaries that lend to microenterprises should be encouraged to build savings mobilization arrangements for their clients, either by providing these services directly, or by making arrangements with another financial institution. Banking regulations need to be adapted to encourage those microfinancing institutions with the capabilities to legally mobilize savings from clients or the general public.

At the same time, it is important to recognize that not all institutions that are good lenders will be good at savings mobilization. Specialized financial intermediaries can mobilize equity, issue debt instruments, and borrow from banks as legitimate, long-term means to mobilize funds for lending. Financial intermediaries that serve microentrepreneurs need to view external grant and soft loan financing as complements and catalysts for domestic resource mobilization. These external infusions are important in the start-up and build-up stages, until the retail intermediary has achieved the scale and efficiency to attract domestic resources from the general public or from institutional sources.

Provide Financing that Fits the Institution

If governments and external funders are to help build financial institutions that serve the majority, they will need to adopt new funding approaches that provide and promote:

- small amounts of grant funds for promising new entrants to finance start-up operating costs and loan portfolios over a short period;
- capitalization for institutions that meet performance standards;
- access to refinance from development banks and other second-tier intermediaries; and
- partial loan guarantees to encourage the build-up of leveraged credit lines by local banks to specialized financial intermediaries. Once an institution has reached the scale and efficiency to cover costs and manage fully commercial sources, it will be able to access international commercial funds directly and through networks.

Where Appropriate, Utilize Second-tier Institutions

A second-tier institution is a financial intermediary or network that provides financial and institutional support services to retail intermediaries. Development banks and practitioner networks have major roles to play over the next five to ten years, as wholesalers of capitalization, refinance and institutional development support, in:

- building an agreed set of standards as the eligibility criteria for accessing support services;
- organizing performance benchmarking systems;
- encouraging exchange of experience among participating retail institutions;
- serving as a wholesaler or broker of seed funding, capitalization funds, refinance of loan funds, and institutional development support;
- encouraging mutually advantageous linkages between commercial banks and specialized financial intermediaries; and
- helping ensure that the appropriate legal, regulatory and supervisory structures and incentives are in place.

To succeed in providing these services, the second-tier institution needs to be autonomous, and free from political interference; have the capabilities to mobilize funding; know the retail institutions intimately; and be able to motivate retail institutions while being tough in the enforcement of standards and eligibility criteria for support.

Building the Regulatory and Incentive Framework

Governments have important roles to play in establishing a favorable policy, regulatory and incentive framework for microfinancing institutions. In building policies, regulations and incentives for financial institutions that serve the poor, several principles and practices are key:

- a range of institutions should be encouraged to enter and expand;
- microfinancing institutions that meet performance standards should be allowed to operate as recognized financial intermediaries;
- entry thresholds, such as minimum capital requirements, should be kept low enough so that specialized institutions can become part of the formal financial system;
- supervisory and reporting requirements should be kept simple, with a focus on key performance indicators;
- institutions lending to micro and small enterprises should be free to set their onlending interest rates; and
- attractive incentives should be provided to these intermediaries.

This Note was prepared by Nancy Barry, President, Women's World Banking, and CGAP Policy Advisor, as a summary of "The Missing Links: Financial Systems that Work for the Majority", Women's World Banking (WWB) Global Policy Forum, June 1995. Copies of this report are available from WWB, 8 West 40th Street, New York, NY 10018, (212) 768-8513, (212) 768-8519 (fax).

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