



Expanding financial access: principles for policymakers

Ensuring universal access to quality financial services calls for effort at various levels within the financial system as well as outside it. We need to understand the role of finance in people's lives and develop business models that offer financial services in holistic and viable ways. These efforts are situated within the policy framework of a country's financial system, which defines what can and cannot be done. A quick look at international experiences reveals a mixed picture, with various approaches being applied by various countries, and significant changes in policy over a period of time in any given country. Considering this variety and the complexity in policymaking, it helps to distil broad prescriptive principles to guide policymakers. This would obviate the need for such an effort by each country.

IFMR Trust Advocacy Unit (ITAU) has been studying various policy principles relevant to expanding financial access in an efficient and orderly manner. In the process, we have sought to partner with institutions that have expertise in such research and advocacy processes. One institution with which we have been working is the Centre for Global Development (CGD), the influential US-based policy research organisation. CGD has released a report that lays out certain principles for financial system policymakers to expand financial access through regulatory reform.

The report is the result of a year's work by a task force composed of leading international experts on financial access and financial regulation. The task force, co-chaired by Stijn Claessens (IMF), Patrick Honohan (Central Bank of Ireland) and Liliana Rojas-Suarez (CGD), included Nachiket Mor (ICICI Foundation for Inclusive Growth and IFMR Trust), Jonathan Morduch (New York University), David Porteous (Bankable Frontier Associates), Elisabeth Rhyne (Centre for Financial Inclusion, Accion International), among other experts.

The policy principles were developed with the goal of expanding availability

of suitable products at affordable prices, whilst ensuring stability in the financial system and wisely using government and donor support. Ten principles are organised under three pillars:

Institutional infrastructure for promoting access

The focus of the principles under this first pillar is on creating institutions that can deliver or facilitate delivery of financial services to the excluded. Promoting entry by qualified suppliers that improve the quality and price of services to customers, and competition among financial firms are taken as important pre-conditions for enhancing

Various approaches are being used across the world to expand access to finance. Broad prescriptive principles will help guide policymakers.

access. Suppliers can work towards expanding access more efficiently if barriers and gaps in the institutional infrastructure relevant to small-scale supply are identified and eliminated. The infrastructure needed to support financial access ranges from information databases such as credit bureaus and credit, collateral and other real estate registries, to legal and social institutions required for speedy and fair settlement of debt disputes, to physical entities such as electronic networks for payments systems. The state has a central role in ensuring the availability and maintenance of much of this infrastructure.

On the demand side, the report calls for policy efforts to facilitate education and confidence-building measures

among those currently excluded, by coordinating, setting standards and curricula, and, possibly, co-funding private efforts. Service providers can play a crucial role in fostering informed consumers, especially by making information available in a client-friendly manner.

Regulation of financial service providers and financial services

While the first pillar focuses on fostering competitive supply and informed demand of financial services, the second pillar looks at the prudential regulation and supervision of providers to ensure the financial health of providers as well as stability in the overall financial system. To facilitate expansion of financial access the report calls for rules and procedures for prudential regulation of financial service providers to be carefully designed, for consistency in financial service provision at a small scale. The report says regulation should be assessed for its impact on access, and must reflect the risks faced by low-income households and small firms. The report also prescribes extending regulation to non-deposit-taking institutions, and cross-agency regulatory harmonisation to avoid regulatory arbitrage.

Protection of customers against abuses by providers is an important policy objective, requiring, among other things, that providers be subject to legislation designed to ensure that they do not sell customers products that are not suited to their needs. The report also recommends that the policy should be such that compliance costs are minimised while retaining their effectiveness. Based on existing evidence, it recommends that policymakers do not impose interest rate ceilings as they often prove ineffective, even counterproductive

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against predatory lending. Where such ceilings are retained, they should be pitched at realistic levels in relation to costs in each market segment, and adjusted over time in line with movements in the wholesale cost of funds.

Direct policies using public resources

The third pillar focuses on principles for using public resources to promote and provide financial services in a manner that the resources are used where they are best suited, without impeding scale through leverage of private capital and initiative. Some forms of temporary and catalytic direct government involvement in financial service provision may be justifiable — for example, when it is otherwise difficult to overcome market failures or to deal with incomplete private market provision. But this should happen with clear and measurable objectives. Political interference should be avoided, especially where credit is being extended. State-run firms must be transparent, modelled on best practices for non-government-owned firms, and the non-commercial objectives of such firms should be publicly known and quantified. If there are subsidies, the report advocates that they be designed to be time-bound and aimed at making institutions and access self-financing and

sustainable. Taxation of financial services should be access-friendly.

Another important principle mentioned in the report relates to the role of government in ensuring data-collection, monitoring, and evaluation. The recommendation calls for ensuring the collection of enough data to allow for determination of gaps in access to financial services that would facilitate private sector solutions, provide accountability of public policy for monitoring and evaluation of the effectiveness of pro-access policies, and help build a better, research-based understanding of what works in relation to access.

Together, these principles provide an interesting framework to assess how enabling a country's financial system policies for expanding financial access are.

How well is India doing against these broad principles? A country case study of India, including a detailed assessment of the policy framework against these principles, is being prepared by IFMR Trust Advocacy Unit, in partnership with CGD and the Centre for Micro Finance at IFMR, Chennai. The case study will be out soon.

Evolution of policy in India

A quick look at the way the policy space has evolved in India throws up a few important facts. Overall,

policymakers in India have always expressed their intent for access expansion. This is implicit in the priority sector requirements for banks and insurance companies, as well as requirements for opening branches in rural areas. The recent requirement to open no-frills accounts is yet another policy response to the financial inclusion challenge. Regulators have traditionally viewed inclusion as one of the parameters in assessing the performance of an institution. But though the intent appears to be in favour of inclusion, the actual policy presents a mixed picture compared with the principles outlined in the CGD report.

Significant strides have been made in the recent past on some of the principles, indicating a move forward. Regulators have come up with significant relaxations in entry and competition policies. Banks are free to set up ATMs, and domestic banks can open branches in smaller towns provided at least one-third of them are in under-banked pockets. Still, restrictions on tier 1 and tier 2 cities remain the same, and the bank licensing regime hasn't changed. The business correspondent regulation was almost the equivalent of delicensing branch opening, but a few restrictions were subsequently imposed. Now, the Central Bank is considering lifting some restrictions, and the overall trend seems to be towards more free entry and competition. Similarly, on the usury laws the movement has been quite consistent with the principles outlined in the report.

There are hardly any restrictions on interest rates charged by micro finance institutions. Banks' interest rates are restricted when they lend directly, but even here it is likely that some leeway may be given for the business correspondent channel. The recent RBI working group on business correspondents has come up with recommendations allowing the collection of fees to improve the viability of the channel.

On other principles, progress has been slow and staggered and it is difficult to identify a clear trend. For example, the area of legal and information institutions and hard infrastructure presents a mixed bag. Progress in this area is a composite of changes in various fields, some of which are not directly under the influence of financial system regulators. The judicial process in India is considered slow, and though the government has been calling for improvements there has been no significant change. This affects financial access in various ways, including the cost of securing property rights, cost of resolving conflicts, and so on. Property rights in India, especially land titles, remain unclear in many parts of the

country; thus their collateral value is negligible. This prevents people from using these assets to access liquid funds that could be invested in enterprise or used for consumption purposes. On credit bureaus, though licenses have been issued by the Central Bank, progress has been slow in extending credit bureaus to rural areas. The low number of currency chests close to rural areas contributes to the high costs of cash management in rural finance. Considerable streamlining of regulatory structures is required to avoid regulatory arbitrage, inconsistencies, and gaps.

On some other principles, regulation is practically non-existent though it is slowly coming into force. For example, the best way to ensure consumer protection is to make sure that mis-selling doesn't occur at the point of sale. This is especially true for sale of insurance and mutual funds. Proposals have recently been passed, and others are in the pipeline, to ensure that sellers are incentivised to consider the clients' financial wellbeing while pushing a certain product at the point of sale. Removal of entry loads on mutual funds was a step in this direction. A set of proposals, prepared by the Committee on Investor Awareness and Protection of the Ministry of Finance, is under consideration. These proposals, if accepted, are likely to make a significant difference to the selection of agents, their training, and incentives offered in the process of selling the product.

As regards cross-regulatory agency cooperation, a lot of work remains to be done. The financial system needs an effective oversight agency with statutory authority. In India, inter-regulatory coordination is under the aegis of the High-Level Coordination Committee on Financial Markets that consists of the RBI, Securities and Exchange Board of India (SEBI), the insurance regulator, and others. But it lacks proper statutory authority.

These are just some of the issues that come up while considering India's financial system policy framework in the light of these principles. Clearly, more work needs to be done. And there is significant awareness about what needs to be done. Recommendations similar to these principles have been made by committees like the Committee on Financial Sector Reform, chaired by Professor Raghuram Rajan, but implementation of the recommendations has been extremely poor. A roadmap exists; we need to act on it with caution and conviction.

See the report of the CGD task force on access to financial services here: <<http://www.cgdev.org/content/publications/detail/1422882/>>

AN IDEA WHOSE TIME HAS COME?

Mutual funds: a new source of financing for MFIs

FMR Capital has completed landmark securitisation of a pool of JLG loans originated by the MFI Equitas, with a combination of several investors including a mutual fund (ICICI Prudential) and bank treasuries (Axis Bank and Dhanalakshmi Bank). ICICI Prudential took a majority of the deal size for inclusion in its short-term debt funds, marking the advent of mutual funds (MFs) as investors in micro finance securities. This transaction paves the way for other MFs to invest in micro finance securities. IFMR Capital CEO Sucharita Mukherjee remarked: "This transaction has allowed Equitas to access funding at a rate significantly lower than its average cost of funds. It also sets a new benchmark for other micro finance institutions that have robust systems and high levels of transparency."

Micro finance can become an attractive asset class for MFs as:

- MFs generally have a mandate for high quality assets. With a delinquency rate of less than 2% (industry-wide), MFI loans are superior to other asset classes like vehicle loans, credit card receivables and small-ticket personal loans. Moreover, investment-grade and above ratings of tranches of MFI loans provide extra comfort to MFs.
- In view of a new SEBI directive, mutual funds have to hold three-month maturity papers in liquid schemes. The short tenure of MFI loans (about a year) has opened up an opportunity for them. Top-rated senior tranches of MFI securitisation can be structured to mature in three months, to match liabilities with assets.
- At present, MFs are getting fairly low returns on bank CDs. SBI is currently offering 6% return on CDs, which is expected to drop further to 5.5% because of excess liquidity in the financial system. MFI securities offer a better opportunity because their P1+/AAA-rated paper can give a 150-200 basis point spread over CDs. However, as more MFs participate, this spread is expected to come down.

For MFIs, the transaction initiated by IFMR Capital opens a whole range of possibilities:

- MF investment in MFI securities can lead to a significant reduction in overall cost of funding to MFIs. MFIs will be able to access debt funding at much cheaper rates, and much more efficiently, reliably and quickly. This will create a level playing field for MFIs, irrespective of size and vintage, where the only variable that will determine access to capital markets will be the underlying quality of the MFI and its assets.
- MF investment potentially offers a fundamentally new direction away from complete dependence on priority sector guidelines, to spur financing for MFIs. This also makes it possible to seek financing outside of the narrow January to March window that is typically active for priority sector requirements.
- MF investment makes it possible for MFIs to access low-cost funds without collecting deposits — offering a very good way out both for them as well as for their customers. In some countries MFIs do collect deposits, which allow them to access low-cost funds.
- Once MFI securities are listed on the stock exchange, their appeal will be considerably enhanced, even for a broader investor group.

MF investment also presents a way to harness the power of capital markets to exercise continuous "oversight" on the large numbers of local financial institutions (LFIs) that are needed to make universal financial inclusion a reality. LFIs are an important step in this direction; while they are involved in origination of services, part of the risk is held by specialised aggregators like mutual funds.

Read more about the landmark transaction here:

<http://www.ifmrtrust.co.in/announcements/ifmr_capital_equitas_press_release.php>

Key recommendations

- **Promote entry by qualified suppliers to improve the quality and price of services to customers.**
- **Eliminate gaps in the institutional infrastructure relevant to small-scale supply.**
- **Facilitate education and confidence-building measures among those currently excluded.**
- **Carefully design rules and procedures for prudential regulation of financial services.**
- **Regulation should be assessed for its impact on access, and must reflect the risks faced by low-income households and small firms.**
- **Protect customers against abuses by providers.**
- **Government involvement in financial services should happen with clear and measurable objectives.**
- **Ensure collection of enough data to allow for determination of gaps in access to financial services.**

CENTRE FOR MICRO FINANCE

Data analysis contest

The Centre for Micro Finance (CMF) works to engage students and researchers in the cause of rigorous research on micro finance. Through outreach activities, CMF hopes to cultivate the next generation of researchers dedicated to poverty alleviation, international development and micro finance. As a component of this overarching goal, Indian graduate students, both Master's and doctoral, were invited to submit research papers based on datasets gathered through CMF's field research. These datasets are all available online. Nineteen initial expressions of interest were received. The deadline for papers is December 4, 2009. Applicants included students of IIT-Madras, University of Delhi, and IIM-Lucknow.

Spandana evaluation-II

Building off the success of the landmark impact evaluation of MFI Spandana's expansion into the slums of Hyderabad, the Centre for Micro Finance has signed a memorandum of understanding with Spandana to conduct a second endline evaluation. The extension was encouraged by both the leadership at Spandana and

by the principal investigators. The survey will likely begin in December 2009 or January 2010. Read about the first landmark impact evaluation here: <http://www.ifmrtrust.co.in/resources/discussion_papers_01.php>

CENTRE FOR INSURANCE AND RISK MANAGEMENT

Financing disaster management

The Centre for Insurance and Risk Management (CIRM) made a presentation on 'Financing Disaster Management in India: Possible Innovations', at the second India Disaster Management Congress held in New Delhi on November 4-6, 2009.

The paper analyses the current funding mechanism to finance disaster management in India. It looks at drawbacks in the existing system which is focused on ex-post strategies. It also examines possible ex-ante strategies that could strengthen the current mechanism.

The paper highlights the importance of a domestic insurance market and challenges in this market, and suggests possible features of a domestic insurance market that could be created in India.

IFMR HOLDINGS/IFMR VENTURES

Empowering rural schools through finance

Schools in rural areas are crucial agents of change that can define the path to inclusion for years to come. Pudhuaru Kshetriya Gramin Financial Services (PKGFS), promoted by IFMR Holdings, and RPSNE (Rural Private Schools Network Enterprise), promoted by IFMR Ventures, have joined hands to offer financing facilities to private schools in Thanjavur district, Tamil Nadu, to enable them to provide better education. The product, launched on October 1, 2009, enables schools to take a term loan to improve infrastructure and other facilities. The loan, which is given for a minimum of one year and a maximum of three years, will range from 40% to 100% of the school's annual surplus. Initial due diligence to assess the eligibility of a school to avail of the loan is done by the PKGFS-RPSNE team; RPSNE uses various parameters like teacher quality, study materials, and training levels.

PKGFS arranges the financing of the loan to the eligible school, using a customised template to compute the annual surplus of the school. Collateral and a personal guarantee from one of the school's trustees back the loan.

BLOGTALK

Excerpts from the INDIA DEVELOPMENT blog*

It is chic to be freaked out (by impact evaluation results)?

...Some folks over at the Centre for Global Development (CGD) blogged recently that results from two micro finance impact evaluations, one conducted by the Centre for Micro Finance and the Poverty Action Lab and the other by Innovations for Poverty Action, have freaked out donors, investors and micro finance institutions. Apparently the news that micro credit did not drastically reduce poverty among clients or impact social indicators such as health/education/empowerment let some air out of the ballooning expectations placed on micro finance...

...The CGD authors observe (incisively in my opinion) that it's premature to panic because, among other well-argued reasons, a) not all micro finance products are created equal, nor are all contexts where micro finance is delivered; ergo, we cannot expect the same results from the myriad products/services offered by MFIs everywhere; b) the effects of micro credit may take

time to manifest and the period over which impact was measured in these initial studies was quite short...

I would add a few more items to their list. First thing is that development interventions have always been imperfect, iterative, and most have undergone major facelifts. Micro finance was once squarely in the sphere of development interventions, right alongside education, health, post-conflict and human rights, etc. For these latter programmes, NGOs, donors and scholars have collectively spent millions of hours tinkering with what works, deriving best practices, and working to maximise impact. Even if a particular education programme failed to flourish, it did not force the development sector to swerve from the firm belief that "education is good", or "access to education is good".

I think we shouldn't approach financial services for the poor too differently. Unfortunately, I think stakeholders on all sides have used jargon that feeds into a do-or-die paradigm. "Either micro finance is working or it's not!"... "the miracle of micro finance"... "the myth of micro finance". I bet we'll never see

a headline proclaiming "the myth of education"...

Posted by Alex

Read the complete post here:

<<http://www.indiadevelopmentblog.com/2009/11/it-is-chic-to-be-freaked-out-by-impact.html>>

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