

Government's Role in Facilitating Access

GIVEN THE EVIDENCE THAT FINANCIAL ACCESS VARIES WIDELY around the world, and that expanding access remains an important challenge even in advanced economies, it is clear that there is much for policy to do. It is not enough to say that the market will provide. Market failures related to information gaps, the need for coordination on collective action, and concentrations of power mean that governments everywhere have an extensive role in supporting, regulating, and sometimes directly intervening in the provision of financial services.

Not all government action is equally effective, however, and some policies can be counterproductive. Complex system responses can make well-intentioned policies misfire, so successful policy design must be context specific. Governance issues are important: policy success can depend on institutional quality. Measures that are effective in environments that already enjoy strong institutions may fail elsewhere. At the same time, a well-functioning financial system itself is likely to contribute to strengthening national governance.

Previous chapters have already mentioned some individual policy issues. This chapter takes a broad view of the role of policy in improving access. It draws as much as possible on findings from formal quantitative research to throw light on a few of the more difficult choices that arise. Implementation of policy requires complementing the results of research analysis with practitioner experience, which this study does not attempt to summarize. Nonetheless, the analysis presented in this chapter provides a base for sound policy advice. The treatment is necessarily selective but illustrates how other issues can be approached.

Government action is necessary to correct market failures, but some policies can be ineffective or counterproductive

Policies to improve financial access and financial development are not always the same

Many of the policies often recommended to enhance overall development of the financial sector—including the legal and information underpinnings needed to lower the cost of services for large enterprises, governmental entities, and wealthy individuals, and to improve the innovative capacity of the financial sector—will also help increase access to those now excluded from, or poorly served by, the financial sector. That reduces the number of difficult trade-offs that have to be made. But the overlap and alignment of the goals are not perfect. A policy reform package for the financial sector that does not explicitly prioritize access will tend to make different choices from one that does. For example, certain regulatory prudential measures aimed at financial stability can restrict the degree to which banks can serve small borrowers. Concentrating institution-building efforts on developing an offshore financial center to export efficient wholesale financial services could result in the neglect of the infrastructures needed to help onshore financial intermediaries reach small, local producers. A reform approach to financial sector policy that explicitly recognizes the importance of access can help ensure that financial development also makes financial systems more inclusive.

It is important to set realistic goals

In prioritizing access policy, it is important to recognize the limitations of even a very efficient financial system supported by a strong contractual and information infrastructure. Not all would-be borrowers are creditworthy, and there are numerous examples of overly relaxed credit policies that have reduced national welfare. Indeed, prudential regulation of banks in developing countries is largely concerned with ensuring that loss-making credit decisions are, on average, avoided. It is also important not to undermine market discipline by adopting rules or regulations (such as mispriced deposit insurance) that may distort the risk-taking or monitoring incentives of market participants. Access to other formal financial services can approach universality as economies develop—indeed the presumption that everyone should be entitled to some form of account at a financial intermediary has gained ground in advanced economies and is essentially a reality in several European countries. The fixed costs of service provision, however, have made it very difficult for traditional financial service providers to reach customers whose need is only for tiny payment and savings transactions or who are located in small and remote markets. Over time, technological and organizational innovations should begin to overcome these barriers, and entry and other regulatory policies should be designed so that such innovation is not inadvertently blocked. More generally, the challenge

for policy is to help build the necessary infrastructures and to ensure that the financial system is one in which service providers are delivering as widely as is possible, given existing infrastructures, and are not hampered by inappropriate regulatory or other policies or by coordination failures (Beck and de la Torre 2007).

This chapter begins by discussing some overall market development issues concerning general measures for improving the contractual, information, and other infrastructures needed to support an effective financial system with good outreach. It highlights recent findings that address the question of which institutional reforms should be prioritized. For example, in low-income countries, improving information infrastructures seems to yield more immediate access benefits than undertaking legal reforms. But legal reforms are also important, and among those, there is evidence that other aspects of contract enforcement may be more important for access than protection of property rights against the state. It also notes that intermediaries can be helped to work around hard-to-remedy institutional deficiencies.

The chapter then turns to specific enabling policy actions to boost the capacity of market intermediaries to deliver financial access. It reviews the many supportive measures that need to be addressed. These range from specific legislation to underpin payments technologies that use the Internet and mobile phones, to ensuring that anti-money-laundering regulations do not choke household access, to securities markets regulation that is not so costly as to prevent listings by medium-size firms.

The chapter then moves to a discussion of regulatory structure. Much of the needed regulatory structure for finance is designed to improve competition and efficiency while restraining excesses, including imprudent or exploitative behavior. The chapter focuses in particular on the potential for positive policy action to mandate access-enhancing product development, contrasting this with the usually counterproductive effect of unrealistic usury ceilings. It also describes recent evidence showing that market discipline can complement official prudential regulation but needs an appropriate policy environment to be effective.

Next the chapter addresses the controversial question of whether government should enter directly into the access business through ownership or subsidy of financial service providers. Here it looks in some detail at state-sponsored credit guarantee schemes (showing how some of these appear to be as costly as many old-fashioned state-lending programs,

This chapter starts with an examination of institutions and infrastructure—

—and then turns to intermediaries—

—and the tricky issues of government ownership—

—and political economy

with little clear benefit, while potential improvements in scheme design have often been ignored).

Before concluding, the chapter turns to the links between politics and access. Financial sector reform delivering outreach is not politically unproblematic. Elites in closed-access societies may lose in the short run by policies that open access to finance and thereby to wider economic opportunities.

Expanding Access: Importance of Long-Term Institution Building

There is little disagreement that the ability of financial service providers to reach a broad clientele is highly dependent on macroeconomic environment and on the overall state of the contractual and information infrastructure.

Macroeconomic stability
can foster financial sector
development—

Theoretical and empirical research has confirmed that macroeconomic instability is an important obstacle to effective intertemporal contracting.¹ Fiscal imbalances in particular generate high and variable inflation, often making the future value of money so uncertain (and difficult to hedge) for both suppliers and demanders that long-term financial contracts simply do not exist. Households will not give up control over their savings for longer time-periods in unstable macroeconomic environments, and financial institutions will not commit beyond short-term contracts given funding uncertainties. Unsustainable macroeconomic and fiscal policies have often been the prelude to financial instability and crises; the fear of macroeconomic and financial instability also inhibits financial innovation that can promote access. In addition, the scale of borrowing by free-spending governments tends to crowd out other borrowers, including (perhaps especially) small firms.

—as can a positive business
environment—

There is thus clear scope for positive government action in the areas of macroeconomic stability and general institution building that supports greater financial access. Policies not specifically addressed to financial sector needs but designed to improve the general business environment (communication, transportation, and energy infrastructure) in which financial institutions operate, as well as the general security situation, are also of evident importance.

—supported by well
functioning institutions

The emphasis in recent literature on the importance of institutions—the “rules of the game”—for economic development, and on the parallel

role these institutions are thought to play in financial development, suggests that the mechanisms of finance are at the heart of the complex processes that lead to accelerated economic growth in a way that is still far from being fully understood (Beinhocker 2006). As such, adjusting institutions in directions that clearly help improve the functioning of finance is likely to be a highly effective pro-growth strategy. Even if the claims that finance plays the chief causal role in economic growth were to be proved false, and instead all of the causality came from the underlying institutional framework, emphasis on ensuring financial performance is likely to select growth-effective institutions.

Building these institutions is typically a long-term and diffuse endeavor, and it necessarily involves a key role for government. Government is the natural—in many cases the only—provider of some of the key organizations that support good institutions, such as efficient, speedy, and fair courts. Government may also need to provide some or all of the needed registries of credit information, liens, and property ownership. Legislation that defines the rights and responsibilities of companies, financial entities, and other financial market participants, avoiding uncertainty or ambiguity in contracts, is also a valuable part of the financial infrastructure provided by government. First and foremost, then, governments can broaden access by making and encouraging infrastructure improvements needed for market development.²

For the policy maker, or the adviser on policy matters, the range of institutional reforms demanded can seem overwhelming, as can the difficulty of implementing even a subset of them. What then are the priorities and how best can the obstacles to implementation be overcome? These are questions to which researchers are only beginning to find solutions.

This is not the place for a handbook of good practice in institution building. For one thing, much of what is held to be good practice in this regard still amounts to a transplant of models that have been successful in advanced economies and otherwise lacks systematic evidential foundations from across the world.³ Yet, there are some interesting lessons from recent research findings that speak to the priorities and likely successes in institutional reform.

The first wave of cross-country empirical literature on law and finance (La Porta and others 1997, 1998) established the strong role of institutions in boosting financial market depth and economic growth, including financial access.⁴ To take one dimension of this, although most will agree

Institution building requires a long-term commitment

Evidence that legal institutions matter

that enforcement of investor and creditor rights is important for access, there has been less agreement on the nature of the legal systems that are best adapted to financial development. As with financial depth and other aggregate measures of financial development, there appear to be fewer barriers to financial access in countries with a common law legal tradition than in those whose legal origins spring from civil codes.⁵ But perhaps it is not so much legal origin per se, but rather a degree of adaptability in legal institutions that is essential to ensure that contract enforcement can keep pace with changing financial technologies. In analyzing the World Business Environment Survey data, Beck, Demirgüç-Kunt, and Levine (2005) also use measures of judicial independence and adaptability to look more closely at whether the style of law in effect has an impact on access as reported in these surveys. Their regressions suggest that firms in civil code countries face larger obstacles to accessing external finance than do firms in common law countries, especially in the dimensions of collateral requirements, long-term loans, and paperwork and bureaucracy. Based on the performance of the other legal variables in the study, the authors suggest that these obstacles are more likely to result from the lack of adaptability in many civil code legal systems rather than from a lack of judicial independence from political pressures.⁶

Arguably the most important institutions to put into place to achieve economic growth are those that reliably constrain the state from compromising private property rights. North, Wallis, and Weingast (2006) argue persuasively—in their ambitious, albeit not fully elaborated or proved, thesis—that the most fundamental distinction between types of organized societies is that between open access societies and those that limit access to economic resources. The course of history suggests that the former have proved to be far and away the more successful, especially in recent times. According to the authors, social order in an open access society is maintained by competition, not rent creation, and competition requires a political system that does not depend on creating and capturing rents for a limited elite.

This proposition finds some confirmation in econometric analysis of the cross-country data that is available on various aspects of national institutions relevant to financial sector performance. In particular, Acemoglu and Johnson (2005) have looked carefully at the different types of institutional variables found in cross-country studies to influence financial sector development and economic growth. They distinguish between those legal and political institutions that mainly underpin the

The risk of expropriation can be a major threat to financial sector development

security of contracting between economic agents on the one hand and those that ensure the security of private property rights vis-à-vis the state on the other. Security of contracting includes measures of legal complexity and formalism in debt recovery; security of property rights includes measures of the constitutional constraints on the political executive and the degree of protection against risk of expropriation. All of these variables are strongly correlated with financial development and economic growth (and with each other).

To eliminate the likely feedback or reverse causality from growth to institutional performance, Acemoglu and Johnson employ as instruments not only legal origin, but also the mortality of colonial settlers,⁷ with the interesting twist that legal origin proves to be a predictor only of the contracting institutions and settler mortality to be a predictor of the institutions related to private property rights. Indeed, they show that legal origin is also strongly correlated with enterprise survey responses on the quality of the courts and the functioning of the judicial system, but not with survey responses on official corruption and predictability of regulation, whereas exactly the opposite is true of settler mortality. Using these instruments, it is the private property rights institutions, rather than the contracting institutions, that prove to be most strongly associated with banking depth and GDP per capita.⁸

If the econometric findings of Acemoglu and Johnson are to be taken at face value, they have some clear implications: a “grabbing state” is a major threat to financial sector development (and thus to economic growth); without institutions that restrain the state from preying on private property, the financial route to economic prosperity is severely constrained.

A conjectural synthesis of these results with those of Beck, Demirgüç-Kunt, and Levine (2005) on judicial adaptability would say that protection of private property against the state is key for the *depth* of financial sector development, but that more specific protections of contracts between private agents are important for determining *access*.⁹

The nature of the 19th century European colonial engagement is of course not the only determinant of modern institutions in countries that were formerly colonized, but the long-lasting influence of that engagement has far-reaching implications for the needed institutional reforms along this dimension. Whether a country has been a settler colony (with the settlers ensuring that they would be relatively free of arbitrary exactions by the state) or an extractive colony (seen by the colonizing

A potentially difficult transition to open societies

country as merely a source of rent through primary production) seems to have had an enduring effect. As North, Wallis, and Weingast (2006) have stressed, only a few countries have successfully made the transition from a rent-creating, limited-access society to an open society where private property accumulation is relatively secure against expropriation by government. And researchers are a long way from understanding how, when, and why countries are transformed from closed to open access. Yet this transformation is what is called for.

What should the institutional priorities be?

Pending success in reforming these most important—but intractable—institutions, it may be easier, and less politically contentious, to make progress on other dimensions. For example, within the category of legal institutions that support private contracting, Haselmann, Pistor, and Vig (2006) have distinguished between those that chiefly enable the individual lender to recover on a debt (for example, institutions relating to collateral) and those that are mainly concerned with resolving conflicts between different claimants (for example, bankruptcy codes). Basing their analysis on evidence from the transition economies of Central and Eastern Europe—which adopted relevant legal reforms at different times after the collapse of the planned economy system—these authors are able to show that bank lending is more sensitive to the institutions that govern individual claims than to those that resolve conflicts between multiple claimants.¹⁰ Given the relative complexity of bankruptcy codes compared with laws and procedures related to collateral, this finding—which matches practitioner experience—is good news for governments overwhelmed with institutional reform challenges.¹¹

While it is well accepted that, in addition to *legal* infrastructures, *information* infrastructures are also key for both financial depth and access, it is not so clear which of the two classes of infrastructure matter most for developing countries.

Information infrastructure appears to be especially important for poorer countries

A recent contribution by Djankov, McLiesh, and Shleifer (2007) in this area has uncovered systematic differences in the relative importance of these two dimensions of financial infrastructure to the growth of private credit. Based on a panel of aggregate data for 129 countries over 25 years, they confirm that creditor rights and the existence of credit registries, whether public or private, are both associated with a higher ratio of private credit depth to GDP, whether measured in levels or in terms of change. Interestingly, creditor rights (especially strong in countries that inherited the common law system) prove to be particularly important for private credit in the richer countries, whereas the information infrastructure (in

the form of credit registries) seems to matter more in the poorer countries. Given that it is arguably easier to build credit registries and other elements of the credit information infrastructure in low-income countries than to make lasting improvements in the enforcement of creditor rights, this is a finding of considerable importance and practical value.

The private sector does, of course, have a number of ways of working around dysfunctional institutions. De la Torre and Schmukler (2004) discuss how U.S. dollar contracts (rather than local currency contracts), short maturities with rollover clauses, and contracting under foreign jurisdiction are mechanisms that cope with systemic risk arising from institutional deficiencies in developing countries. Using a remarkably detailed data set on the interest rate, collateral, and maturity of some 60,000 large bank loans in 21 countries, Qian and Strahan (2007) show how banks adapt to an environment of official corruption and defective property rights by shortening maturities and increasing collateral (thereby facilitating timely action to intervene and recover on debts that begin to look doubtful). These findings reinforce the point that even if protection of property rights is the key institution to get right, the collateral regime does act as a kind of substitute. If so, an improvement in the security of contracts can help the financial system work around the other deficiencies. Qian and Strahan note two other interesting points. Where the procedural costs of enforcing collateral are high, local banks hold a higher share of lending to unrated firms (including SMEs); foreign banks, which have to rely more on collateral, stay away. In addition, only the interest rate on secured loans to rated firms varies with the cost of enforcement—lenders have little intention of pursuing their claims on unrated firms through the courts.

Differences in the efficiency of legal systems can also affect the sectoral structure of lending. Haselmann and Wachtel (2006) show that banks in transition economies whose managers have more trust in the country's legal system also provide more SME and mortgage lending and less lending to consumers, large enterprises, and government. In Brazil banks provided payroll loans—loans whose repayment is deducted directly from the borrower's payroll check—at significantly lower rates than regular consumer loans, which were subject to the slow and inefficient recovery procedures of the Brazilian legal system (Costa and de Mello 2006).

These findings well illustrate the ability of financial intermediaries to adapt and work around *some* of the constraints and environmental deficiencies that they face.¹² This may explain why some reforms have

The private sector can adapt to weak institutions

Some reforms may require others to affect access significantly

disappointing results. For example, especially since the work of Hernando de Soto, it is commonly observed in the literature that, given the importance of collateral, and the fact that secure land titles can often be the best collateral available to a borrower, effective land titling programs should be a good way of enhancing access to credit. Yet, when individual land titling experiments in specific countries are examined—as reviewed, for example, in a recent paper by Pande and Udry (2006)—the estimated impact on credit has often been negligible and statistically insignificant. Evidently, in these cases lenders had already substantially worked around the lack of land as collateral, or repossession of the land was not possible despite the title, or the cumulative effect of other obstacles to the functioning of the credit market remained severe. In any event, the single reform of titling has in these documented cases not had the impact anticipated in the literature. Sometimes a comprehensive set of policy reforms is needed.¹³

One example of the kind of shortcut that governments can take to improve the functioning of the credit market is illustrated by the introduction in India in the 1990s of a new expedited mechanism for loan contract enforcement. As Visaria (2006) has shown, this new procedure bypassed dysfunctional court procedures and resulted in a considerable increase in loan recoveries. Furthermore, interest rates on new loans contracted after the introduction of the new mechanism were 1–2 percentage points lower because of compositional changes in banks' portfolios. Visaria is able to establish this from an econometric study exploiting the facts that only loan contracts above 1 million rupees fall under this new procedure (thus generating cross-firm variation for the analysis) and that political resistance and a court injunction had prevented simultaneous introduction of the new institution across all Indian states (thus allowing cross-time and cross-state variation and the use of the difference-in-differences estimator discussed in box 2.1).¹⁴

Specific Policies to Facilitate Financial Access

Policies to complement the long-term process of institution building

While indispensable for long-term sustainable broadening and deepening of financial systems, broad institution building is a long-term process. The government can achieve additional impact in the short to medium term by taking action specifically directed at facilitating financial market activity that helps access. Beyond the overall legal structure and its pro-

tections, an important practical question is the extent to which contract enforcement in finance needs to be supplemented by specific laws restricting and clarifying, and thereby offering more reliable protection to, certain types of financial contracts or financial business more generally. The trend worldwide has been to expand greatly the degree to which the law is tightly defined by statute rather than relying on judicial precedent in areas such as accountancy, banking, securities markets, unit trusts, leasing, payments, and so on. Indeed, the experience of practitioners in developing countries has been that many financial contracts simply do not happen without the presence of an adequate explicit law to clarify that the contract will have the protection of the courts. But it is possible that law and regulation can become too intrusive, to the point where they are counterproductive for access; two such areas—prudential regulation and anti-money-laundering—are touched on later.

Some of these measures for facilitating financial market activity are generally unproblematic from a policy point of view, and their implementation is constrained only by government capacity. These measures include putting in place the legislation, taxation, and other rules needed for specific financing tools and institutions such as leasing and factoring that are particularly suited to small and medium enterprises. So long as the tax arrangements are not unduly generous, these improvements will be uncontroversial.¹⁵ Improved financial literacy might also help if it can be provided at a low cost. The capacity of individuals and entrepreneurs to take advantage of available financial services (and to avoid pitfalls) depends to some degree on adequate financial education. Other policies can be more controversial, either because they involve trade-offs between the goal of achieving enhanced access and other accepted goals of public policy, or because the improvement in access is ambiguous.

As discussed in previous chapters, credit registries—through which lenders share information about their clients' repayment records—are an established way of enhancing the ability of borrowers to signal a good credit record. Such registries have emerged in the private sector in numerous countries, but the public sector has also taken a leading or complementary role in many others (Miller 2003). Even where the operation and ownership of registries is left to the private sector, government action strongly influences the ability of registries to function. For example, given that privacy laws may severely constrain information sharing, the design of credit registries is highly relevant. Sharing of credit information strengthens the competitive environment in the credit

Credit registries can increase access by establishing a good credit record for some—

market. Incumbent banks, however, might not be interested in sharing positive information, as that increases competitive pressure from possible entrants. So the government may have to consider making information sharing mandatory, either through legislation or by regulation of licensed intermediaries. At a more prosaic level, measures such as giving every individual a national identification number can dramatically improve the ease and effectiveness of the operation of the credit information industry with regard to individual or microfinance borrowers.

–but also exclude high-risk borrowers

Some have argued that credit registries have drawbacks. While better credit information gives lenders the confidence to expand their customer base, it also enables them to identify and screen out some high-risk borrowers who might have received credit in a low-information environment. If so the improvement in access may not be uniform and may result in some groups being left even further behind. Evidence for this kind of effect comes from the so-called “home credit” market in the United Kingdom, where more refined information and credit scoring systems have resulted in the main mortgage lenders withdrawing from some geographical segments.¹⁶ On balance, though, the indications are that the number of losers is small compared with the number of winners, and besides the losers are likely to be the least creditworthy and most prone to overindebtedness (U.K. Competition Commission 2006).

Some observers have also questioned the degree to which compulsory sharing of credit information undermines the profitability of relationship lending, thereby discouraging lenders from investing in such relationships and possibly reducing access in some market conditions (Semenova 2006). Errors and abuses in the maintenance of credit records can be damaging for individuals; regulations need to guard against such errors and to ensure that the collection and sharing of credit information does not in practice represent an unwarranted invasion of borrowers’ privacy. Even the establishment of national identity numbers has been controversial from a civil liberties perspective in some countries.

Difficulties in repossessing collateral may lead to higher interest rates and reduced access

Reducing costs and increasing the certainty of registering and repossessing collateral in the event of a default is also crucial. In Brazil, for example, legal and enforcement obstacles facing lenders trying to repossess property have kept mortgage rates too high to be affordable for the poor (Kumar 2005). Residential mortgage lending remains small in scale and accessible mainly to upper-income groups, although there are a growing number of experiments in microlending for housing. Some specific legislation and other policy measures are typically called for to

support developments here. For example, practitioners discuss the question of special policies to promote a market in mortgage securities that would help expand the supply and lengthen the maturity of housing loans (Chiquier, Hassler, and Lea 2004). Of course policy efforts to improve housing for a wider group go well beyond issues of housing finance.¹⁷

The rapidly evolving technologies based on the Internet (e-finance) and cell phones (mobile phones, or m-finance) can be powerful engines of access (Porteous 2006).¹⁸ But a lack of legal clarity may impede the adaptation of these technologies. Government needs to keep legislation up to date not only to ensure contracting parties that what they intend will be unambiguously enforceable but also to prevent legislation from blocking new innovations. Even though most of the technical problems seem to have been readily soluble, and despite the huge potential market—probably more individuals have mobile phones than are connected to the electricity power grid in many low-income countries—m-finance has been slow to take off. A major early success was in the Philippines, where two companies signed up a total of 4 million customers. South Africa was also an early adopter of m-finance, and it has been followed in Africa by the Democratic Republic of Congo, Kenya, and Zambia, illustrating the potential for this technology (with its low marginal costs) to overcome the problem of high unit costs that shut out low-income customers in countries with relatively weak infrastructures.

But when it comes to policy design as it relates to m-finance, some unresolved problems have emerged. Defining and updating the legislation that gives participants in the market (especially providers) full legal protection for the diverse electronic transactions that are involved is a costly and difficult undertaking for low-income countries. From this point of view, providers have had to take a leap of faith to enter this market. There is also the question of regulatory barriers to entry. From a technical and financial point of view, telephone companies can provide small-scale payments services without having to draw on the services of a licensed bank. But regulation may insist that such services are provided only by a bank (as is the case in South Africa), and if so the compliance costs can be a major barrier to entry (Porteous 2006).¹⁹ A contrasting example is Kenya, where the regulatory regime has been more open to initiatives of the phone companies, and innovation is beginning to be rewarded by relatively rapid consumer take-up.

Any payments system can entail risks of money laundering and terrorism financing, potentially justifying the imposition of AML-CFT

Legislation must adapt to new technologies—

—including m-finance

**Balancing access against
formality of investor protection
in the regulation
of securities markets**

(anti-money-laundering and combating of financial terrorism) regulations. This too can become a barrier to the establishment of m-finance facilities, even though a risk-based approach would show that almost all of the m-finance customers pose negligible risks of this type.²⁰

Even more controversial is the design of regulation for *securities markets*. While general principles have been agreed under the auspices of the International Organization of Securities Commissions, these can be implemented with varying degrees of formality. More formality means higher fixed costs of establishing and maintaining a stock market listing, and the result can be a crowding out of smaller issuers. Low-formality models, such as London's innovative Alternative Investment Market, rely heavily on the reputation of intermediaries known as "nominated advisers" to ensure that the issuer complies with the relevant principles. Because of its lower cost, this model has attracted a large number of issuers. This system has been criticized for not doing enough to protect investors. There is little systematic empirical evidence on this topic; however, some practitioners argue that by lowering entry costs, this kind of approach could yield substantial benefits of greater access for medium-sized issuers, especially in low-income countries (Grose and Friedman 2006).²¹

Policies to Promote Competition and Stability

The literature on the functioning of policies for financial intermediary competition, prudential regulation and supervision, and protection of the poor against abusive lending is vast; here we can only mention a small selection of relevant research findings. The reader also should bear in mind that the applicability to developing countries of lessons learned in advanced economies is not always clear. For instance, numerous deposit insurance schemes have been transplanted from advanced economy models and proved poorly adapted to the circumstances of their developing country hosts, resulting in excessive risk taking by banks and subsequent widespread fragility and crisis (Demirgüç-Kunt and Kane 2002). Regulatory institutions that have evolved in advanced country settings should not be unthinkingly transplanted to the very different political and institutional settings that prevail in most developing countries.²²

**A limited range of effective
tools for competition policy—**

The role of competition in enhancing access has already been discussed in chapter 2. Policy makers who seek to stimulate greater competition often have only a limited range of effective tools they can

use, especially in small, low-income markets. A liberal entry policy vis-à-vis reputable financial service providers can help, but it may not be enough. Transparency of product pricing and the compulsory sharing of credit information can also help, as can rules about network access and interoperability of networks in the retail payments system, but these may not be fully effective either.

Because of their traditionally high unit costs, the main banks in most countries have been slow to provide products adapted to the needs of low-income households, even though they could be in a better position to do so than others because of the advantages of incumbency. More and more advanced economies have been adopting affirmative regulatory policies that require financial intermediaries to make appropriate products available to disadvantaged groups.²³ The features needed in such products can be deduced from the reasons given in surveys of those who do not use banking services, including the cost of banking and the risk of a costly loss of control of their finances. Among the products that could help are basic bank accounts that allow low-cost, simple transactions of modest size and that have mechanisms to protect low-income users from inadvertently triggering unauthorized overdrafts.²⁴ Where low-income customers represent only a fraction of a profitable banking market, the authorities can insist on such facilities being introduced without fear that the banks will exit. This might not be the case in many developing countries. But recently in South Africa, financial service providers introduced voluntarily (albeit under an implicit threat of legislation) a financial sector charter that included a basic bank account scheme.

More generally, as discussed in chapter 2, policies to promote competition in the banking system can also help restrain the exercise of market power that could be damaging to access. With their traditional lines of business coming under competitive pressures, incumbent institutions have an incentive to reach the underserved segments and increase the speed with which access-improving technologies are adopted.²⁵

The same competition that can help foster access to financial services can also result in imprudent lending binges if it is not accompanied by a proper regulatory and supervisory framework. The financial market rules with the highest profile are the increasingly complex battery of prudential regulations imposed on banks to help minimize the risk of disruptive and costly bank failures. The contraction of credit often associated with systemic banking crises hits the poor as well as the rich—sometimes more so—and the poor are less able to bear losses (Honohan 2005a; Halac

—such as affirmative regulatory policies

Prudential regulation and supervision can reduce the risks of banking crises—

and Schmukler 2004). The goal of financial stability is thus generally aligned with that of access, although some stability-oriented measures have the potential to restrict access (box 4.1).²⁶

Indeed, an important current debate among scholars centers on what style of prudential regulation works best, both in ensuring stability and avoiding potential side effects such as hindering financial sector development and facilitating corruption.

Barth, Caprio, and Levine (2006) have addressed this issue with regard to banking. They collected detailed information about the powers and conduct of bank supervisors in over 150 countries in 1997 and in 2001, searching for causal links between regulatory style and the performance of banking systems across the world. Based on regression analysis linking measures of national regulatory style to financial access and other economic outcomes at the individual firm level, the authors concluded that

—but too much discretionary powers for bank regulators can be harmful

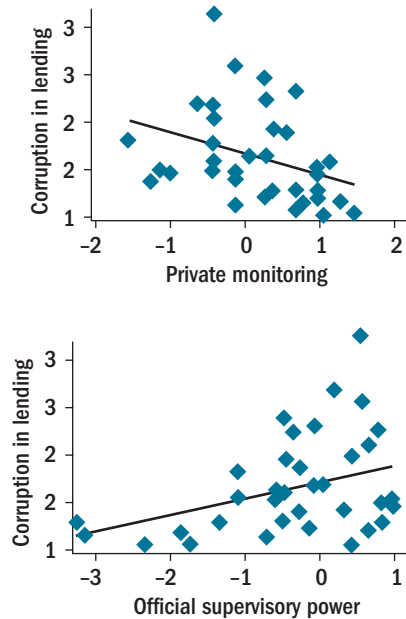
Box 4.1 Basel II and access

FOLLOWING AGREEMENT AMONG THE REGULATORS of the largest industrial countries on a revised framework establishing minimum capital requirements for international trading banks and new supervisory practices, bank regulators all over the world have been taking steps to make comparable revisions in their bank regulation. The new framework, known as Basel II, is intended to avoid regulatory arbitrage by sophisticated banks by making required capital more sensitive to measurable differences in credit and other risks faced by banks. Although it is recognized as embodying technical compromises and could in certain circumstances amplify risk, Basel II's more elaborate approach to capital requirements has triggered technological advances in risk measurement by banks. There is much to be said for the drive to a more scientific approach to risk management, which has been encouraged by the Basel II process and which has the potential to improve access for creditworthy borrowers.

But Basel II also has the potential to limit firm access to finance in developing countries. For one

thing, the risk weight attached to international bank lending to some developing countries is likely to increase, especially at times of economic difficulty, and this could contribute to an onshore credit crunch affecting firm borrowers (Ferri, Liu, and Majnoni 2001).

Concerns have also been raised that foreign-owned banks, reluctant to incur the costs of multiple regulatory reporting, might pressure regulatory authorities to adopt the new system even in developing countries where the advanced risk measurement techniques of Basel II are impractical or premature (Honohan 2001). If that occurs and results in higher compliance costs for local banks and inappropriate risk rating of borrowers, access could be damaged. In addition, by failing to make full allowance for the potential for a portfolio of SME loans to achieve risk pooling, the Basel II rules miss an opportunity for banks to use improved information on the distribution of risks to make SME loans at more competitive rates (Adasme, Majnoni, and Uribe 2006).

Figure 4.1 Supervisory approaches and corruption in lending

Source: Beck, Demirgüç-Kunt, and Levine (2006).

Note: This figure shows the correlation between the average financing obstacles due to corruption reported by firms and (a) the degree of private monitoring across countries and (b) the degree of supervisory power.

relying too much on discretionary powers given to government officials to keep the banking system safe, sound, and efficient may be misguided. Using the same data, Beck, Demirgüç-Kunt, and Levine (2006, figure 4.1) found that firms in countries that grant the largest discretionary powers to their bank supervisors tend to complain more that the corruption of bank officials is an obstacle to their firm's growth.²⁷

Barth, Caprio, and Levine argue that for banks to promote social welfare, a country needs political and other institutions that induce its officials to develop policies that maximize social welfare, not the private welfare of officials or bankers. From this analysis, it seems that empowering and inducing large private market participants to conduct their own due diligence or monitoring of banks (for example, ensuring good disclosure of information) can be a powerful and often-neglected way of strengthening the stability of banking while at the same time improving the reach of the system. And this is not just a message for

advanced economies. On the contrary, the potential for market discipline to be relatively effective even in low-income countries is often underestimated (Caprio and Honohan 2004). Similarly, ensuring that bank supervisors are independent of the political sphere and of the supervised entities themselves, while at the same time accountable to the general public is important, though often difficult to achieve given political and institutional traditions. In many countries, especially those whose law is based on civil code, supervisors are still liable for their actions, even if undertaken in good faith, making them subject to frivolous law suits. Similarly, many countries seem reluctant to give the same degree of political independence cum accountability to bank regulatory entities as they have given to central banks (Quintyn, Ramirez, and Taylor 2007).

Policies restraining abusive lending to the poor

Prudential policies, however, are important not only at the bank or system level but also at the borrower level. As discussed in chapter 3, when it comes to borrowing by the poor, more is not always better. Very poor people, especially those hit by adverse shocks, such as ill health or natural disaster, and those with chaotic lifestyles, can easily find themselves in an overborrowed situation where their inability to service accumulated debt has severe effects on their wellbeing. Most often this occurs by accident, but in some cases it can be attributable to predatory behavior by lenders deliberately exploiting the gullibility and ignorance of the borrowers to trap them in spiraling charges.

The approach of *caveat emptor*, which assumes that borrowers have a clear picture of the costs and benefits of entering a borrowing relationship and the capacity to make rational choices, is certainly not true for marginal groups—and the margin can be quite large in developing countries.²⁸ These borrowers need to be protected against abusive, deceptive, extortionate, or predatory behavior, but doing so is not easy. Although protecting the vulnerable from unwise borrowing and dealing with the overborrowed poor has long been considered an appropriate matter for public policy, as yet no generally agreed policy approach has emerged, even in the advanced economies. Policy measures to deal well with these kinds of situation may be beyond the technical capacity of many developing country governments.²⁹

Interest rate ceilings are rarely effective—

One traditional approach, a ceiling on interest rates (usury laws), is still widely used, although it is increasingly considered rather ineffective as a measure, not least because opaque cost structures can result in total costs of credit greatly exceeding stated interest rates. Using what is known as “behavioral pricing,” unscrupulous lenders advertise low

interest rates knowing that they will attract naïve and disorganized borrowers who do not realize that their predictable behavior is sure to result in a very high overall cost of credit when penalties for late payments and other charges are factored in. At the same time, to the extent that regulators can detect and limit these extra charges, low ceilings on interest rates are clearly counterproductive if they exclude many low-income households that could be creditworthy even at the high rates needed by lenders to cover the costs of processing the borrowings. As a result, although most advanced countries still have usury ceilings, these have been relaxed or qualified by exemptions (Policis 2004; Helms and Reille 2004; Goodwin-Groen 2007). Constraints on interest ceilings do exist in numerous developing countries, and it is widely accepted that they inhibit the expansion of credit by formal and semiformal intermediaries. For some Muslims, prohibition of *riba* entails avoidance of all interest-based finance, although there are practical alternatives (box 4.2).

Allowing a category of licensed or supervised lenders to exceed the basic usury level is one device that many advanced jurisdictions have used to bring high-interest lending into the light of day, rather than consigning it to the shadows in illegality.³⁰ This licensing needs to be accompanied by enforceable consumer protection rules to ensure that charges are

Box 4.2 *Sharia-compliant instruments for firm finance*

RELIGIOUS SCRUPLES CAN RESULT IN SOME self-exclusion. To meet the financing and investment needs of Muslims whose beliefs and ethical frameworks may preclude them from using some conventional financial instruments, a large industry of *sharia*-compliant financial instruments has emerged in recent years and is being constantly refined. These instruments are scrutinized and authorized by legal scholars for their compliance with Islamic precepts. Financial instruments are prohibited if they allow forbidden forms of exploitation by charging riskless interest (*riba*); entail radically uncertain financial transactions (*gharar*) or zero-sum games of pure chance (*maysir*), especially those that involve actual or potential deception; or finance

forbidden (*haram*) activities. Experts have found ways of meeting the core financing requirements of modern economies (including insurance through *takaful*) without violating these precepts. Indeed, innovation in *sharia*-compliant financial engineering continues with the goal—shared with conventional finance—of providing for the needs of enterprise while pooling risk and assigning risk to where it can best be borne (Jaumdally 1999; Obaidullah 2005). For example, the global demand for *sukuk*, a type of Islamic bond that Malaysia helped popularize, has been growing very rapidly. In addition, many Muslims advance charitable funds (*qard al-hasan*) at a zero rate of return to help meet the financing needs of poor people.

transparent and that lenders do not make loans to those who cannot bear the service charges.³¹ This approach is also used in South Africa, and it could be applied more widely in developing countries, though its effectiveness depends on the capacity of the licensing authority to enforce the accompanying rules of good lender practice. But even advanced countries have had difficulty enforcing the transparency requirements, and in an environment of widespread illiteracy, establishing what information has been provided to the borrower is not obvious. As a result, this approach is not practicable in many low-income countries.

—and may even be counterproductive

A recent comparison of consumer credit in the three largest EU economies displays the wide variation in regulatory philosophy and suggests the very considerable consequences that this variation may have for the scale and nature of the consumer credit market for middle- and low-income people. Although thorough econometric analysis is still lacking, the tighter interest ceilings (and other rules for lenders) in France and Germany may have had quite significant effects on restricting the range and availability of legally provided credit, compared with credit in the United Kingdom, and seem to have been associated with a *higher* incidence of overborrowing (Policis 2006). The fraction of borrowers who have defaulted on high-cost, subprime credit cards is much higher in U.S. states with binding usury laws than in states without such laws, pointing to the lack of other more suitable sources of credit for low-income borrowers (Policis 2004).

Even in the United Kingdom, which no longer has usury laws, a small minority of individuals in difficult circumstances has no access to legally provided credit. But when these individuals have recourse to illegal lenders, they pay on average about three times the prevailing cost of legal credit and are typically subjected to aggressive debt collection and predatory lending abuses. Usury laws in France and Germany are likely at the root of the finding that more of the destitute in those countries borrow in the illegal market than do the poor in the United Kingdom; if so, the usury ceilings effectively remove protection from them rather than giving it (Policis 2006).

Bankruptcy laws should take moral hazard into account

Overborrowing can result from misfortune as much as from abusive behavior of lenders. In that case, the primary need may be for assistance to the overborrower in finding a viable workout plan with the creditors. Some countries have formalized personal bankruptcy or administration schemes. The likely impact on credit market functioning should be borne in mind in designing public policy regarding overborrowing, respecting

the danger of moral hazard behavior, the limited capacity of courts or bankruptcy tribunals, and the impracticality of having costly procedures to deal with debts of poor people that are small in absolute terms.

Public policy around the supply of credit for low-income households thus needs to ensure contract and pricing transparency, lender responsibility, and measures to facilitate workouts for the overborrowed. Many administrative resources must be used to implement and enforce these policies, and those costs must be factored into the policy design.

Government Interventions in the Market

If access to financial services is a powerful tool for reducing poverty, as many economists and policy makers argue, an a priori case might be made for subsidization. Subsidization of these fixed costs, however, would have to be justified in relation to competing demands for public funds. As chapter 3 discussed, the case for subsidization of financial services in this context is hotly contested in discussions of microfinance. The deadweight cost of diverting subsidies to intramarginal clients, especially when the target group cannot be well defined, and the risk of undercutting market innovation that could enhance access on a sustainable basis are but two of the problems cited. The fiscal costs of de facto credit subsidies can be high—often much higher than predicted ex ante (see, for example, Adams, Graham, and von Pischke 1984; and Micco, Panizza, and Yañez 2007³²).

The effectiveness of numerous official attempts to improve the reach of SME lending and the maturity structure of SME loans is doubtful (Caprio and Demirgüç-Kunt 1997; Beck and Demirgüç-Kunt 2006). Political subversion of directed credit programs has been a significant problem. Sometimes such schemes have ended up channeling sizable loans to political cronies, but politicization of small-scale lending has also been observed. It is easy to see why: extending small loans is an ideal political lever, with evident benefits and opaque costs. That is especially evident when the lenders are state-owned banks, as discussed below. Even where politicization is not a problem, attempts to redirect credit toward disadvantaged groups often seem to be ineffective.³³

Perhaps the most widely discussed policy intervention of this type was the restrictive branching law adopted in India in 1977; under this law banks wishing to open additional urban branches were first obliged to open additional rural branches. The rural locations benefited from

Interventions through taxes and subsidies—

—can be politicized

additional banking services, although the process was not costless (box 4.3). This intriguing scheme can be considered an implicit self-financing combination of tax and subsidy, but it would be hard to judge whether the tax fell more heavily on the banks or the urban dwellers.

Ease of raising revenue from the sector has resulted in numerous other forms of tax or quasi-tax being imposed on the financial sector in most countries; not least are large and underremunerated reserve requirements and—a recent fashion—financial transactions taxes. The distortions created by these taxes have sometimes been very severe, especially when inflation is high. The potential negative impact on the outreach of the financial system from the introduction of such taxes needs to be borne carefully in mind (Honohan 2003).

Interventions through government-owned intermediaries have a poor record—

Despite a few success stories, substituting government provision of financial services for that of the market is generally considered problematic. The poor record of government development banks in delivering broad access or lowering poverty weakens the case for using this tool

Box 4.3 Rural branching in India

Between 1977 and 1990, the Reserve Bank of India mandated that a commercial bank could open a new branch in a location that already had bank branches only if it opened four in locations with no branches. This regulation was part of a social banking program that tried to expand access to financial services in rural areas. An ex post evaluation of this policy (Burgess and Pande 2005) shows that it had sizable effects. The 1:4 rule was a binding constraint on banks and together with a regulated branch-level loan-deposit ratio of 60 percent led to an increase in bank branches and in rural credit in less densely banked states, even after controlling for other state characteristics that might have driven branch and credit expansion. One interesting finding: whereas the presence of more bank branches in a state was associated with more rapid poverty reduction in that state in the period before and after the policy was in effect, this correlation was absent between 1977 and 1990. This finding, which is robust to

other policies introduced over the period and to controlling for endogeneity, suggests that availability of a bank branch is poverty reducing, even where the branch has been opened only as a result of the policy. The regression results imply that rural branch expansion during the policy period may have accounted for 60 percent of all rural poverty reduction during the period, largely through an increase in nonagricultural activities, which experienced higher returns than in agriculture, and especially through an increase in unregistered or informal manufacturing activities. But there was a significant downside: commercial banks incurred large losses attributable to subsidized interest rates and high loan losses—suggesting potential longer-term damage to the credit culture. Furthermore, many governments do not have the carrot of licensing branches in markets as dynamic as those of some of the largest Indian cities to compensate for the stick of compulsory rural branches.

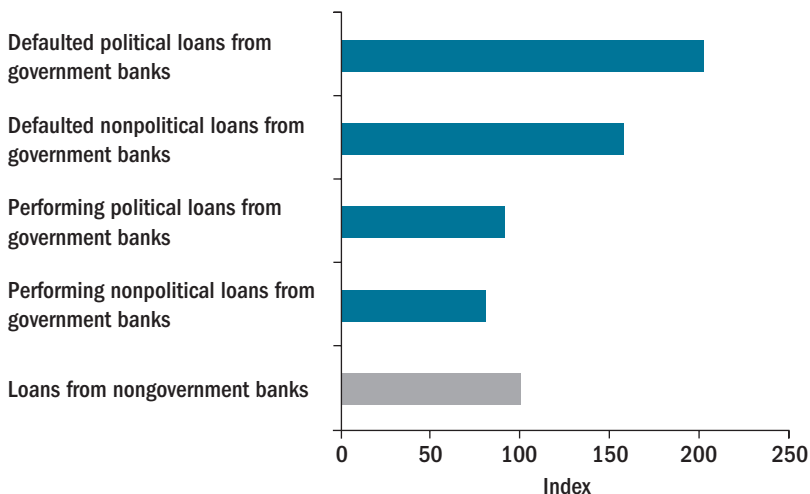
on the credit side. Instead the evidence is that state-owned banks tend to lend to cronies, especially around the time of elections, as vividly displayed by recent detailed analysis of statistics on bank credit by Cole (2004), Dinç (2005), and Khwaja and Mian (2005), whose findings confirm numerous anecdotes.

For example, Cole has shown that government-owned banks in Indian states ramped up agricultural lending in tightly contested districts in election years. Given a history in which state governments cancelled banking debts in the past, borrowers might not only have been glad of the loan, but likely assumed that it might not have to be repaid if times became hard.³⁴ Dinç showed that increased lending by government-owned banks right before elections is not specific to India but can be observed in data from 22 developing countries.³⁵

Drilling down to the individual loan level, Khwaja and Mian found evidence from Pakistan that politically active borrowers were able to secure larger and cheaper loans from state-owned banks and defaulted on these loans much more than other business borrowers (figure 4.2).³⁶ Even though not all state-owned banks performed poorly (Levy Yeyati, Micco, and Panizza 2006), this and a large body of other evidence make

—including the use of political criteria to grant loans

Figure 4.2 Size of loans by Pakistani banks



Source: Based on Khwaja and Mian (2005).

Note: Larger, politically connected loans default more than nonpolitical loans and are more likely to be from government-owned banks. There was no significant correlation between political connections and size of loan from nongovernment banks.

The record is better for state-supported savings and payment services

it easy to see why many countries have preferred to sell large state-owned banks, even to foreign-owned entities.³⁷

In the case of depository services, experience has been more mixed. The postal banking service and state-supported savings banks have traditionally been seen as the providers of depository services to low-income groups. The wide geographic network of post offices and agencies makes it the tool of choice for offering basic payment and savings products in more remote areas. Japan Post Bank and the Russian Sberbank (formerly a savings bank) are among the largest retail financial institutions in the world. Indeed, in France, the right to a banking account is essentially ensured through the postal savings system. Given the sunk cost nature of the post office infrastructure, banking services can be offered at marginal costs, a fact that implies significantly lower costs in the case of low-income clients with the need for small transactions (World Bank 2006b). At the same time, examples abound of postal banks with weak financial structures because they lack a clear legal and accounting separation from the post office. Preliminary cross-country evidence on access barriers suggests that, despite explicit mandates for government banks to expand outreach, in banking systems dominated by state banks, there are fewer bank branches and automated teller machines. Customers in such systems do face lower fees, but they also experience poorer service quality (Beck, Demirgüç-Kunt, and Martinez Peria, 2007a, b).

DFIs could become more effective as providers of know-how than of credit

Some state-owned banks, designated as development finance institutions (DFIs) or development banks, have a specific public policy mandate to make long-term credit available to promote economic development in particular regions or sectors. While these banks have typically been urged to operate in as commercial a manner as is consistent with fulfilling their mandate, the difficulty of doing that has led many to reconsider their business model. A handful of more sophisticated government-owned DFIs have moved away from credit and evolved into providers of more complex financial services. Their know-how, willingness, and capacity to take initiatives that are consistent with their social remit—even at the cost of a lengthy initial period of loss-making—has allowed them to introduce into developing countries financial products and markets that have been proven elsewhere but that entail heavy setup costs without certainty of high financial return. Involving few if any credit risks, these services are less subject to political subversion. Moreover, employing public-private partnerships, the DFIs can help overcome coordination failures, first-mover disincentives, and obstacles to risk sharing and distribution.

Three examples from Mexico illustrate. One is the electronic brokerage of reverse factoring, developed by Nafin, a government development bank, which allows many small suppliers to use their receivables from large creditworthy buyers to obtain working capital financing (Klapper 2006). Another example is the electronic platform implemented by BANSEFI, another government-owned institution, to help semiformal and informal financial intermediaries reduce their operating costs by centralizing back-office operations. Finally, a government-owned DFI, turned investment bank, FIRA, has brokered quite complicated structured financial products to realign credit risks with the pattern of information between financial intermediaries and the different participants in the supply chains for several industries, including shrimp and other agrifish products (De la Torre, Gozzi, and Schmukler 2007). Given patient capital, the private sector could have undertaken each of these successful initiatives. Indeed, the Mexican government explicitly envisages privatization of at least some of these initiatives. But they have had a useful catalytic function in “kick-starting” certain financial services in Mexico.

Evaluation of interventions

It is increasingly recognized that direct interventions to support access need careful evaluation. There are at least three potentially important dimensions to the needed evaluations.

- First, a management audit is necessary to try to ensure that delivery is cost effective and that decision and control structures are optimized against best practice, with, for example, clear and effective procedures for measuring intended outputs and desired outcomes.³⁸
- Second, the impact of the scheme on the intended beneficiaries must be assessed. Comparing beneficiaries before and after the intervention is not sufficient, as a recent example of a government-sponsored scheme of poverty reduction loans in China shows (Chen, Mu, and Ravallion 2006). Once the researchers controlled for the selection bias of the program targeted to poor households and for potential spillover effects to villages that were not in the program, they did not find any long-term effect on incomes, except for the poor who were relatively well educated.

The best methodology is often randomized evaluation, as discussed in chapter 3.³⁹ This methodology requires recording the experience both of program beneficiaries and of a control group; the latter must be selected with care to ensure that they were not excluded from the program as a result of the program's design. Unfortunately, most control groups are not selected until after the program has been started, complicating the subsequent evaluation.

- Third, general equilibrium, or “system,” effects, especially of large-scale programs, must be taken into account. These are especially difficult to assess, given that they affect nonparticipants as well as participants and may be subtle. Thus, for example, it is often argued that direct provision of services below cost can undermine the capacity or motivation of private service providers to incur setup costs for competing services. This is especially important in cases where there is no clear provision that the government intervention or subsidy will end after a certain time period. Not only can governance problems undermine the effectiveness of the program but they also can have negative spillover effects on the economy at large. This is where it is important to have a good conceptual understanding of the potential processes at work and the honest and skilled use of econometric techniques to deal with endogeneity, selection bias, and errors in variables.

Overall, whereas better nutrition or education for the poor may be uncontroversial as overarching goals, the immediate goals of policy interventions to improve financial access need careful definition. Direct policy intervention has a chance of working only if attention is paid to getting four things right:

- Clarity and logical coherence of the objectives of intervention
- Governance structures that inhibit subversion of these objectives
- Control over agency costs, especially credit risk related to adverse selection and moral hazard
- Adequate technical and administrative arrangements.

A canonical example of direct intervention: the credit guarantee scheme

In the following pages we take a close look at one type of direct intervention—government-backed credit guarantees. Most of the issues that

arise in designing credit guarantee schemes have their counterparts in other types of direct intervention. The details described here for credit guarantees thus carry lessons for a wide range of policy initiatives.⁴⁰

With direct and directed lending programs somewhat in eclipse in recent years, the direct intervention mechanism of choice for SME credit activists in recent years has been the government-backed partial credit guarantee. According to Green (2003), well over 2,000 such schemes exist in almost 100 countries.⁴¹ Thus more than half of all countries—and all but a handful of the developed countries—have some form of credit guarantee scheme, usually targeted at some sector or category of firm that is thought to be underserved by the private financial sector. Typically, these guarantee programs seek to expand availability of credit to SMEs and are sometimes focused on specific sectors, regions, or ownership groups, or on young or new technology firms (or even on firms that have been hit by an adverse shock and risk failure). Often there is a subsidiary employment, innovation, or productivity growth objective.

But these trends reflect more the disappointing experience of other forms of intervention than any substantial body of evidence that publicly funded credit guarantee schemes work well. Indeed, while new guarantee schemes are contemplated in several countries, some of the countries with the largest and longest-established guarantee schemes have been downsizing or drastically redesigning their programs.

Of course, credit guarantees are observed in private financial markets without explicit government support. They emerge typically for one of three main reasons: first, because of differential information, as where the borrower's creditworthiness is better known by a well-capitalized guarantor than by the lender; second, as a means of spreading and diversifying risk; and third, as a regulatory arbitrage, as when an unregulated firm provides a guarantee allowing the lender to bring an otherwise insufficiently secured loan into compliance with regulatory requirements or other government programs or financial industry risk-rating practices and conventions.

Government involvement in creating a credit guarantee company is often rationalized by the observation that SMEs commonly do not have the kinds of collateral that bankers require. Given that financial markets are not perfectly efficient, a decision by the government to step in where private financiers have not found it profitable to do so need not necessarily involve subsidy and fiscal outlay—although typically it does.⁴² With many competing pressures for public funds, an economically coherent argument in favor of a subsidized credit guarantee system needs to go

**Weighing the welfare benefits
against the costs of subsidies**

a lot further than the observation that such a scheme would increase the availability of credit. The government needs to be sure that such a scheme will increase overall welfare by enough to justify the subsidy cost, and not simply result in a costly distortion. A welfare economics perspective suggests three possible sources from which a net welfare improvement could come:

- *Market failure related to adverse selection.* Lending may be rationed and undersupplied relative to the social optimum (see box 1.2); in such circumstances a credit subsidy might improve overall welfare.⁴³
- *Correcting for unequally distributed endowments.* Lack of collateral is most acute for low-wealth individuals and groups of people and for poorer geographical areas. However, it is far from clear that credit allocation is the best or even a good instrument to correct for unequal initial endowments.
- *Kick-starting SME lending.* SME lending is not well developed in part because lenders have not accumulated the needed practical experience and the stock of credit information, and therefore face a lengthy loss-making startup period. Credit appraisal and management can build on experience, including systemwide credit history data and credit scoring.

Reading between the lines of the diverse and often rather vaguely stated goals of publicly sponsored credit guarantee schemes, one can usually detect hints of one or more of these economists' arguments, perhaps most often the last one mentioned.⁴⁴ Whether these goals are fully achieved and at what cost is something that has never been evaluated in a fully satisfactory way even after the event, much less in advance. The evaluations that have been carried out focus on operational aspects such as ensuring that sufficient take-up or keeping the cost of the scheme within bounds.

The cost issue sometimes attracts less attention in the early days of the scheme. After all, one obvious but superficial attraction for promoters of credit guarantee schemes is that the upfront cash commitment by the government is small in relation to the total volume of credit supported by such schemes. The liabilities are contingent and in the future, while operating costs can be covered by fees and premiums paid by beneficiaries. The endowment of capital may be a small fraction—often 5 percent—of the allowed total sum guaranteed and need not be paid in cash. In due course, loan losses do emerge, and the adequacy of the

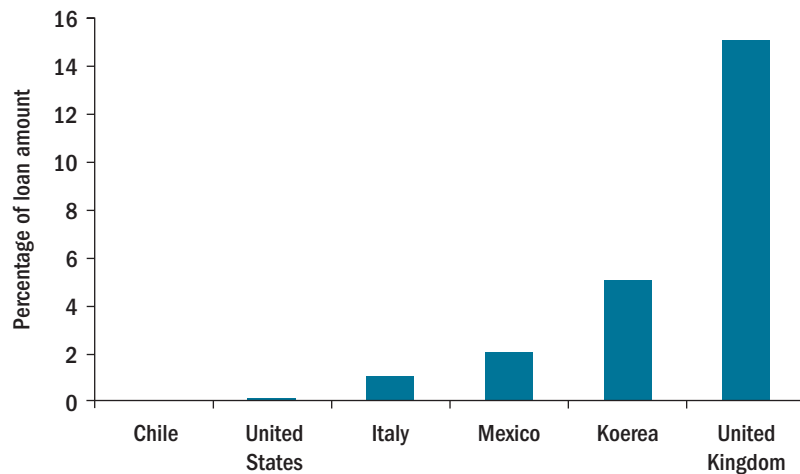
It can be difficult to evaluate the total costs of a scheme at its inception—

fees and premiums becomes evident only over time as the contingent liabilities inherent in this soft budget constraint crystallize.

Estimating likely future underwriting losses is not as easy as it might seem, especially at start-up.⁴⁵ If the target group has not been borrowing, there is little experience on which to project defaults and the consequent losses. Furthermore, default experience is highly dependent on the state of the business cycle, so that it is unwise to extrapolate from the experience of a few years. If there is a major economic downturn, then default rates and resulting losses can soar, as was seen in several East Asian countries in recent years.

In practice the range of experience regarding cost has been enormous (figure 4.3).⁴⁶ While numerous schemes have experienced much higher-than-expected losses, heavy and unanticipated underwriting costs are by no means a universal experience of credit guarantee schemes (Doran and Levitsky 1997; Bennett, Doran, and Billington 2005). This finding is consistent with the belief of many bankers that loan losses can be held to acceptable levels through good credit appraisal and monitoring practices, but that it is the cost per loan of appraisal and monitoring that under-

Figure 4.3 Estimated annual subsidy cost of selected credit guarantee schemes



Source: Approximate figures based on data in Benavente, Galetovic, and Sanhueza 2006; Bennett, Doran, and Billington 2005; Benavides and Huidobro 2005; Zechinni and Ventura 2006; Shim 2006; and Graham 2004. The U.S. figure assumes average maturity of 13 years (U.S. General Accounting Office 1996). The U.K. figure is the 2003–4 outlay divided by that year's flow of new guarantees (Graham 2004, para 1.12); using the average of the previous 10 years' new guarantees would give a much higher figure.

—and even harder to calculate
the benefits

mines the profitability of SME lending. If so, a well-run credit guarantee scheme may not need to be very expensive, but it may also not be enough to attract bankers into the market for loans to the target group.

If it is difficult to estimate the likely future cost of a credit guarantee scheme, it is even more difficult to evaluate the social benefit that results. Evidently the volume of loans guaranteed is a wholly inadequate measure of social benefit. On one hand, there might be no additionality involved—the loans might have been forthcoming anyway even in the absence of the guarantee. On the other hand, additionality might be greater than the loan amount guaranteed, as receipt of the guarantee might leverage a much more substantial, unguaranteed financing package. Most evaluations of guarantee schemes rely on the qualitative assessment of bankers and SME insiders to determine whether availability of credit to SMEs has eased. Depending on the design of the scheme and in particular on the nature of eligibility rules, formal econometric methods can sometimes be used to throw light on this question, but only a few systematic attempts to do so have been made.⁴⁷ A specific policy change in Pakistan allowed Zia (2007) to uncover credible evidence of very substantial deadweight (lack of additionality) in the subsidized export credit scheme in Pakistan.⁴⁸ By distinguishing between the experience of Chilean firms whose main bank began using the FOGAPE scheme at different times, Larraín and Quiroz (2006) estimated that micro-firms whose bank used the FOGAPE scheme had a 14 percent higher probability of getting a loan. At the same time, Benavente, Galetovic and Sanhueza (2006) note evidence of sizable displacement in the scheme—for example, a large and growing share of successive guarantees being granted to the same firms.

Second, even if there is additionality, it might involve such heavy loan losses or transaction costs as to result in net welfare losses for the economy as a whole. And even if fiscal costs are low, the economic costs of misallocated resources can be high. In the Pakistan case, Zia calculated that diversion of unneeded credit to beneficiary firms could have held GDP below its potential by 0.75 percent.

Operational design is
important

The operating expenses and underwriting experience of a credit guarantee scheme depend on the design of the scheme (as well as on the effectiveness of its administration). These will also clearly affect the success of the scheme in improving the availability of credit and achieving any other goals of the scheme. The first issue is pricing: systematic underpricing clearly adds to the fiscal cost of any such scheme. Three other design dimensions are worth noting.

- First is the question of whether the guarantee scheme should carry out its own credit appraisal of each final borrower who is being guaranteed. Some of the best-regarded schemes do not conduct such retail assessments but instead rely on an assessment of the intermediary whose portfolio of loans is being guaranteed.⁴⁹
- Second is the rate of guarantee, that is, the proportion of the total loan that is guaranteed (along with related aspects, such as whether the losses are shared proportionately between lender and guarantor, or if the guarantor covers the first or last portions). Many practitioners argue that the lender should retain a significant part of the risk (at least 20 percent and preferably 30–40 percent, according to Levitzky 1997 and Green 2003), so that there will be an incentive to conduct credit appraisal. In practice, most schemes offer slightly higher rates of guarantee—70 to 80 percent being about the norm—and up to 85 percent in the case of the U.S. Small Business Administration and 100 percent in some other cases (for example, Japan). Guarantee rates significantly under 50 percent fail to attract lenders. Scaling guarantee rates according to the claims experience from each lender can improve lender incentives without the adverse distributional impact that would result from requiring final borrower guarantees. Chile's FOGAPE has started to auction available guarantee amounts, with the lenders bidding on the rate of guarantee.⁵⁰ Bankers who bid for lower guarantee rates than the maximum allowable have their requests filled; others are rationed. In practice, the auctions have resulted in the primary lender retaining between 20 and 30 percent of the risk (Benavente, Galetovic, and Sanhueza 2006; Bennett, Doran, and Billington 2005).
- Third is the nature of the lending criteria, such as the categories of eligible borrowers and the terms of the lending. Some schemes have relatively broad eligibility rules (for example, a ceiling on borrower size as measured by turnover, and a ceiling on the guarantee fund's overall exposure to the borrower). The more complex the criteria, the more likely opaque political interference with the granting of guarantees. At the same time, a broad set of criteria leaves the door open to deadweight in the allocation of subsidy to borrowers that have no need of it. Restrictions on the lending terms, such as interest ceilings, seek to limit the degree to which the lenders in an uncompetitive

market capture rent from the scheme, but if these restrictions are set at unrealistic levels, they can open the door to corrupt side-payments. In practice the trend has been to move toward less complicated eligibility criteria over time.

Although Japan and Korea have had very extensive credit guarantee schemes, with the stock of guarantees exceeding 7 percent of GDP in 2001, and still in excess of 5 percent of GDP at the time of writing,⁵¹ guarantee schemes in most countries have typically covered only a small fraction of total SME lending, and guarantees amount to a fraction of 1 percent of GDP. Sometimes this is due to capacity constraints (as in the well-regarded Chilean scheme, which covers only about one-sixth of micro-, small-, and medium-enterprise lending). In other cases it is attributable to lack of demand, which in turn can be traced to such features as excessive procedural costs, lack of lender confidence, delays in claims payments, or narrow eligibility criteria.

Subsidies are not an ingredient for success

Systematic economic evaluations do not yet offer enough evidence to form an impression of which schemes, if any, truly represent value for money. But as this brief review suggests, the lessons of operational experience are that government-sponsored credit guarantee schemes have the most to show for their efforts where they have effectively and credibly delivered an attractive package of services to lenders, with a view to enhancing their capacity to lend to the underserved sector, thereby propelling them to a sustainably higher level of lending. Innovative pricing can induce improved results (for example, better loan appraisal by lenders); even without subsidy, demand from lenders may be high where the scheme operator can add value, for example, by disseminating industry information on SME loan performance. More and more guarantee schemes are likely to move to broad eligibility and other criteria, reduced subsidies, and more use of the portfolio and wholesaling approach in preference to case-by-case evaluation by the guarantor of retail loans.

Government-sponsored credit guarantee schemes will never substitute for reform of the underlying institutional requirements of an effective credit system. The best of them can probably survive and add value even without ongoing government subsidies.

Given the checkered record of such schemes in the advanced economies, and this is true of many other types of direct government intervention in the financial market, the question is not just one of avoiding

unthinking transplantation of success stories; it is more a matter of pausing to consider whether, if success is unlikely in a favorable governance and general institutional environment, an adaptation can work in the more difficult environment of the developing world?

Box 4.4 Subsidy and access

THE NET FISCAL COST INCURRED BY PUBLICLY funded credit guarantee schemes is just one example of a variety of access-related subsidies. As in other areas of development, the use of public funds is easy to justify in the interest of improving access and thereby promoting pro-poor growth. Such subsidies of course need to be evaluated against the many alternative uses of the donor or scarce public funds involved, not least of which are alternative subsidies to meet education, health, and other priority needs for the poor themselves. In practice, such a cost-benefit calculation is rarely made. Indeed, the scale of subsidy is often unmeasured.

Furthermore, as with financial sector taxation, subsidies in finance can be more liable to dead-weight costs than is the case for many other sectors (Honohan 2003). It is often especially hard to ensure that finance-related subsidies reach the target group or that they have the hoped-for effect.

But an even more serious problem is the possible chilling effect of subsidies on the commercial provision of competing and potentially better services to the poor. Subsidizing finance is likely to undermine the motivation and incentive for market-driven financial firms to innovate and deliver. It is this danger—that subsidies will inhibit the viability of sustainable financial innovation—that can be the decisive argument against some forms of subsidy.

Note that it is not subsidization of the poor that should be questioned: the poor need help and subsidies in many dimensions. Subsidies to cover fixed costs (for example, in payments systems, especially when these generate network externalities) may be less subject to this chilling effect than those that

operate to subsidize marginal costs. But every case must be assessed on its own merits.

Microfinance is the area of financial access where subsidies have been most debated. Many well-intentioned people have sought by means of subsidy to make credit affordable for the poor. As a result, a majority of microfinance institutions (MFIs) today—though fewer of the largest ones—operate on a subsidized basis (Cull, Demirgüç-Kunt, and Morduch 2007). Some of these subsidies are for overhead, and the MFIs do not think of them as subsidizing the interest rates. Many currently subsidized MFIs aspire to reach a break-even point and ultimately become fully profitable. Others, including the famous Grameen Bank, consciously apply subsidies to keep interest rates down. MFIs that operate group-lending schemes and that in practice are more focused on the poor rely on the highest subsidies.

While many borrowers are able and willing to service interest rates at levels that allow efficient MFIs to be fully profitable, there is no doubt that demand and borrower surplus would be even higher if interest rates were lower. Many would agree with Morduch (1999) that the prospects of reaching many of the very poor with unsubsidized credit are low. But even with a subsidy, credit will rarely be the first financial service need of the very poor. Also, apart from ensuring that the subsidy does reach its target group, the question, as always, is whether introduction of subsidy undermines the emergence of a sustainable industry with extensive—albeit incomplete—outreach.

Political Economy of Access

Politics and finance are the keys to economic access. If North, Wallis, and Weingast (2006) are correct in their view that the decisive transition in economic history is that between limited and open-access societies, to understand this transition is, as they point out, to understand modern development.

It is one thing to identify a policy measure that will achieve a net improvement in financial access at reasonable cost and limited overall side-effects. It is quite another to suppose that such a policy will automatically be implemented by an enthusiastic government.⁵² Governments are, after all, operating in a political environment, and the package of policies that is implemented often owes more to the balance of political influence than to the state of knowledge about policy effectiveness.⁵³ Why should governments introduce reforms that might be at the expense of incumbent elites?

Existing elites may benefit from restricted access—

When the political and social structure of the state is predicated on limited access and the resulting rents, existing elites have limited enthusiasm for policies that would increase access to financial services (Rajan and Zingales 2003). It may well be, as Rajan (2006a) argues, that in unequal societies the desire of each subgroup to preserve its economic rents against all others tends to reinforce the status quo. The policy reform agenda is therefore not a simple matter of adjusting a flawed policy stance or adapting existing laws to changing market and technological realities. Instead the reforms must be far-reaching if the gain in economic performance is to be large enough to be attractive to existing elites, who will have a smaller share of the larger postreform cake. Vested interests must be convinced of the merits of transition. Making that argument is a more effective way of inducing change than direct attacks on privileges. And prioritizing financial access generates a detailed policy agenda for converting the aspiration for transition into concrete measures. For, despite the far-reaching nature of the institutional changes involved in the transition to an open-access society, it seems clear that reforms that really do improve financial access should also help drive the societal transformation. The financial access agenda thus points back to the nature of the institutional changes that are needed in society and as such provides a touchstone for reform.

The reforms needed to improve financial access as the decisive change mechanism in the economy are not only necessary but almost sufficient

to define that wider policy agenda. This agenda ranges from matters of great generality down to questions of operational implementation and design. Delivering on this agenda calls on many different agencies of government and also typically needs support from external development partners. Engagement of civil society is essential to create the political environment within which governments will be induced to act.

Numerous examples can be cited from research on policy adoption to illustrate the pressures that are involved. When and how do financial sector reforms occur? What is the relative importance of private and public interest and ideology? In a classic paper, Kroszner and Strahan (1999) argued that the sequence in which U.S. states liberalized banking was consistent with the view that resistance to such policy changes was driven by the well-organized private special interest of the bankers and not by an objective or ideologically driven view of the public interest.⁵⁴ Eventually, technological progress and a competitive political system overcame the special interests of small bankers who benefited from the constraints. In contrast, Haber (2005) argues that a less competitive political system in Mexico meant that the government limited entry into the banking sector in return for favors and for financing for much longer than did the United States; as a result, by the early 20th century, Mexico was left with a much smaller, more concentrated, and more inefficient banking system.

The example of branch deregulation in the United States also shows the potential for exogenous events, such as technological innovation, to overcome political resistance to competition-enhancing reforms. As the introduction of ATMs, money market checking accounts, and improvements in communication technology have reduced the banks' need to be physically close to their clients, the monopoly power of small local banks declined and with it political resistance to change. The prospect of accession to the European Union helped many governments in transition economies to overcome political resistance against institutional reform (Beck and Laeven 2006). It is worth looking for such windows of opportunity when political resistance to reform may be weaker.

Once started, there seems to be an internal dynamic to the process of financial sector reforms, though timing can be also be influenced by macroeconomic conditions. Based on the timing of financial liberalization in 35 countries over the period 1973–96, Abiad and Mody (2005) found that countries with highly repressed financial sectors are unlikely

—but vested interests can be overcome in a competitive political system—

—and through technological innovation

to reform.⁵⁵ Once reforms, even small ones, take place, however, the process builds momentum and further reforms become more likely. A balance-of-payments crisis typically triggers financial sector reforms, but a banking crisis is often associated with an interruption or reversal of liberalization.

Many other examples of political influence on financial sector policy are reported in the literature. For example, seeking to explain the frequency with which underpriced privatizations are observed, Biais and Perotti (2002) discuss how a strategic privatization program allocating left-leaning voters enough underpriced shares can induce a voting shift away from left-wing parties whose policy would reduce the values of shareholdings. Perotti and Volpin (2004) argue, with some supporting evidence, that in countries with low political accountability, incumbent firms succeed in persuading politicians not to strengthen effective investor protection in order to prevent potential entrants from raising capital.⁵⁶ Along similar lines, Feijen and Perotti (2005) suggest that, following financial liberalization (which typically results in improved access to finance by new entrants), elites successfully lobby politicians to ensure weak contract enforcement with the result that their highly leveraged recent entrant competitors are unable to refinance in downturns, and have to exit the market. And lobbying can be effective even at the micro level. Claessens, Feijen, and Laeven (2007) discovered, using data on every political donation made by Brazilian firms in the runup to the 1998 elections, that political contributions are somehow rewarded by subsequent excess returns in the stock market.

The middle classes can be powerful allies for the poor

How to help align reform-making process with public interest? This is another area where much more research is needed. Greater public awareness of the potential benefits of policies to broaden access will also be important to shift the political equilibrium in the direction of reforms that promote the public good. In this context, the challenges of financial access and financial inclusion clearly go well beyond ensuring financial services for the poor. The middle classes too have insufficient access to finance. Advertising the access agenda as a broad one that includes the middle class helps mobilize a powerful supporter in the struggle to broaden access (Rajan 2006b). The same mechanisms that expand access for middle-class households and SME entrepreneurs will often help expand the access for the very poor as well. This process will also help strengthen the links between formal and informal financial systems and allow the poor to migrate upward.

Conclusions

This chapter has highlighted the complexity of the policy challenge in improving access. The discussion has been necessarily selective, setting out principles for effective government policy by drawing on and generalizing lessons from specific examples.

Deep institutional reform that above all ensures security of property rights against expropriation by the state is an underlying, albeit often long-term, goal. Meanwhile legal and especially informational infrastructures can be strengthened to help financial institutions work around a difficult environment, thereby making the provision of wider access privately profitable.

Ensuring competition is an essential part of broadening access as competition encourages incumbent institutions to seek out profitable ways of providing services to previously excluded segments of the population and increases the speed with which new, access-improving technologies are adopted. In this process, providing the private sector with the right incentives is key, hence the importance of good prudential regulations. A variety of regulatory measures is needed to support wider access. Taking consumer protection against abusive lending as an example, we have shown that interest ceilings fail to address the problem adequately and can even be counterproductive; increased transparency and formalization and enforcement of lender responsibility are a more coherent approach, along with support for the overborrowed. However, delivering all of this is administratively demanding.

The scope for direct government interventions in improving access is more limited than often believed. Here, we have used credit guarantee schemes as an example of direct government intervention aimed at increasing access for SMEs. These programs can be more costly in budgetary terms than anticipated, and their performance can be improved by careful scheme design. In the absence of thorough economic evaluations of most schemes, their net effect in cost-benefit terms remains unclear.

If the interest of powerful incumbents is threatened by the potential emergence of new entrants financed by a system that has improved access and outreach, lobbying by those incumbents can block the needed reforms. A comprehensive approach to financial sector reform aiming at better access must take these political realities into account. Given that the challenges of financial inclusion and benefits from broader access go

Institutional reform and building infrastructure are key long-term priorities

Ensure competition and provide the private sector with the right incentives

A limited role for direct government interventions

The middle class may have the power to overcome the vested interests of the elites

well beyond ensuring financial services for the poor, defining the access agenda more broadly to include the middle class will help mobilize greater political support for advancing the access agenda around the world.

Notes

1. For a theoretical analysis, see Huybens and Smith (1998, 1999), among others, and for empirical analysis of the cross-country relationship between finance and inflation, see Boyd, Levine, and Smith (2001); Honohan (2003).

2. This infrastructure can also be seen as a public good that private providers are not willing to provide.

3. Recently more country-specific evidence has been accumulated through two programs conducted by the World Bank, in the latter case jointly with the International Monetary Fund. The Reports on Observance of Standards and Codes on insolvency and creditor rights, corporate governance, auditing and accounting standards, and other areas are detailed assessments of the contractual, information, and regulatory frameworks of countries and provide detailed reform suggestions. The Financial Sector Assessment Program provides a detailed assessment of the stability and development of countries' financial systems as well as road maps to short-, medium- and long-term deepening and broadening.

4. LaPorta and others (1997, 1998) (and the literature that ensued) showed that, compared with French legal origin countries, the English common law countries have deeper banking systems and securities markets, more initial public offerings, more diffuse ownership of public equity, a higher ratio of market to book value of shares (Tobin's Q), and higher dividend payouts that are more closely tied to profits. The interpretation of these findings remains quite controversial. LaPorta and others relate these outcomes to cross-legal system variation in the protection of minority shareholders and creditors and enforcement of law. Thus, to oversimplify, the common law system tends to offer stronger legal protection of shareholders and creditors, together with more efficient courts and judicial systems.

5. While most scholars believe that efficient protection of creditor and investor rights is an important determinant of financial development, there has been considerable debate as to whether the legal origin variable proposed by La Porta and others (1997, 1998) is at the root of international differences in these rights, let alone their enforcement. This variable is correlated across countries with other predetermined variables such as geographical endowments, political structures, and ethnic diversity (Beck and Levine 2005; Ayyagari, Demirgüç-Kunt, and Maksimovic 2006b, 2007c).

6. However, related work shows that the distinction between legal systems according to adaptability is not completely aligned with the difference between civil and common law (Beck, Demirgüç-Kunt, and Levine 2003). German civil code legal systems are found to be as adaptable as common law systems, suggesting reform possibilities to policy makers within the civil code legal tradition.

7. A proxy indicator for the quality of institutions that colonizers established during the 18th and 19th centuries, introduced by Acemoglu, Johnson, and Robinson (2001, 2002).

8. That is not to say that contracting institutions are of no importance. Far from it, as is shown, for example, in Cull and Xu's (2005) analysis of the contrasting experience on both of these dimensions in Chinese provinces. They find that both property rights protection and contract enforcement matter for firms' reinvestment decisions.

9. This conjecture is not inconsistent with Acemoglu and Johnson's (2005) finding that it is the private contracting institutions that remain significant in explaining stock market capitalization.

10. Given their heavier reliance on secured lending, it is not surprising that foreign bank lending increases by even more.

11. This is not to say that reform of bankruptcy code cannot have an important impact, as Gine and Love (2006) show for the case of Colombia. Once it was reformed, the country's insolvency system managed to separate viable from nonviable enterprises, allowing the former to restructure and liquidating the latter. Further, systems with effective collateral systems and ineffective insolvency systems can result in severe imbalances in the long term. In practice, designing the needed reforms requires great attention to detail if they are to work effectively. For example, practitioners may have to scrutinize such aspects as the relative priority of secured and unsecured creditors in an insolvency, the availability of corporate workout solutions, the remuneration of insolvency professionals, personal liability for officers and directors, discrimination between local and foreign creditors, stays on the premature dismemberment of a debtor's assets, and so on.

12. It is not only intermediaries that can perform the work-around. Fisman and Love (2003) found evidence that trade credit partly offsets national weaknesses in financial sector deficiencies; industries with higher dependence on trade credit financing (measured by the ratio of accounts payable to total assets) exhibit higher rates of growth in countries with relatively weak financial institutions.

13. Field and Torero (2006) and Galiani and Schargrotsky (2005) find similar results for land titling in the cases of Peru and Argentina, respectively.

In both cases the effect of land titling programs on access to finance was low or zero. In Peru, Field and Torero explain their finding with the political economy observation that freshly titled landowners feared less expropriation from lenders than before.

14. The Brazilian authorities have introduced several shortcuts to allow contracting parties to work around the painfully slow process of enforcing contracts through the court system, which can take several years. Apart from allowing payroll deduction of consumer loans, certain contract forms allow for expedited court procedures or even out-of-court enforcement (Kumar 2005).

15. Tax concessions to boost specific financial markets risk misfiring, because of the considerable potential for arbitrage. For a discussion and some overall principles, see Honohan (2003).

16. In this market, licensed lenders visit the borrowers in their homes on a weekly basis to collect the repayments, typically 3 percent of the initial amount borrowed over 55 weeks. (Ellison, Collard, and Forster 2006).

17. Pensions represent another area where details of legislative and regulatory design can be crucial. Practitioners have been studying the performance of innovative regimes such as the one in Chile, and much research still needs to be done on ensuring that pensioners get value for money and a reasonable risk-return balance (both in the accumulation and the payout phases) and that pension funds contribute to the availability of long-term and risk finance to the private sector (Rocha and Impavido 2006; Rocha and Thorburn 2007).

18. Regulatory design should ensure sufficient certainty around electronic contracting, protecting customers adequately against fraud and abuse and aiming for interoperability between the technical platforms of different suppliers. In addition, Porteous (2006) proposes three principles of good regulatory design if m-finance is to transform the payments environment for low-income customers in developing countries. First, customer due diligence procedures for account opening should be risk based and should not unduly prejudice remote account openings by small customers. Second, customers should be able at least to make deposits and withdraw cash through agents and remote points outside of bank branches. Third, adequate provision must be made for the issuance of e-money by appropriately capitalized and supervised entities, which are not necessarily banks.

19. A regulatory decision in Brazil to allow limited banking services to be operated on an agency basis by lottery offices and other bank correspondents raised similar issues, but in practice this initiative has worked effectively and has greatly improved access. By 2004 all municipalities in Brazil had some form of banking service, whereas only 29 percent had access to these services in 2000; half of the increase was exclusively attributable to correspondents (Kumar 2005).

20. More generally, the need to make AML-CFT regulations as access-friendly as possible is recognized by specialists in the field (Hernández-Coss and others 2005). To do so requires ensuring that these requirements are risk based and that they therefore do not impose documentation and verification requirements for low-income customers accessing services that have limited scope for abuse. Regulatory authorities need to engage with financial service providers to design services needed by the poor, such as basic bank accounts, in such a way that they can be safely offered without triggering AML-CFT concerns.

21. Early evidence with these separate boards suggests a higher entry and exit rate of listed companies (potentially reflecting the dynamism of the SME sector), but also lower liquidity, as most of the trading is done by institutional investors (Yoo 2007).

22. This is the case not least where regulation is in flux in the advanced economies, as with recent rules on corporate financial information. Low-income countries in particular should not be made guinea pigs for novel and untested regulatory ideas that could impose costs. Assessments being carried out by the World Bank—often in the context of the already mentioned joint World Bank-IMF Financial Sector Assessment Program, and the wider Reports on the Observance of Standards and Codes—of the compliance of individual financial systems with international financial regulations have sought to bear this potential problem in mind.

23. In the United States, there are no such requirements, but the U.S. Treasury has negotiated with a wide range of deposit-taking institutions for the establishment of limited service, low-cost accounts known as electronic transfer accounts (ETAs), into which federal payments such as Social Security can be electronically deposited, even for beneficiaries with poor credit histories (Caskey, Ruiz Duran, and Solo 2006; Claessens 2006). So far, however, only a tiny fraction of the unbanked beneficiaries of federal payments have opened such accounts.

24. For example, arranging for money entering the account to trigger automated, direct debit, bill-payment instructions so that payments cannot be made without money to cover them, a feature still lacking in the basic bank accounts recently introduced in several countries (Collard and Kempson 2005).

25. Competition policy for payments systems is an especially complex issue: new technology for retail payments requires novel theoretical analysis of the resulting two-sided markets involving both merchants and consumers (for an accessible survey, see Evans and Schmalensee 2005). There can be a tension between the desirability of achieving scale and network economies (through cooperation) and keen pricing (through competition). Specialists are still debating optimal competition policy for advanced economies, with practitioners only beginning to look at the issues for developing countries (Guadamillas 2007).

26. While protection of small depositors is important, the design of the financial safety net should minimize moral hazard, thereby reducing risk-shifting behavior from bankers to society at large.

27. Once again these are the responses to the WBES survey. Numerous firm- and country-level controls were included in the regressions, which used a sample of about 2,500 firms in 37 countries, and the likely correlation of errors across firms within countries was carefully taken into account using a clustering technique. The authors also control for each firm's response to financing obstacles generally to ensure that what is being measured as corruption is not just a generalized complaint about lack of access.

28. Indeed, the notion that consumer borrowing decisions are rationally made is undermined by clear evidence from an interesting experiment conducted recently in South Africa by a large consumer lender. Loan offers with randomized interest rates were mailed to some 50,000 customers, along with numerous variants of advertising material. The researchers (Bertrand and others 2005) found that loan demand was sensitive not only to the quoted interest rates but to several of the advertising devices. For example, including a photograph of a woman in the accompanying literature (as opposed to a man) was, in terms of its influence on loan take-up, equivalent to lowering the rate of interest by over 4 percentage points a *month*.

29. Extortionate or predatory behavior is particularly hard to define. In more than 30 years of operation, the U.K. legislation against "extortionate lending" led to only 10 successful claims by borrowers. New legislation enacted in 2006 broadens the criteria by which lending may be found "unfair" and thus illegal (U.K. Department of Trade and Industry 2003).

30. This could happen either by removing the ceiling altogether or by retaining it at a fairly high rate for licensed lenders. In Ireland the annual percentage rate of 200 percent still applies to licensed money lenders (compared with the traditional ceiling of 23 percent for unlicensed lenders). The 200 percent ceiling appears to be constraining at very short maturities for the main lenders in the high-risk market but not for maturities of several months or more (U.K. Competition Commission 2006). Of course much higher interest rates (in the millions of percent per year) have been documented all over the world in illegal or unregulated lending to unfortunate individuals.

31. Such requirements should not be too draconian, as where unfavorable registration on the national credit registry is enough to exclude a borrower from future loans.

32. Using an eight-year bank-level dataset for over 100 countries Micco, Panizza, and Yañez (2007) confirm that state-owned banks in developing countries are less profitable than privately owned banks because of lower margins and higher overhead costs, even after controlling for the dynamics of ownership over time, most notably regarding privatization. The relationship is much weaker in

developed countries. Of special interest is the finding that state-owned banks report higher profits in years of economic expansion compared to privately-owned banks, but they are much less profitable in election years, a result which, because it is driven by differences in net interest margins rather than overhead costs, points to loan losses (or debt forgiveness) in those years.

33. Even the U.S. Community Reinvestment Act may have had little effect, at least in its early years. Introduced in 1977, this law is sometimes pointed to as an example of a well-functioning directed credit program. Banks are rated on their “efforts in determining community credit needs, marketing credit, participating in community development, maintaining branch offices and avoiding discriminatory credit policies” in low-income neighborhoods. But, at least before 1997–98, they were not assessed on whether they actually lent more to target groups. Indeed, Dahl, Evanoff, and Spivey (2000) found that banks whose performance under the law was downgraded did not respond by increasing the share of their lending to target groups.

34. Cole analyzed the allocation of agricultural credit from government-owned banks in India and found a strong suggestion of political influence. Across a sample of 412 districts in 19 Indian states in each year 1992–99, and including 32 elections, he finds that not only did credit increase in election years but the election-year credit surge was greatest in the districts most closely contested. Given that it is state-level governments that appoint members of the coordinating committee for lending practices and policies, political pressure can be coming from different parties in different states even in the same year, a feature of the data that helped pinpoint likely political effects.

35. Using a sample of 22 developing countries with 10 banks from each country over the period 1993–2000, Dinç found that in the months before elections, government-owned banks increase their lending—and the amount of loans restructured or overdue—relative to privately owned banks. This suggests not only politically motivated lending at government-owned banks but also loan forgiveness before elections.

36. Khwaja and Mian analyzed all 112,685 business loan accounts at banks in Pakistan during 1996–2002 and uncovered strong circumstantial evidence of corruption at state-owned banks. The loan files contained the names of the borrowing companies’ directors, which allowed the authors to link them with the names of all of the candidates in the 1993 and 1997 general elections. Fully one-quarter of the candidates were directors of borrowing firms. More important, their firms borrowed more, paid lower interest rates, and defaulted more often (a 24 percent default rate, compared with a 6 percent for others, even after inclusion of firm-level control variables). These effects proved to be entirely attributable to borrowing from state-owned banks—implying sizable fiscal costs as well as the costs from misallocation of investable funds—and they were larger, the more electorally successful the politician. The effects are smaller in districts with a healthier democratic process, as measured by voter turnout.

37. See World Bank (2001) and Hanson (2004) for other reviews of the experience with state-owned banks.

38. For some examples related to financial access, see <http://www.ifc.org/ifcext/sme.nsf/Content/Publications>.

39. Also see Duflo and Kremer (2005) for a discussion of the relative merits of randomized evaluation and competitors such as propensity score testing and the difference-in-difference methods for estimating the partial equilibrium effects on beneficiaries of direct policy interventions.

40. The analysis of credit guarantee schemes displays some similarities and some contrasts with that of deposit insurance schemes (Demirgüç-Kunt and Kane 2002). In both types of schemes, the benefits of expanding access have to be balanced with the moral hazard risk. Perhaps the main difference is that coverage of a credit guarantee scheme can be credibly limited, whereas deposit insurance guarantees tend to be extended to all depositors, especially in a crisis. In addition, pricing and other features of credit guarantees can more easily be made realistically risk-related. For example a sizable degree of coinsurance is the norm with credit guarantees, and coverage can vary. But, as is argued in the text, just as with deposit insurance, success is less likely in poor institutional environments.

41. Curiously, the large, publicly funded SHG-bank linkage program in India, which provides subsidized refinancing (by NABARD) of bank loans to self-help groups, directly benefiting about 14 million households, offers no loan-loss guarantee to the bank.

42. For example, government interventions in every one of the 25 EU member states involve subsidies or fiscal outlays, according to Dorn (2005); 47 EU schemes are reviewed by Gracey (2001).

43. Note, however, that this line of reasoning is more specific than is often portrayed. Depending on the exact nature of project risks and of the information asymmetries between lenders and borrowers, there might even be *more* lending than is socially optimal (DeMeza and Webb 1987; Besley 1994). The successful operation of MFIs that charge high interest rates shows that this problem is not decisive in all markets.

44. Even in the United Kingdom, the stated purpose of the government's Small Firms' Loan Guarantee (SFLG) scheme has been simply the limited, instrumental one of assisting "SMEs who have a viable business plan but lack the collateral necessary to secure the loan that they seek."

45. Even the U.S. Small Business Administration's (SBA) long-established SME guarantee scheme (the so-called section 7a scheme) has been criticized for poor underwriting loss estimates (U.S. General Accounting Office 2001). Curiously,

though, the SBA erred on the conservative side in this matter; its actual underwriting losses turned out to be considerably lower than had been budgeted.

46. The highly regarded Chilean FOGAPE scheme has increased its annual charge to between 1 and 2 percent of the loan amount depending on the claims performance of participating banks; to date, the charges have been sufficient to cover the administrative expenses of the scheme as well as claims (Benavente, Galetovic, and Sanhueza 2006; De la Torre, Gozzi, and Schmukler 2007). Schemes in Malaysia and Thailand have also required very little subsidy over the years. The long-running SBA section 7a program in the United States entails a one-time subsidy of only about 1.3 percent of the value of the guaranteed loans, including provision for calls on the guarantee and operating expenses. The annual subsidy for the Italian SGS system grew to about 1 percent by 2004. Other programs have had higher costs. The charges of between 0.5 and 4 percent of the sum guaranteed by Mexican schemes cover only about half of the operating costs and underwriting losses (Benavides and Huidobro 2005). The very large Korean KCGF charges between 0.5 percent and 2 percent depending on the borrower's credit rating, with an average of just over 1 percent, but this revenue covers only a fifth of the scheme's outlays. Indeed the two major Korean schemes operated at a loss of almost 4 percent a year of the stock of outstanding guarantees in 2001–5 (Shim 2006). Over the years, the (much smaller) U.K. SFLG scheme—which charges an annual 2 percent fee—had experienced defaults on more than one in three of its guaranteed loans, requiring a subsidy amounting in a recent year to 15 percent of gross new guarantees in that year (Graham 2004).

47. One recent attempt to use quantitative information to estimate additivity is Zecchini and Ventura (2006), who compare data on some 4,000 Italian firms eligible for the SGS guarantee scheme and 6,000 controls—firms that were not eligible because of their sector. Estimating a regression equation explaining the level of bank borrowing by firm in terms of the firm's number of employees, sales, tangible and intangible assets, nonbank debt, net worth, and net earnings, they find that, even after taking account of eligibility (using an instrumental variables technique), a firm's use of SGS guarantees is associated with a modestly higher level of bank borrowing (about 10–13 percent). Another econometric effort was made by KPMG Management Consulting (1999), but it looked only at assisted borrowers and did not include a control group.

48. The key natural experiment allowing identification of the effect of subsidized export credit was the removal of one important sector, cotton yarn, from eligibility for subsidy. Apparently the authorities wanted to concentrate available funds on export sectors with higher value added. The cotton yarn sector, which had accounted for over half of the 100,000 individual loans made in the scheme between 1998 and 2003, survived this removal with output and exports almost unaffected. While some smaller, unlisted firms without multiple banking relationships were hit by the change, the larger firms just saw a reduction in their profits. An estimated one-half of the subsidized funds had gone to financially

unconstrained firms that did not need it. Interestingly, it was not systematically the less-productive firms that were hit by the removal of the subsidy.

49. A third form is the wholesale guarantee of, for example, a bond issue by a specialized SME lender, a securitization of the underlying loans, or a block loan to a specialized lender by another intermediary. The Italian SGS provides counterguarantees on a wholesale basis to mutual guarantee associations for bank loans of their members. Accion International has had many years of experience on a cross-country basis in wholesale guarantees of facilities provided to its local affiliates.

50. This can be seen as an application of the increasingly fashionable idea of auctioning a block of subsidy funds to the highest bidder. In finance, the risk that the beneficiary will ultimately default, thereby eventually paying much less than she promised, makes auctioning of rather limited application. It can work in the case at hand, where the block of funds and the subsidy involved is only a small part of the bidder's business.

51. Chinese guarantee funds, some of which are publicly backed but result from regulatory arbitrage, were estimated to cover loans amounting to 2.6 percent of GDP in 2005 (Shim 2006).

52. Sometimes such measures can also be undermined by judicial decisions, as is illustrated by the case of payroll loans in Brazil, which were declared unconstitutional by a court, leading to higher borrowing costs (Costa and de Mello 2006).

53. The study of Braun and Raddatz (2007) provides an excellent example of this. Distinguishing between economic sectors that are more or less likely to favor financial liberalization, the authors were able to show that in countries in which the economic power of the former grew (as a result of trade liberalization), subsequent financial deepening was faster.

54. Specifically, Kroszner and Strahan (1999) examined the removal of restrictions on branch banking. They trace the origin of these restrictions to the interest that 19th century state governments had in creating local banking monopolies that could be taxed. Resistance in the 20th century to deregulation came from the incumbent small banks, and indeed it was the states with many small banks that deregulated last.

55. They constructed an indicator of financial liberalization encompassing credit and interest rate controls, entry barriers, restrictive regulations, government ownership, and restrictions on international financial transactions.

56. From cross-country evidence from 38 countries they find that greater political accountability is associated with higher entry in sectors that are more dependent on external capital and have greater growth opportunities.