

FINANCE FOR ALL?

POLICIES AND PITFALLS IN EXPANDING ACCESS

A WORLD BANK POLICY RESEARCH REPORT

Summary

A new World Bank policy research report (PRR) from the Finance and Private Sector Research team reviews a broad range of research work, completed or in progress, focusing on access to finance.

Entitled "FINANCE FOR ALL? POLICIES AND PITFALLS IN EXPANDING ACCESS," the report

- presents indicators to measure financial access, analyzes its determinants, and evaluates the impact of access on growth, equity, and poverty reduction, drawing on research that uses data both at the firm and household level.*
- discusses the role of government in advancing financial inclusion and these policy recommendations are stressed throughout the report.*

Although much remains to be learned, a significant amount of empirical analysis has been conducted on these issues over the past years. As with any review, taking stock of all this research also allows us to identify the many gaps in our knowledge and helps chart the way for future research.

It has long been recognized that well-functioning financial systems are essential for economic development. And much attention has been paid to the depth and efficiency of financial systems. Promoting broader access to financial services, however, has received much less attention, despite the emphasis it has received in theory.

Without inclusive financial systems, poor individuals and small enterprises have to rely on their own resources to invest in education or take advantage of promising growth opportunities. Financial sector policies that encourage competition, provide the right incentives to individuals, and help overcome access barriers are thus central not only to stability but also to growth, poverty reduction, and more equitable distribution of resources and capacities.

The access dimension of financial development has often been overlooked mostly because of serious data gaps: researchers have only recently started to systematically collect data on access to and use of financial services across countries.

The first step in improving access is measuring it

While data on financial sector depth – aggregate credit, stock market liquidity, etc. – are readily available, data on access to and use of financial services, especially on the

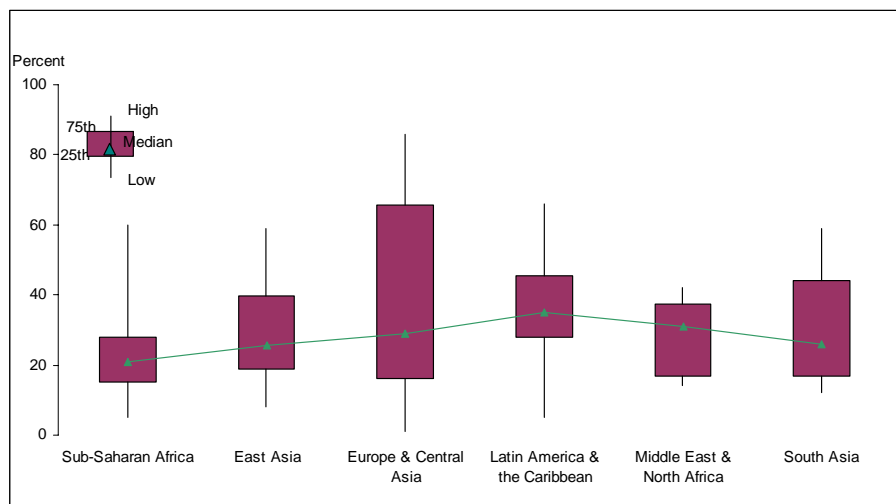
household level are wanting, partly because of the cost of such data collection, partly because of methodological hurdles.

In the absence of micro-data, researchers have sought to create synthetic headline indicators, combining more readily available data on the number of deposit or loan accounts with the results of a few existing household surveys.

These headline indicators reveal a large variation in the use of financial services: almost all households use finance in many Continental European countries, but on average fewer than one in three households do in most of the developing world (see figure 1).

Financial exclusion thus affects not only the poor, but also large proportion of the non-poor population in many developing countries.

Figure 1: Proportion of households with an account in a financial institution



Source: World Bank (2007).

In addition to measuring finance, it is important to identify the barriers that prevent small firms and households in many developing countries from using financial services. These include:

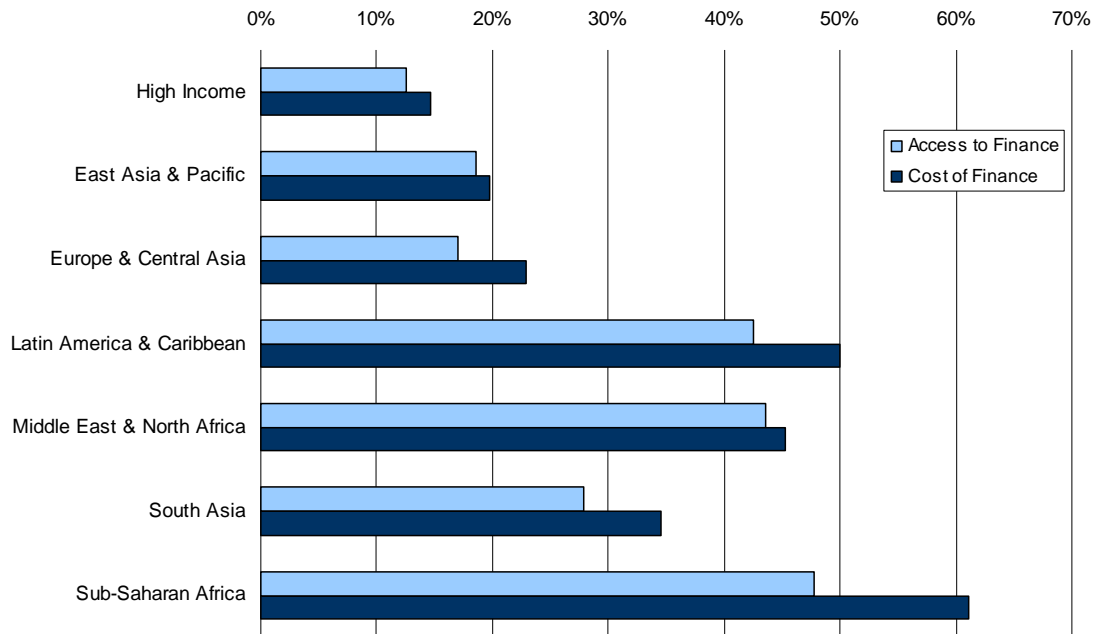
- Physical access to the nearest branch or bank outlet.
- a lack of proper documentation, such as identification, pay-slip or proof of residence.
- high minimum account balances and annual fees to open and maintain checking and savings accounts

Access to finance can promote new firm entry, growth and innovation

There is a greater availability of survey data for firms, and entrepreneurs in developing countries often list lack of access to finance as a major obstacle to their growth (Figure 2).

Data also indicate that less than 20 percent of small firms use external finance, about half the rate of large firms.

Figure 2: Percent of firms reporting finance as a problem



Source: Investment Climate Survey (ICS) responses by enterprises in 76 countries, grouped by region.
 Note : The figure shows the percentage of firms reporting access to finance or cost of finance as a severe or major obstacle to firm growth.

Recent research using detailed firm-level data and survey information has documented that access to finance favorably affects firm performance along a number of different dimensions:

- (i) Access to formal financial services can reduce financing constraints especially for small firms and others who have difficulty in self-financing, such as start-ups.
- (ii) Financial inclusion helps incumbent firms grow to their optimal size by exploiting investment opportunities.
- (iii) Access to finance can help firms finance both product and process innovations.
- (iv) Access to finance enables firms to choose more efficient organizational forms, such as incorporation, and more efficient asset portfolios.

Access to bank finance is typically the major source of external finance for firms of all sizes. Modern transactional lending trends suggest that improvements in the availability of information (for example through the development of credit registries) and technological advances in analyzing this information are likely to increase access for small enterprises. Provided the legal and regulatory frameworks are in place, asset-based lending techniques, such as leasing and factoring, can also help small firms gain access to external finance. However, relationship lending will remain important in environments with weak infrastructures.

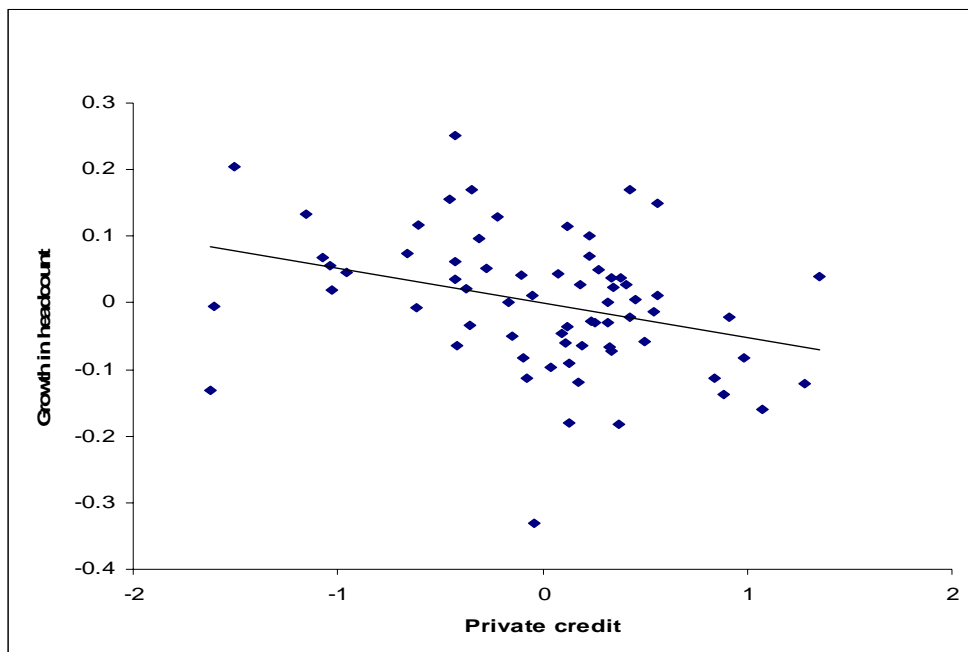
Evaluating impact of access to finance for households

Recent evidence suggests that finance is not only pro-growth, but also pro-poor. Countries with better developed financial systems experience faster reductions in income inequality and poverty (see Figure 3).

What are the channels through which finance impacts the poor? Existing evidence suggests that indirect second-round effects through more efficient product and labor markets might be more important effects of access to credit. Hence improving financial access in a way that most benefits the poor requires a strategy for inclusion that goes well beyond credit for poor households: it is important to broaden the focus of attention to improving access for *all* who are excluded.

Fostering more efficient capital allocation through competitive and open financial markets still remains an important policy goal both for growth and poverty reduction.

Figure 2: Finance and Poverty Reduction



Source: Beck, Demirguc-Kunt and Levine (2007).

Note: This figure is a partial scatter plot of growth of poverty headcount v. private credit to GDP, controlling for the initial level of poverty headcount, with data averaged over the period 1980-2005.

The provision of better financial access to the excluded nonpoor micro- and small entrepreneurs can have an especially favorable indirect effect on the poor. But that is not to say improvements in the direct access for the poor should be neglected. The benefits there may be more modest in the long run, but nevertheless immediate.

High transaction costs and lack of collateral are two important barriers for the poor to access credit services. A new wave of specialized microfinance institutions serving the poor has tried to overcome these problems in innovative ways, such as with group lending schemes and bigger loan sizes, as customers continue to borrow and repay on time.

Although the effectiveness of these and other innovations is still being debated, over the past few decades, microfinance institutions have managed to reach millions of clients and achieved impressive repayment rates. Indeed, mainstream banks have begun to adopt some of these techniques and to enter some of the same markets.

But has microfinance been able to meet its promise of reducing poverty without requiring continuous subsidies? While many heartening case studies are cited – from the villages of Thailand to the Peruvian Andes – it is still unclear how big an impact microfinance has had on poverty overall. Despite product and technological improvements, the institutions that serve the poorest still remain grant and subsidy dependent, pointing to a trade-off between profitability and serving the very poor.

Although the attention of microfinance has traditionally focused on the provision of credit for the very poor entrepreneurs, much of micro-credit is used for consumption rather than investment. How credit is used is of paramount concern. For poor households, credit might not be the only or the priority financial service; good savings, payments (including international remittances) and insurance services may rank higher. For example, one of the reasons why poor people do not save in financial assets might be the lack of appropriate savings products, with consumption credit being a second-best solution.

Should financial services for the poor be subsidized? Answering this question requires comparing costs and benefits of subsidies in the financial sector with subsidies in other areas such as education or infrastructure. Compared to credit subsidies, there is likely to be a stronger case for subsidizing payment and savings services, since these are basic services necessary for participation in a modern market economy.

People are sometimes less likely to repay a credit when subsidies are involved. Because of this, encouraging technological innovation and taking advantage of technological advances, which are becoming more widespread in the era of globalization, may be more promising.

Policies to broaden access

Since expanding access remains an important challenge even in developed economies, it is not enough to say that the market will provide. Market failures relating to information gaps, the need for coordination on collective action and concentration of power mean that governments across the world have an important role to play in building inclusive financial systems.

However, not all government action is equally effective and some policies—such as overly relaxed credit policies—can even be counterproductive. Hence it is important for governments to have *realistic goals*.

Deep institutional reform ensuring, above all, security of property rights against expropriation by the state is an underlying, albeit often long-term, prerequisite for well-functioning financial systems. Can we *prioritize institutional reforms* to broaden access in the short to medium term? Recent evidence suggests that

- In low income countries, establishing credit registries to improve the information infrastructure matters more than improving creditor rights.
- In relatively underdeveloped institutional settings, reforms that enable an individual lender to recover on debt contracts (for example, those related to collateral) are more important in boosting bank lending than reforms related to resolving conflicts between multiple claimants, such as bankruptcy codes.
- Introducing specific legislation to underpin modern financial technology, from leasing and factoring, to electronic-finance and mobile-finance—will also produce results in the short- to medium-term.

Encouraging openness and competition – including private ownership and foreign entry - is also an essential part of broadening access, as it encourages incumbent institutions to seek out profitable ways of providing services to the previously excluded segments of the population. It also increases the speed with which access-improving new technologies are adopted.

Providing the private sector with the right incentives is important, as competition can also result in reckless or improper expansion if not accompanied by proper regulatory and supervisory framework. As the increasingly complex international regulations—such as Basel II—are imposed on banks to help minimize the risk of costly bank failures, it is important to ensure that these arrangements do not inadvertently penalize small borrowers by failing to make full allowance for the potential for a portfolio of SME loans to achieve risk-pooling.

Research suggests that while banks making small loans have to set aside larger *provisions* against the higher expected loan losses from small loans – and therefore they need to charge higher rates of interest to cover these provisions – they should need relatively less *capital* to cover the upper tail of the distribution, i.e. to support the risk that losses will exceed their expected value (to cover what are sometimes known as “unexpected” loan losses).

The scope for direct government interventions in improving access is more limited than often believed. While there is a large body of evidence that suggests interventions through government-owned subsidiaries to provide credit have generally not been successful, the experience has been more mixed for non-lending services.

Further, a handful of government financial institutions have moved away from credit, and evolved into providers of more complex financial services, entering into public-private partnerships to help overcome coordination failures, first-mover disincentives, and obstacles to risk sharing and distribution. Ultimately, these successful initiatives could have been undertaken by private capital, but the state has had a useful role in jump-starting these services.

Direct intervention through taxes and subsidies can be effective in certain circumstances, but experience suggests that they are more likely to have large unintended consequences, more so in finance than in other sectors. For example, with direct and directed lending programs discredited in recent years, partial credit guarantees have been the direct intervention mechanism of choice for SME credit activists. However, these are often poorly structured, embody hidden subsidies, and benefit mainly those who do not need the subsidy. In the absence of thorough economic evaluations of most schemes, their net effect in cost-benefit terms thus remains unclear.

Looking forward

While this report reviews and highlights a large body of research, it also identifies many gaps in our knowledge.

- Much more research is needed to measure and track access to financial services, to evaluate its impact on development outcomes, and to design and evaluate policy interventions.
- Building data sets on access to finance that benchmark countries annually would help focus policymakers' attention and allow us to track and evaluate reform efforts to broaden access.
- Better data on the firm and household level are important in improving our understanding of the impact of access. Indeed, household surveys are often the only way to get detailed information on who uses which financial services from which types of institutions, including informal ones.

In evaluating impact, randomized field experiments are promising. By introducing a random component to assignment of financial products, such as financial literacy training or random variation in the terms or availability of credit to micro-entrepreneurs and households, such research can illustrate how removing barriers and improving access affects growth and household welfare.

Finally, careful evaluations of direct interventions would also help improve design of policies to build more inclusive financial systems.