THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

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Workshop Report
PROMOTING FINANCIAL INCLUSION THROUGH INNOVATIVE POLICIES
[First Draft]

Alliance for Financial Inclusion / Advisory Group

A WORKSHOP JOINTLY ORGANIZED BY
THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING
THE APEC BUSINESS ADVISORY COUNCIL
THE ASIAN DEVELOPMENT BANK INSTITUTE
THE ALLIANCE FOR FINANCIAL INCLUSION

IN COLLABORATION WITH THE FOUNDATION FOR DEVELOPMENT COOPERATION, THE INTER-AMERICAN DEVELOPMENT BANK AND THE INTERNATIONAL FINANCE CORPORATION

PROMOTING FINANCIAL INCLUSION THROUGH INNOVATIVE POLICIES

31 March – 3 April 2009
Asian Development Bank Institute
Tokyo, Japan

Tuesday, 31 March 2009

OPENING SESSION

Session Chair:
Mr Worapot Manupipatpong, *Director Capacity-Building and Training, Asian Development Bank Institute*

Welcome Remarks

Mr. Yoshihiro Watanabe, Chair, ABAC Finance and Economics Working Group and Managing Director, Institute for International Monetary Affairs.

After words of welcome from Mr Worapot, Mr. Watanabe acknowledged the organisers of the workshop. He introduced participants to the work of the APEC Business Advisory Council, its monitoring of the current financial crisis and economic recession, and its periodic communications on the subject to APEC Economic Leaders. Mr Watanabe noted that financial inclusion is an important part of ABAC's current agenda, the more so because of the effect of the crisis in diminishing the flow of capital to developing economies, with consequent negative consequences for the poor. He compared microfinance lending favourably with 'the widespread irresponsible lending that created the subprime mortgage crisis. Microfinance, by contrast, has 'tremendous potential to promote social equity and broad-based economic growth', a potential that will be realised with the assistance of innovation and technology. For this reason, leaders in policy reform in a wide range of countries have been invited to attend this workshop. Apart from immediate measures to ameliorate the consequences of current economic difficulties, ABAC sees the need for medium- and long-term measures to ensure stable and sustained growth in the Asia-Pacific region. Financial inclusion should be part of such a longer-term agenda.

Opening Remarks
Mr. Gempachiro Aihara, *Co-Chair, APEC Business Advisory Council (ABAC) and Counselor, Mitsui & Co., Ltd.*

Mr Aihara briefly sketched out ABAC's current concerns across the spectrum of economic issues, describing the global situation as the worst in ABAC's experience. Financial inclusion has an important role in ABAC's broader agenda of financial sector issues. Giving it greater prominence will validate ABAC's view that enterprise is the key to regional prosperity.

Dr. Twatchai Yongkittikul, *Co-Chair, Advisory Group on APEC Financial System Capacity-Building; Co-Chair, ABAC Finance Working Group and Secretary-General, Thai Bankers' Association*

Dr Twatchai remarked that capacity-building to develop financial markets and systems is very important, especially in the face of their globalisation. In that context, financial inclusion enables

greater economic opportunity and equity, providing appropriate regulatory and policy environments are put in place. ABAC's Advisory Group on Financial Sector Capacity-Building has been active in this field since 2003. The current workshop is an outcome of an Advisory Group meeting in Jakarta in January 2008 (the report of which is circulated at this meeting) and the group will pursue the matter further at a meeting of central bank regulators to be conducted in Hanoi in July 2009.

Dr. Alfred Hannig, *Executive Director, Alliance for Financial Inclusion*

Dr Hannig informed participants of the broad-ranging nature of this workshop, both in terms of the backgrounds of contributors and their geographic spread. Particularly notable were representatives of some countries beyond the Asia-Pacific region, chosen because of the example they present of 'South-South' collaboration in the field of policy and regulation. Thus Bolivia and Uganda are represented because of their track record of fruitful cooperation, with Bolivia having provided sustained technical assistance to Uganda, with such success that Uganda is now itself a 'champion' of microfinance well beyond its own boundaries. In fact, less developed countries have developed and pioneered many 'solutions' to particular problems in providing sustainable financial services to the excluded.

Dr Hannig gave participants an overview of the agenda and scope of the Alliance for Financial Inclusion (AFI), which is particularly concerned to facilitate 'South-South' collaboration and technical exchange of the type exemplified by Uganda and Bolivia. AFI is to be a network, commencing with the recruitment of central banks and ministries of finance and widening its membership over time. It was unexpected that AFI should have commenced operating under such disturbed world economic conditions, but these conditions increase the importance of its work.

Keynote Address

Mr. Nobumitsu Hayashi, *Deputy Vice Minister for International Affairs, Ministry of Finance, Government of Japan*

Mr Hayashi expressed his pleasure at the opportunity to address this audience, some of whose members he described as representing an 'innocent' financial sector. This 'innocent sector' contrasts sharply with an 'overblown financial sector [which] has not only collapsed itself into a crisis, but dragged the world economy into the most severe recession in decades'. He described the two current and correlated problems of credit and demand which must be solved, how much we know about solutions, and how limitations of fiscal resources and political capital stand in the way.

Since the Asian crisis of 1997, arrangements of mutual financial cooperation and support have been building among the economies of East and Southeast Asia and APEC has played a role in securing these. Deputy Vice Minister Hayashi noted that 'in the APEC Finance Ministers' process in particular, there have been made important discussions on building more efficient and durable money and capital markets in order to support sustained economic growth and to heighten the resilience against the possible financial strain'. However the emerging economies 'cannot hope to have a solidly and stably based economic growth unless the capital markets and the banking sector are accessible to every part of their society. Only such accessibility will insure more business chances, broaden development opportunities, and bring about sustained economic growth'. Hence it is unfortunate to see that a majority of populations in many Asian countries are not provided with access to financial services.

In consequence, 'we have to seriously consider ways to widen financial inclusion, where microfinance has emerged as a promising tool, as it bridges the needs and opportunities at the base of the economic pyramid with the resources and appetites of the banking sector and capital markets'. In relation to the task of the workshop, Mr Hayashi said that 'the challenge before us is to foster better environment for further popularization of microfinance. The six key areas have been identified by the ABAC and they will be discussed in the workshop to facilitate the necessary policy reforms'. He added that 'the workshop can also make an important feedback on promotion of microfinance to the APEC process, especially to its Finance Ministers' Meeting, where microfinance is not at all a new issue. Back in 2002, when Mexico chaired the APEC meetings, microfinance and

SMEs was taken up as an agenda. But microfinance has developed tremendously since then and we see the need to renew our discussion'.

Despite our current preoccupation with crisis, 'it is high time that the world community stand up together for truly global causes, especially to alleviate and safeguard the most affected, those who gained little from globalization but [were] thrown to poverty in the economic downturn'. Noting that 'APEC Finance Ministers have discussed above all on how to foster capital market development' he expressed the view that 'microfinance has a potential to enrich capital markets and broaden the base of economic developments' among APEC economies. Mr Hayashi challenged participants to ensure that 2009 would not be remembered simply as a year of crisis, but also a fruitful year in the development of financial inclusion and microfinance.

SESSION ONE

OVERVIEW

Questions and issues explored during this session included:

- Recent developments in microfinance and their implications on policies and the role of government in promoting financial inclusion.
- Challenges in identifying appropriate financial inclusion policies and policy tools to facilitate access to finance.
- Lessons from successful experiences in developing economies, particularly in Latin America.
- The development of micro-remittance, its potential for benefiting migrant workers in the Asia-Pacific and policy implications.
- Possible roles that APEC can play in promoting financial inclusion in the Asia-Pacific region.

Session Chair:
Mr. Yoshihiro Watanabe, *Chair, ABAC Finance and Economics Working Group; Advisor, The Bank of Tokyo-Mitsubishi UFJ, Ltd.; and Managing Director, Institute for International Monetary Affairs*

Financial Inclusion: An Overview of Issues
Dr. Alfred Hannig, *Executive Director, Alliance for Financial Inclusion*

Dr Hannig commenced by offering insights into the close correlation existing between access to finance and GNI per capita across the globe and the scale of the problem of financial exclusion worldwide. He noted the wide geographic spread of the problem and the existence of three major obstacles to its solution. First, local efforts to counter financial exclusion have thrown up a range of innovative solutions in widely dispersed countries in the 'Global South'. These have occurred, for example, in countries such as Mexico, Peru, Bolivia and Brazil (in the Americas) Kenya, South Africa and Uganda (on the African continent) and in India, Indonesia, Malaysia and the Philippines (in Asia). However this scattering of knowledge in pockets around the globe poses the challenge of disseminating useful information. This situation suggests that facilitating 'South-South' collaboration and information exchange will be a positive contribution to achieving global financial inclusion. AFI has adopted South-South cooperation as a major plank in its operations.

Secondly, policymakers in countries suffering significant exclusion face a bewildering choice of potential development partners. The choice of partners has crucial implications for the path to be followed. Thirdly, there is still a lack of evidence concerning crucial questions asked by policymakers: What works and what does not? How are solutions put into action? How effective are the solutions, and who benefits? Do we have the data to judge impacts? How can the political economy of particular situations be managed, apart from the choice of technical and managerial solutions? How best can learnings and policy insights be exchanged, and how can genuine and effective 'South-South' collaboration occur?

AFI has identified six key policy areas that appear to offer the best prospects for answering such questions. These are: (1) agent banking, (2) mobile phone banking, (3) diversification of savings and insurance providers, (4) the reform of public banks, (5) financial identity development for low-income clients, and (6) consumer protection in financial services. It has recruited 15 partners (mostly official agencies so far) and is actively expanding this membership. These six areas of reform and action, which have been adopted by ABAC as the themes for its work in this area, provide a template for work programs aimed at systematic and sustainable improvements in financial inclusion. Among the earliest work to be supported by AFI under this framework will be an action research project on creating financial identities for the poor in Indonesia, to be conducted by that country's central bank. Dr Hannig concluded by appealing for support from participants and their organisations for AFI's work program and for constructive suggestions as to its directions and activities.

Microfinance: The Latin American Experience

Ms. Sandra H. Darville, *Senior Investment Officer, Multilateral Investment Fund, Inter-American Development Bank*

Work done by IDB suggests that there are some 70 million 'enterprises' in Latin America and the Caribbean, that there is a 'funding gap' of perhaps $250 billion, representing the unmet demand for financial services of enterprises, and that this market, while underserved, is in no sense a 'subprime' sector. IDB is active in providing technical assistance to the sector and a range of funding sources and instruments, together with direct equity investment and the creation of a variety of investment vehicles.

While projects for urban micro-enterprise finance, relying on grants and soft loans, date back to the 1970s, private commercial banks have long since entered the market and provided a growing share of micro-financial services. Regulated institutions account for some 70% of loan portfolio across the region. These include significant lending 'downscaled' banking operations as well as by 'upgraded' MFIs and 'greenfield' operations created specifically for the sector. Latin American microfinance is the most profitable, the fastest-growing and the least risky of all world microfinance sectors. It is also, in general, well-integrated with domestic financial sectors. Under current conditions, where foreign sources of funding have diminished, microfinance institutions that are well-connected locally are faring relatively well.

The maturity of the sector is shown by the fact that 31 of the top 100 world MFIs, rated on criteria of outreach, efficiency and transparency, are in the region. Meanwhile, based on criteria such as regulatory environment, investment climate and institutional development, there are substantial inter-country variations in performance within the region. Nonetheless in almost all countries bankers report higher returns on microfinance portfolios than on their more conventional portfolios, while industry associations acknowledge the evolution of microfinance and SME lending as mainstream banking products. The interest of commercial bankers has been stimulated by these products' relatively good performance in adverse economic conditions, pressure on bank profits from competition in other segments, and the diversification of portfolio risk and greater utilisation of banking capacity that is possible. Surveys suggest that 70% of commercial banks in the region expect to become involved in the sector within the short- to medium-term (compared with 30% at present).

Meanwhile the international financial crisis has had some impacts, including reduced access to external credit lines, higher funding costs and reduced margins, some portfolio deterioration, greater focus on existing clients and greater attention to domestic deposit mobilisation. Micro-enterprise clients in turn face higher interest rates and stricter criteria, shorter loan terms, lower loan amounts and a more limited supply of financial services. The IDB has been able to assist some MFIs by providing access to an 'Emergency Liquidity Facility' (ELF) set up some years ago to support institutions suffering problems due to external shocks.

The Need for an Inclusive Financial Infrastructure -- Challenges for Japan in the Coming Years
Mr. Hideo Kazusa, *General Manager, Transaction Services Division, Bank of Tokyo-Mitsubishi UFJ, Ltd. and Board Member, Society for Worldwide Interbank Financial Telecommunication (SWIFT)*

Mr Kazusa noted that Japan is a 'world leader' in terms of the demographic challenge arising from the aging and decline of its working age population. This has strong implications for labour supply and the demand for foreign workers. Thus, from a dependency ratio of 3.0 (population over 65 as a proportion of population 20-64) in 2005, Japan will move to ratios of 1.7 in 2030 and 1.2 in 2055. So far, migrant workers have been concentrated in the manufacturing sector, enjoy limited employment mobility within Japan and return home after completion of their engagements. The numbers of 'legitimate' migrants and their families are still relatively small (2.0 m in 2005 in a total population of 120m, or less than 2%, as compared with 10% in Germany) although the implication is that these numbers must increase.

Foreign workers in Japan were responsible for some Yen 400bn in officially recorded remittances (approx. $4bn) in 2007. However estimates of the total (including remittances sent via unofficial channels) are as high as a trillion yen (say, $10bn) suggesting a massive gap between the services provided by authorised financial institutions (which until this year have been limited to commercial banks) and the real requirements of remitters. Migrant workers are inadequately provided with other financial services during their residence in Japan. For example, consumer loans, insurance and investment options for them and their resident family members are ill-developed and expensive. Further, there is a lack of services that would enable Japanese resident workers to manage their financial affairs back home.

These deficiencies will only become more glaring in future, as the numbers of affected workers increase, unless the Japanese financial system can meet the challenge of providing the needed services. While it is evident that commercial banks alone cannot bridge the gap, the banks themselves must recognise resident foreigners as a market segment, overcome language and information issues, and develop relationships with correspondent banks and new non-bank partners to serve this segment. From 2009, payments services may be provided by non-bank service providers and a variety of remittance service-providers are being permitted to operate. Japanese banks are in need of partners able to provide links to the many foreign recipients who do not have bank accounts. While legislation may seek to remove barriers, administrative impediments may still occur. These may arise from official concerns regarding 'AML/KYC' considerations, the need for 100% security of funds transmitted and the verification of identity in accordance with GoJ standards. The approach taken to such issues may impose layers of expense and complexity to new procedures intended to facilitate transmission of remittances. It will be important for authorities to keep such issues under review to assure the financial inclusion of Japan's migrant worker population.

Report of the ABAC/Advisory Group Workshop on Commercially Sustainable Microfinance: A Strategy for Promoting Financial Inclusion in APEC
Dr. Julius Caesar Parreñas, *Coordinator, Advisory Group on APEC Financial System Capacity-Building and Senior Advisor, Chinatrust Financial Holding Co., Ltd.*

In this presentation, I would like to summarize the outcomes of a workshop that we held last year in Jakarta. Financial inclusion is an important issue for APEC. In our own region, huge portions of the population in developing economies do not have access to financial services. But at the same time, this also presents an opportunity, given the benefits to the financial sector, the economy and society that can be realized, if these huge numbers of people can be brought into the economic mainstream and become regular consumers of financial services. Microfinance has attracted growing attention as a tool to make this happen with its ability to reach the financially excluded.

In 2002, under the Mexican chairmanship, APEC undertook a major initiative on microfinance. Being an advisory group to APEC Leaders, ABAC was called upon to give its views. At that time, ABAC made four recommendations. The first was that APEC promote an environment conducive to the development of micro-enterprises and MFIs. Second, ABAC proposed that policy reforms be accompanied by capacity-building measures, supported by multilateral financial institutions. Third, ABAC called on commercial institutions to support lending to microfinance. ABAC was keen to emphasize that whenever

done as part of commercial lending, it should be based on commercial principles. Finally, ABAC called for appropriate regulations for bank lending to MFIs.

Unfortunately, there was little further work undertaken in APEC after that, until last year when ABAC decided to revisit the issue. Let me dwell on the developments that have changed the landscape of financial inclusion in the intervening years. Over the previous half-decade, microfinance has grown significantly, expanding its client base and its linkages to banking systems and capital markets. This rapid transformation has changed many people's views about the commercial viability of microfinance. This reassessment focuses on several characteristics that define microfinance today.

First, microfinance has proven to be profitable. During the past few years, a growing number of MFIs have become regulated deposit-taking institutions. Measured by return on assets, these institutions have outperformed the commercial banking sector in much of the developing world. Second, microfinance has become very attractive. Commercial banks use a wide range of options to engage in microfinance: front and back office functions, wholesale lending, equity, and loan service companies, in addition to specializing in microfinance. Microfinance investment vehicles began to attract a growing number of investors, offering geographic diversification with low volatility, low correlation and high asset quality.

Third, the scope of microfinance has considerably expanded. MFIs now offer a wide range of services, such as consumer and housing loans, savings accounts, life and health insurance, utility bills payments and international money transfers. Behind this transformation lie a number of key factors –technology, innovation, evolution, and policy reforms. MFIs have been quick to take advantage of IT connectivity, ATM, point-of-sale and mobile technology, smart cards and biometric information to reach a wider clientele. Today, clients can access financing through loan service agents, lottery agents, traders and processors, point-of sale networks including retail stores, ATMs and mobile phones. MFIs are evolving from their early origins to become licensed financial institutions that are now serving as bridges between large investors and low-income borrowers. And finally, policymakers now realize that an enabling environment is more effective than government credit and guarantee programs in promoting commercially sustainable microfinance.

There has been a growing realization that government's role should be to address legal, policy and regulatory barriers in order to facilitate the development of microfinance and increase its access to commercial funds. Progress toward financial inclusion can be accelerated by identifying the most critical policy solutions. Last year, we considered the study by GTZ on alternative policy measures to promote financial inclusion. We eventually agreed to endorse the six policy solutions that we have chosen to discuss in greater detail in this workshop.

I mentioned earlier that an attempt was made in 2002 to tackle microfinance as part of APEC's agenda. In our view, this did not succeed because microfinance was not treated as a policy tool to address financial exclusion. It was seen at that time primarily as a social welfare measure to address the issue of poverty. Consequently, it did not attract the right audience and the right expertise that would have helped address the key issues. It also struggled unsuccessfully to fit into the SME development agenda, which required a totally different approach. We do believe, however, that the time has now come to give microfinance a fresh start in APEC, as a tool for promoting financial inclusion and as part of the Finance Ministers' agenda.

Finally, let me go over our recommendations. First, as mentioned before, APEC should promote financial inclusion by incorporating it in its agenda. On account of financial inclusion being a central task of financial sector development, and the role that financial regulation and financial institutions would have to play in this process, its appropriate place should be within the APEC Finance Ministers' Process. Second, an APEC financial inclusion initiative should focus on providing an enabling legal, policy and regulatory environment. We suggest that this initiative include a research component, policy dialogue, sharing of experiences, and capacity-building activities. Finally, private sector collaboration is important for the successful design and implementation of critical measures.

ABAC has offered to work with APEC finance officials to realize this initiative. Through the Advisory Group, ABAC is also inviting interested institutions to join in this collaboration. We are very pleased that this invitation was immediately taken up by a number of institutions. This workshop is the first fruit of

that growing cooperation, and judging by the quality of participants, I think we could say that we are off to a very good start. Going forward, we hope that APEC finance officials will work with us to design a regional initiative that will add value to both global and domestic efforts, and we hope that we could count on your continued cooperation as this initiative unfolds.

SESSION TWO

BEYOND BRANCHES: AGENT BANKING AND FINANCIAL INCLUSION

Questions and issues explored during this session included:

- Incorporating agent banking into policy and supervisory frameworks, such as rules regarding deposit taking, branching, cash handling, outsourcing, customer due diligence, and consumer protection.
- Using agents to increase the functionality of mainstream bank accounts.
- Expanding the range of agent services beyond pure payments.
- Optimal contracts between banks and agents; risk-sharing arrangements between agents and banks that balance safety and service expansion.
- Cooperation and communication between public and private partners.

Session Chair:
Mr. Hiroshi Toyoda, *Special Advisor for Asia, Inter-American Development Bank (IDB)*

Introduction by the Session Chair

Opening the session, Mr Toyoda remarked on the current grim world economic outlook and the negative impact of this on MFIs whose growth has been fuelled by cross-border capital flows. However he saw promise in the possibility that domestic banks may be energised to mobilise local deposits, including from the poor, in reaction to this situation. In this context, the discussion of agent banking is of particular relevance as a means of extending services more widely.

Agent Banking: Overview of Developments and Policy and Regulatory Issues
Mr. Ernesto Aguirre*, Financial System Advisor, CGAP and Former Superintendent of Banks of the Republic of Colombia*

Mr Aguirre stated his concern as determining the essential elements to be put in place to achieve agent banking networks in national economies. This must involve moving beyond the frontiers of traditional banking to achieve higher levels of 'bancarisation' among excluded populations. However if banks attempt outreach by establishing 'light' branches (that is small, and offering a limited range of services) they may incur high operating costs, as well as reputational risk associated with inability to honour commitments, perhaps due to cash handling and other difficulties. Conducting microfinance is quite expensive enough without such extra costs.

Banks may prefer instead to externalise these costs and risks by appointing agents. But the outsourcing of bank functions may be forbidden in some jurisdictions or at least lack a clear legal framework. This applies particularly to the acceptance of deposits. It may be desirable for the regulation and practice of agent banking to be developed in stages, with deposit-taking allowed eventually. Without being permitted to go this far, 'bancarisation' will be limited to payments services. Consequently, preliminary analysis is necessary to establish whether a legal basis exists for full agent banking, quite apart from determining whether the business case for it exists. Whether the business case can be established depends on the circumstances of each country and should not be taken for granted.

Permitted agency operations should be as wide as possible, to offset cash balances and minimise cash-handling and associated risk. Technologies employed should be appropriate to the agency role while safety arrangements should be adequate, but realistic in terms of conditions in the field. Regulations should be non-prescriptive though comprehensive, covering essential elements in the principal/agent relationship. 'Tiered' relationships may offer administrative advantages to banks, with an intermediate level of agents or 'administrators' inserted to deal with retail agents. However, while costs may be externalised by agency and tier relationships, in the final analysis the bank, as principal, is responsible to clients for the integrity of systems and the handling of their cash.

In regard to ML/CTF issues, the applicable regulations must be adapted to the circumstances of bank agencies with limited financial and technical capabilities and must keep in mind the very weak position of the bulk of clients who lack financial literacy. Limits on transactions and balances should be realistic and financial ID requirements should be flexible. Achieving appropriate transparency, accountability and customer protection will require a regulatory framework that represents the constructive interaction of public and private sector interests. Effective systems for receiving complaints, resolving problems and redressing grievances are necessary, while improving the financial literacy of affected populations is the underlying need. Competition issues must also be addressed.

Branchless banking models may be devised for both banks and non-banks. Technologies including M-banking and POS devices and plastic cards are available; the essential requirement of technology is that it should permit data to be transmitted safely and cheaply, allowing branchless banking to be conducted within acceptable margins of risk. Regulation should be 'proportional', facilitating progress towards profitable operation and permitting innovation. It should also be 'balanced', that is, resulting from co-ordination between all relevant authorities. It is the responsibility of the private sector to make the business case; without that branchless banking simply will not fly.

Agent Banking: Case Study from Russia

Mr. Mikhail Mamuta, *President, Russian Microfinance Center*

Russia is a huge country in physical terms and at the end of the Soviet era it was left with underdeveloped banking infrastructure. It now has about 45% of population either unbanked or underbanked, with wide regional variations in coverage. The crisis has shown the banking system to be excessively reliant on foreign funding and to have neglected domestic savings mobilisation. It has also resulted in substantial branch closures. While agency facilities are widely spread, there are great disparities in the availability of services. For example, agencies cannot take deposits and while perhaps 95% of the population have access to remittance and settlement services (largely via agencies) very low proportions have access to time deposits or consumer and mortgage loans.

A wide range of agency services are available: these include both bank and non-bank models, with services offered including payments and transfers as well as disbursements and repayments. In terms of modes of service, there are B2P services (using terminals), B2P services (collectors, credit brokers, credit cards distributed via the postal service), P2P (money transfers, including via post offices) and G2P (cards for social entitlements, pension payments via post offices). ATMs and terminals sit in bank branches, while banks maintain POS networks. Payments are made and received via post offices in a non-bank environment, while payment acceptance points are found in both bank and non-bank environments. Web-based payments facilities are set up by non-banks while bank-based 'mobile wallets' are provided by mobile phone operators. The Russian postal service is a legacy of the Soviet era which is now greatly underused, but plans are in train for its revival as a medium for financial services. For other service providers the very lack of regulation in Russia encourages innovation, although coverage is still very uneven and the range of services presently available is limited. Since 2003 both banks and non-banks have expanded the availability of a simple and inexpensive 'cash-in, cash-out' terminal which marks an advance over physical agents in terms of quality and convenience of service.

The legal framework for agency transactions is a patchwork of laws and regulations derived from the banking act, the postal law, the civil code and central bank regulations. The boundary between banking, post, agent and communication services has become blurred with the advent of e-money. Many legal restrictions and barriers exist to the flexibility of agency transactions. These include inflexible application of identification rules even for small payments, blurred division of responsibilities between banks and agents, inability of individuals to use electronic signatures, absence of a legal definition of e-money and vague and incomplete provision for consumer protection (as well as for agents).

New initiatives in legislation for and regulation of branchless banking are in preparation, however, and need to address a number of 'open questions'. These include transparency of pricing, how and to whom complaints should be directed, issues raised by the use of 'surrogate e-money', the lack of a single authority to regulate agency services and uniform national treatment of payments services. Finally, there

is the question of whether policy or the market is the catalyst for change and innovation. Policy has lagged behind market innovation in the case of payment terminals, collection services and consumer credit; government has had to accept these developments and regulate accordingly. By contrast, policy has led the market in providing privacy and consumer protection safeguards (as for example in the Credit Bureau law of 2004).

Brief Commentaries:

Mr. Raul Hernandez-Coss, *Director General for Access to Finance, National Banking and Securities Commission (Mexico)*

Sr. Hernandez-Coss provided an overview of the operations of agent banking in Mexico, which has an overall financial inclusion rate of 25% with low penetration and narrow distribution of bank branches. The banking system is highly concentrated (seven banks holding almost 90% of deposits) while competition is lacking and service costs remain high. New regulations for banking agents provide great potential for increasing competition through alternative channels to serve the unbanked. Both bank and non-bank models are possible. Since 2005 new banks tied to retail chains have emerged with a new banking model, including deposit-taking on retail premises. Deposit transactions are conducted electronically in real-time via agents and the banks assume responsibility for transactions, assuring consumer protection and trust. Most strong retail chains are urban and even in urban areas their coverage is uneven. Nonetheless the potential for catalytic development exists, as service points are multiplied and more of the unbanked gain access to services in the familiar surroundings of retail stores. Client transaction costs are reduced and competitive pressures in the banking industry are increased. Banks find a wider client base and face lower infrastructure costs of expansion. Retail premises attract custom by offering financial services and achieve a more loyal customer base.

Some lessons are emerging from this experience. Deeply-entrenched interests emerge to oppose change, including the dominant banks with their branch networks. It has been necessary to define objectives of the agency model clearly and to identity necessary legislative and regulatory changes for their achievement. Keeping customer deposits safe at all times is essential for the system to work. Making regulation too complex may prejudice the usefulness of the model in providing basic banking services, while coordination with all other relevant authorities is essential to achieve the inclusiveness and effectiveness of regulations. Efforts to educate legislators and other regulatory agencies may be necessary to achieve these ends. Finally, there is no such thing as an unequivocal set of guidelines for introducing banking agents; careful study of international experience and the application of this to local conditions are necessary to achieve a tailored solution.

Ms. Juanita Woodward, *Director, Customer Relations for Asia Pacific, Eurogiro*

Eurogiro is a global payments network operating via postal banks which connects 60 organisations in some 50 countries. It regards payments and remittance services, its core business, as a catalyst for financial inclusion. In discussing the potential for agent banking in the region it would be wise not to forget the potential for agency services residing in the public sector, and especially in postal services. Postal organisations have enormous reach, including across international borders, as can be seen from the relationship between Korea Post and the National Savings Bank of Sri Lanka (NSB), which facilitates the remittances of Sri Lankans from South Korea and enables other NSB financial services (accounts, micro-credit, insurance) to be offered to Sri Lankans resident in Korea.

Another, relatively sophisticated, example is provided by Singapore Post's remittance services, in partnership with banks and other financial entities in a number of countries, as well as its provision of consumer loan services and insurance and investment products on behalf of banks and finance companies, life offices and investment managers to Singapore residents including foreign workers. On the other hand, in lower-income countries post offices are a trusted brand and provide an environment congenial to the unbanked. They bring great value to partnerships with private banks, which see the potential of postal service outreach, and there is now a strong trend for financial services to be offered in rural areas via post offices. In terms of the rich variety of experience described above, there is a clear need for regulatory frameworks to take advantage of the potential residing in postal networks. In doing so, it is important for

authorities to avoid setting 'exclusivity' arrangements in place, since these are shown to reduce innovation and price competition.

Mr Vishwavir Saran Das, *Executive Director, Reserve Bank of India.*

India, like the moon, has both a bright and a dark side. Banking policy has often mirrored changes in broader economic policy. Thus bank nationalisations in 1969 engineered an historic shift from 'class' banking to 'mass' banking, a change which made possible the more recent phenomenon of the Self-Help Group. Even so, by 2003 only 59% of the population had access to bank accounts. In 2005 the Reserve Bank, India's central bank, called on the banking sector to 'scale up' its outreach and permitted them to use field agents (called business correspondents or facilitators) many of whom come from the social sector. Agents are permitted to accept small deposits, make payments and process loan applications. They are encouraged to use technology, such as biometric 'smart' cards, and a range of experiments has trialled innovations, with agents providing the 'last mile of connectivity'. The Reserve Bank asked banks to offer 'no frills' accounts from 2006 and there are now some 16 million of these. However surveys suggest a high rate of 'dormancy' of these accounts, suggesting that many holders do not know how to use their accounts, perhaps due to limited financial literacy. India has more than 150 thousand post office branches and the Reserve Bank encourages the banks to use these as agencies. India also has some 360 million mobile phone subscribers and while the potential is obvious, the RBI hasn't got the necessary regulations in place yet. There is no law permitting RBI to regulate TELCOs, should they decide to branch into financial services in advance of regulation. But there are in any case numerous remaining obstacles to using agents as the path to financial inclusion, such as social backwardness, political resistance and limited sensitivity on the part of some banks to the opportunities. So progress has been less rapid than was initially hoped.

SESSION THREE

ACCESS CALLING: MOBILE PHONE BANKING AND FINANCIAL INCLUSION

Questions and issues to be explored during this session include:

- Finding the appropriate regulatory space for mobile phone banking activities, covering issues such as deposit taking, electronic money, payment systems, data privacy and security, consumer protection, and customer due diligence.
- Coordinating policy mandates at this unique intersection of financial services and telecommunications.
- Issue of competition and interoperability.
- Balancing protection with experimentation needed to get mobile phone banking models off the ground.
- Expanding the range of applications used beyond payments.

Session Chair:
Mr. Craig Wilson, *Executive Director, Foundation for Development Cooperation*

Case Study: Mobile phone banking and financial inclusion in the Philippines
Mr. Nestor Espenilla, *Deputy Governor, Bangko Sentral ng Pilipinas*

In terms of conventional retail banking and financial infrastructure, the Philippines has almost 8000 bank branch offices and some 6000 financial cooperatives. Around 7700 ATMs are in commission. There is a concentration of facilities in higher income urban areas and a significant proportion of the low income population remains unserved. Indeed some 40% of municipalities do not have any banking offices. In response BsP, the central bank, has adopted the explicit corporate objective of expanding institutions that use multi-channels to deliver a wider range of financial services to reach more people. Existing branch networks will be expanded, technology will be employed to find new ways to deliver financial services and non-bank retail institutions will be used to extend service networks.

With respect to the uptake of technology, BsP has sanctioned two e-money products. The first, and simpler regulatory challenge, was 'Smart Money', the product of a major commercial bank. At Smart Money's launch, in 2004, existing BsP circulars governing electronic banking and outsourcing were

judged adequate to the task. The second, and more difficult regulatory challenge, was 'G-cash', which is not a bank product. Its provider was ultimately licensed by BsP as a 'remittance agent'. This followed a careful process of examining the product and consulting with the service provider. Issues such as consumer protection, money-laundering and the soundness of the product itself were considered. Given its potential scale, BSP felt it better to accept responsibility for the product rather than allowing it to proceed unregulated. Subsequently the central bank has worked through a range of issues arising from the e-banking phenomenon and issued circulars on topics such as registration for AML compliance, technology risk management and consumer protection. Most recently (2009) it has issued comprehensive regulations for issuance of electronic money. These are generalised to deal with the further development of the industry.

The impact of e-money has been substantial. Some eight million people use one or other of the two products, while the numbers of banks involved is growing. Apart from the larger commercial banks, increasing numbers of small rural banks are participating. Some banks have lowered interest rates, by up to 50bps/month, on microfinance loans administered via the phone repayment platform. Lower cost remittance channels have seen remittance costs fall markedly. These advances are opening the way for concerted action to increase financial inclusion through an integrated system of e-money. This will require the convergence of mobile technology, e-money and the traditional brick-and-mortar networks of financial institutions. It will involve bank and non-bank partnerships and require an integrated and seamless regulatory framework under the guidance of the BsP. The act of creating e-money will be decoupled from banking transactions, while 'non-exclusive' third party agent networks will be enabled to handle all transactions other than retail deposits, which will remain the province of regulated banks.

Proportionate regulation will be necessary to avoid stifling innovation and to permit market growth. E-banking and e-money cannot be permitted to challenge the integrity of the financial system or the rights of consumers and appropriate regulation and supervision are essential. There will need to be clear delineation of deposit-taking transactions as against receipt of funds for other purposes and the proportionate regulation of each. Financial inclusion can be deepened by simple and convenient deposit and fund transfer products that can mature into more value-generating relationships. The reach of banking services can be leveraged by the combination of a liberalised branching regime, mobile banking technology and strategic partnerships with third party non-bank agent networks. Sound internal governance arrangements for all players are essential, both to complement a proportionate scheme of regulation and to maintain order and discipline in potentially large new financial ecosystems.

Mobile Phone Banking: Policy and Regulatory Issues
Ms. Marina Solin, *Programme Director, GSM Association*

The GSM Association is a global industry association for mobile communications, representing some 740 member entities with around 200 associated entities. With funding from the Gates Foundation it is conducting an initiative, 'Mobile Money for the Unbanked'. This aims by 2011 to provide mobile money services to 20 million new unbanked customers living under $2 a day. Additionally, it has the goals: 1) to have mobile money accepted by mobile operators as mainstream business 2) to have the product available extensively to formerly unbanked people, and 3) to extend reach and reduce costs of formal services, including savings, insurance and credit. An initial concern is to identify regulatory change of most utility for its goals. Regulation must help to leverage non-bank distribution chains, must enable easier registration of unbanked customers (thus requiring proportionate KYC provisions) and should regulate products rather than players (such as payments regulation for non-banks).

Convergence between financial services and Telecoms requires financial regulators to become more comfortable dealing with mobile operators providing mobile money. This will flow from dialogue and the exchange of international experience, the study of success stories, and efforts to recognise risks and to find ways to mitigate them effectively. It is necessary to see how regulation can help mobile network operators to reach the unbanked. They need payments as a first step, so we start from there to explore the capability of mobile money to serve them in an effective and proportionate regulatory environment. From there a road map is needed to show regulators and operators how to move customers up the value chain of services in a market-led process. The road map should link risks with proportionate regulation. Attention

should focus on topics (eg, KYC, agency and payment regulation for non-banks) whose appropriate and proportionate regulation offers most scope for outreach to the unbanked. Industry/regulator dialogue should aim to build understanding of the issues and trust between players.

The question of interoperability between service providers is complex, since network effects differ greatly between situations of interoperability and exclusivity. There is no straightforward 'template' solution for all situations since considerations of market power and strategic positioning affect the behaviour and political stances of players. Without interoperability, market behaviour may be very competitive, with benefits for consumers in terms of services available and prices. If interoperability is introduced, the stimulus to competition is likely to be reduced. Attitudes to its introduction on the part of players are influenced by their size and positioning. A dominant player can be expected to oppose interoperability and to 'stonewall' against its introduction. The point at which a regulator might intervene most effectively is not simple to determine either. Different considerations apply in (for example) start-up markets as opposed to established markets with firms of similar market power. Again, in situations where 'asymmetric' firms exist there is typically a threshold market share for the large firm below which it will agree to interconnect and above which it will refuse. Regulators may assist in resolving difficult situations by foreshadowing the introduction of interconnection at some point and according to certain criteria.

Brief Commentaries:

Mr. Hourn Thy, *Project Manager, Access to Finance, International Finance Corporation*

Cambodia is a small (14 million+), poor economy with low banking penetration (about 5%) and a cash-based, highly dollarised economy. Mobile phone penetration is 28% with three operators, the dominant one having 69% market share. This case study concerns 'Wing', a mobile payments service provider and subsidiary of the Australian ANZ banking group. Wing, now operating in an experimental and 'pre-regulation' mode, is the product of collaboration between ANZ and the IFC. The latter took part in the feasibility study and is collaborating in developing and refining the Wing business model. Since January 2009 Wing has enabled customers and businesses to transfer money within Cambodia, and deposit or withdraw, via mobile phones (any phone, any carrier). Customers may make payment for transactions with eligible merchants. There is no monthly fee for holding a Wing m-wallet and customer funds are held in a regulated bank. Wing has an arrangement with an MFI for rural distribution, and persons without phones may use the service, via agents. Arrangements with garment factories permit workers' pay to be credited direct to their m-wallets, where balances are measured in airtime. Apart from garment workers, university students and convenience store owners are immediate market-segments of interest, with farmers targeted for growth over time.

In terms of regulation, the service is available only in the Cambodian *Riel* which is the medium of exchange for only a small proportion of transactions in Cambodia at present. It is planned to revisit this matter quite soon. Authorities are receiving international technical assistance to consider the regulatory issues involved in dollar transactions. There is no regulation on m-banking in Cambodia at present, although Wing has central bank permission to operate on an experimental basis. There is close communication between Wing, ANZ and the central bank on developing the regulatory framework. IFC and experts from a World Bank unit concerned with payments systems are also involved in the process. Wing is thus a work-in-progress but already appears to be a promising 'experiment'.

Mr Taiji Inui, *Senior Manager, Financial Planning and Administration Department, NTT Data Corporation Japan*

Mr Inui reported on Japanese experience with electronic retail payment systems and a wide range of initiatives underway. Electronic money is already very popular in Japan and substantial public and commercial infrastructure exists to support activity. NTT as a technical support provider to the industry has a position of neutrality in relation to service providers. Electronic money may be in stored value form, on IC (smart) cards and on 'contactless' cards, available from many providers in both pre- and post-paid forms. An example of the latter is the Transport Smart Card, with stored value. Some providers allow use with mobile phones (about 10 million phones) which is still small in relation to some 80 million chip-based cards on issue in Japan with total value outstanding of Yen77bn (say $770bn) and annual transactions value of Y564bn (some 800 million transactions). However since electronic money in circulation is still only equivalent to 0.007% of M3 it has no implications for monetary policy. The

importance of remittances from foreign workers based in Japan is large and growing and offers scope for innovation in providing mobile phone-based solutions to this need, both by electronic remittances to foreign bank accounts and by sending 'stored value' as an alternative method. Mr Inui comments that, while Japanese service providers have yet to meet these challenges, he is conscious of 'preaching to Buddha' with this workshop audience.

Open Forum

In response to questions, speakers made the following additional points:

Deputy Governor Espenilla clarified that since demand in the Philippines focuses on payments, the central bank concentrated initially on regulating that area of activity. BsP does not regard stored value as a deposit; it is a payments instrument backed by money in a bank account. Careful attention is given to the governance and internal controls of entities offering this service. However, the Bank sees no sense in heavy regulation for low-value payments which are not likely to be used for money laundering. Even in the case where third party agents are used to accept 'deposits' it still feels that light regulation is appropriate.

Ms Solin dealt with the issue of 'proportionate' regulation in relation to risks. Dialogue with regulators is necessary to agree on the nature of particular risks. Most commonly regulators are concerned with AML issues so it is necessary to agree how this risk may be ruled out. Agency risks are another concern of regulators while how service providers manage their stored value 'float' is an obvious concern. It is necessary to work with regulators to examine each contingency and to see how risk may be mitigated. However it is an important principle that regulation should 'follow the market' (rather than copying the unfortunate example provided by the EU, which imposed an *a priori* regulatory framework on an immature industry). Similarly, to focus regulation only on banks constrains competition and innovation. Ideally regulation should allow for the possibility of bank vs. non-bank vs. 'third-party player' competition.

Welcome dinner

Speaker: Mr Raul Hernandez-Coss, *Director-General for Access to Finance, National Banking and Securities Commission, Mexico*

Mr Hernandez-Coss wanted 'to share with you some thoughts on the journey that Mexico is taking towards financial inclusion'. Mexico believes that economic development without financial inclusion is impossible and is very pleased to have a role in AFI's start-up committee. AFI is an important opportunity for Mexico. First, because 'we want to learn … from those countries that are taking the front seat on branchless banking, payment systems regulations, mobile financial services and other effective policy solutions for financial inclusion … We want to learn from those that are determined to move from the theoretical approaches to implementing innovative practices, regulations and schemes… However we want to tailor those lessons to our own context. We don't want recipes, we want ingredients!'
'Second, we want to share': 'with policymakers, regulators and international organisations the challenges that we have faced, but also the success stories that we are expecting to witness'. And third, 'we want support' in the task of 'designing and implementing a national strategy for financial inclusion' [because] 'being a part of AFI will push for the design of public policies for financial inclusion in our country'.
For these three purposes we need

- A good diagnostic to tell us where we are in terms of financial inclusion
- A common framework to design policies to promote access
- Better coordination among agencies and with the private sector
- New products and services for those outside the mainstream
- Effective methodology to measure policy impact, including solid data

'I see AFI as a policy network, owned by policymakers, all of us here'.

Wednesday, 1 April 2009

SESSION FOUR
NEW MODELS, NEW PROVIDERS: INCREASING THE DIVERSITY OF MICROFINANCE SERVICE PROVISION

Questions and issues explored during this session included:

- Policy choices governing alternative providers of financial services, including tiered license regimes and proportionate regulation of lower-risk deposit takers and micro-insurance providers.
- Balance costs and benefits of regulation and supervision (e.g. make sure that there are sufficient licensable MFIs, introduction of regulation including capacity building is time and resource consuming)
- Regulatory requirements that are best suited to induce scale of micro-insurance business models.
- Leveling the playing field in terms of subsidized funding to encourage deposit mobilization and commercially sustainable operations.
- Dealing with large groups of unregulated providers (e.g. burial societies, cooperative societies that take deposits).
- Fiscal policies that promote new entrants and models without distorting the market.
- Policy instruments that are most effective in crowding in private investment and market development.

Session Chair:
Mr. Eric Duflos, *Senior Microfinance Specialist, CGAP*

Introduction by the Session Chair

In his introduction, Mr Duflos referred to definitions relevant to this session of the workshop. These are promulgated by CGAP, which has offered them as standards for the industry. See 'Guiding principles on regulation and supervision of microfinance', available at http://www.cgap.org/gm/document-1.9.2787/Guideline_RegSup.pdf

Innovative Policy Choices Governing Pro-Poor Financial Service Providers: Case Study from Uganda
Ms Clare Wavamunno, *Consultant, aikan Uganda*

For background, Uganda enjoyed a decade of 6% GDP growth from 1997, with low inflation for most of that period and substantial declines in the incidence of both poverty and HIV. Population growth is very high at 3.4%, while almost 60% of population continue to rely on agriculture and the financial inclusion rate is 38% (21% formal, 17% informal). Financial sector legislation covers banks and regulated financial institutions, financial cooperatives and moneylenders, while NGO/MFIs and other community-based entities are covered by an NGO statute and are not permitted to take deposits. Legislation in 2003 created a new class of 'microfinance deposit-taking institutions' (MDIs). This regularised the status of large and dynamic informal institutions that had emerged to meet the demand for micro-financial services. There are four such institutions and apart from savings facilities they offer short term loans, money transfers and micro-insurance.

The legislation of 2003 had some positive outcomes: the new deposit-taking institutions gained status and public confidence, their ownership and governance structures were clarified and they have been able to invest in HRD and Ugandan leadership, while donor coordination in meeting their capacity-building needs has been facilitated. They are subject to the discipline of standardized reporting and increased competition and better services are evident. On the other hand, compliance imposes high costs and is time-consuming. Relatively few institutions have been able to attain the standards required under the MDI Act. They face stiff competition from non-deposit-taking institutions, which are more lightly regulated and among which malpractice is rife. The Act is now facing a challenge, because the existing MDIs aspire to upgrade to commercial bank status while the best-qualified MFIs operating at the lower level are reluctant to upgrade to MDI status, perceiving MDIs as over-regulated and constrained in their capacity to

react to market opportunities. Some of the best performers may even aspire to transform directly into commercial banks. This apparent impasse, which may lead to an institutional vacuum in the MDI 'space', holds broader significance for efforts to legislate for financial inclusion in comparable countries.

The largest number of poor clients in rural areas is still served by MFIs and SACCOs at the lower level where institutional weakness is rife. Most recently, government has reacted to this situation with a new initiative at that level. It has imposed interest rate ceilings and initiated a 'Prosperity for All' program led by financial extension workers. A credit facility is to be delivered down to the sub-county level using SACCOs and with Post Bank as the linking institution. New legislation and supervision for SACCOs and non-deposit-taking MFIs is promised. The stance is one of re-exerting control due to excesses and strong electoral pressure for grass roots financial service facilities. Meanwhile the impasse affecting the MDIs remains. Nonetheless there are positives from the experience of institution-building in Uganda, with the integration of microfinance products into the business models of a wide range of financial institutions. Policy will continue to ebb and flow and the need for active policy dialogue to avoid negative outcomes has never been more evident.

In question-time, and in relation to regulation as a 'blunt instrument', Ms Wavamunno was asked to consider whether it would have been more effective to legislate for linkage and/or agency relationships rather than creating new regulated MF institutions. She defended the path taken by regulators, who made it clear what the rules were and how they could be taken advantage of. The new MDIs brought many savers into the formal sector and institutions have found this a profitable niche. Concerning linkages: these do operate and MDIs are involved in relationships with commercial banks. Concerning the newly imposed interest rate caps, the government has set up a wholesale fund to direct subsidized funds to MFIs via Post Bank, allowing a maximum spread of 4%

Brief Commentary
Ms. Gabriela Braun, Director, *Alliance for Financial Inclusion*

Ms Braun commented, in relation to the Ugandan case, that even where the direct effects of regulation are disappointing, there may be helpful secondary effects such as drawing the commercial banks into the sector. More generally, it is best to regard microfinance regulation as an integral part of a coherent policy framework for financial inclusion. Legislation should be framed with understanding of the realities of microfinance and especially the risk profile typical of the sector. It should not be a 'cut and paste' job using regulations drawn from other countries. Regulation should embody the understanding that microfinance is 'a line of business' with regulators focusing on products rather than the institutions providing them. Concepts must be clarified and roles defined prior to drafting a law. In this process stakeholder consultation and collaboration are crucial.

The costs of prudential regulation should not be underestimated and the scope of regulation should be defined accordingly. Guiding principles include avoiding premature prudential regulation; there must be a critical mass of 'licensable' MFIs. Also, authorities should not regulate what they cannot supervise. Supervisors should be adequately prepared and equipped for their work. Authorities need to take enough time to get the framework right and should be convinced that the benefits of access to domestic savings justify the extra costs imposed on supervisors and the supervised. Supervisors will require strong technical capacity and in-depth knowledge of microfinance. The supervision of SACCOs is also an issue, due to their typically weak internal controls and the large numbers of small institutions involved. Challenges for regulated MFIs include constraints on their rural outreach due to the costs of opening branches (although agency arrangements may help in this regard) and the high costs of transforming themselves to meet the required standards. In general, there is a danger of politicization, due to the high level of attention given to microfinance when legislation is proposed. This applies particularly when creating a separate law for microfinance.

Comment: Mr Kim Vada, *Deputy Director General, National Bank of Cambodia*

Mr Vada commenced with some comparisons between Uganda and Cambodia. Cambodia has a more credit-focused microfinance industry, with ACLEDA being the only deposit-taking institution as well as

the best-known MFI. With a total population of around 12.5 million, Cambodia has been able to provide financial access to around a million households and government sees microfinance as its most powerful tool against poverty. In regard to development policy, government is permissive in regard to foreign ownership and investment and favours a liberal interest rate regime. Thus with regard to microfinance, foreign sources of funding are important, as is foreign ownership of institutions, while interest rates are unregulated and government is not interventionist towards the industry. As seen in the case of the mobile banking provider Wing (session 3, above) National Bank of Cambodia (NBC, the central bank) has a positive attitude to mobile banking, seeing it as providing more widespread access than either ATMs or internet banking, especially given the inability of commercial banks to reach the rural poor. Since 2001, when a *Law on Banking and Financial Institutions* and associated regulations came into effect, there has been quite rapid development in the industry, with borrower numbers more than doubling while loans outstanding have grown nine-fold to $277m. However deposits are insignificant at $5.4m and the number of depositors has actually declined somewhat. The number of registered MFIs declined from 90 in 2000 to 27 in 2008, due to consolidation and the elevation of some institutions to licensed MFI status (from none in 2000 to 18 most recently). The legal framework established by the Act requires MFIs operating above certain thresholds either to register with NBC or to become licensed by it. Credit MFIs must register unless they have loan portfolio below around $25,000. MFIs accepting deposits from the general public must all register, with insignificant exceptions. Licensing is required for MFIs with portfolio above around $250,000 or savings deposits above about $25,000. Savings are limited to the compulsory deposits of members or clients.

However in 2007 NBC established a new institutional category eligible to mobilize savings from the public, the Microfinance Deposit-Taking Institution (MDI). Five applications for this status, which will require capital of around $2.5m, are under review at present. This is a considerable step up from the minimum capital of $62,500 for a licensed MFI. For comparison, savings banks require a minimum $8m capital and full-service commercial banks around $38m. Eligibility criteria stress MFI operating experience, good performance on NBC's own rating system, an effective MIS and conformance to the NBC chart of accounts, as well as past profitability. Once operating they will be subject to prudential norms, such as now apply to licensed MFIs, including CAR equal to 15% of risk-adjusted assets and a capital guarantee deposit at the central bank. Loan classification and provisioning norms will apply, as also limits on large exposures and related party transactions, minimum liquidity and reserve requirements related to volume of deposits held and maximum net open currency positions. In terms of off-site supervision, licensed MFIs observe a strict monthly reporting regime, while registered MFIs report quarterly and to less demanding requirements. All licensed MFIs undergo on-site supervision over a 12 to 18 month cycle. NBC aims to achieve the linkage of banking and microfinance in the national financial system, and to develop appropriate financial infrastructure including a wholesale national payments system, and money and inter-bank markets including short-term government securities. It aims for similar treatment of entities providing similar financial services and to provide an environment in which non-banks may conduct banking activities. NBC intends to increase access for the excluded, to diversify the range of institutions and to support their sustainability and commerciality with a flexible regulatory and supervisory regime.

Comment: Mr Khairul Anwar, *Head of Bureau, SME Development Bureau, Bank Indonesia.*

Mr Anwar's presentation was titled **Strategy and Policy of Indonesian Microfinance Development** Some 40 million micro- and small enterprises are served by a range of financial institutions, a number of them unique to Indonesia. They include service providers regulated by the central bank, (rural banks, the well-known BRI units, and the BKD or village credit agencies) other formally regulated institutions such as financial cooperatives (both conventional and Islamic), pawnshops and the locally-owned LDKPs (village fund and credit institutions). In addition there is a host of non-formal financial service providers, including NGOs and self-help groups, many of them affiliated with one or another of Indonesia's numerous government credit programs. Non-bank entities are regulated and supervised by government agencies, including sectoral and provincial authorities. Deposits in commercial banks and rural banks are partially secured by deposit guarantees, while credit insurance facilities apply to certain government programs targeting micro-, small and medium-sized enterprises. One such is the KUR (credit for people's

activities) administered by Bank Indonesia, the central bank. This involves channeling funds from commercial banks to MFIs for enterprise lending. For example, at the micro-level, loans range up to IR5 million ($500) with a maximum annual interest rate of 24%. Banks receive favourable treatment in terms of the risk-weighting attached to such credits and also receive credit insurance cover up to 70% from another government agency. With GTZ technical assistance, Bank Indonesia has devoted a lot of attention to its system of around 2,700 small 'rural banks'. These regulated local institutions are seen as occupying a strategic position in relation to micro- and small enterprise financing. Recognising the diversity and range of capacities in this sector, Bank Indonesia has adopted a 'stratification' for these banks with levels of regulation and supervision based on each bank's position. It plans to establish an apex institution to strengthen the capacity and financial stability of the system as a whole. There are also plans for a comprehensive microfinance law to deal with the host of institutions not regulated by Bank Indonesia. Under discussion since 2001, this law has not yet been presented to the legislature.

Micro-insurance: Policy and Regulatory Issues

Mr. Arup Chatterjee, *Principal Administrator, International Association of Insurance Supervisors (IAIS)*

The International Association of Insurance Supervisors (IAIS) is the international standard setter for insurance regulation. In 2006-07 it teamed with CGAP to prepare an authoritative statement on issues in the regulation and supervision of microinsurance. Mr Chatterjee sees a clear distinction between microfinance and microinsurance, summed up by the aphorism, 'microfinance helps people improve, but microinsurance helps them protect the gains'. So poverty reduction requires not just the generation of incomes but also protecting income through effective risk management. Microinsurance is defined as insurance accessed by low-income people, provided by a variety of institutions, run in accordance with accepted insurance principles and funded by premiums. Typically it consists of risk-pooling products designed to be appropriate for the low-income market in relation to cost, terms, coverage and delivery mechanisms. It allows families to move beyond informal risk-sharing arrangements, common in traditional societies, to transferring risks formally. This may be done as policy-holders of regulated insurers (a market-led approach) or as citizen-members of government–financed social protection schemes (a social security approach). The presentation was concerned primarily with market approaches, consistent with the emphasis on commerciality and sustainability in microfinance more generally.

Factors affecting the development of microinsurance include the proportion of population in the low-income categories. Microinsurance development is certainly appropriate when the proportion is high, although the limited discretionary income available for insurance is a hurdle. When general insurance has low penetration the scope for take-up of microinsurance appears correspondingly limited. When low-income communities develop informal pooling mechanisms to cope with risk events this suggests a demand not being satisfied by the formal market and perhaps also the existence of regulatory and other impediments to the formalisation of insurance mechanisms. The adoption of financial inclusion policies can give a 'push' to microinsurance by incorporating it into the inclusion framework. This must provide a clear mandate to regulators and supervisors to support market development. The level of demand provides a 'pull' factor, in the sense that long-term growth and scale depend on the financial viability of each market.

Microinsurance can develop in the absence of regulation but uncertainty will prevail, affecting both providers and customers. Where regulation exists, uncertainty as to its application also undermines microinsurance development. Regulatory approaches may be either proactive or reactive and they may be facilitative or exclusionary. Regulatory burden is a potentially significant constraint on market development, with issues of compliance costs and the pressure for exclusions from regulation. Achieving a low-burden regime reduces the need for special dispensations while high burden regimes combined with limited regulatory capacity (a common enough situation) provide incentives for informality and constrain market development. Most potential national microinsurance markets are in the early (dormant) stages of development. The external environment for market development, in terms of political stability, property rights and contract enforcement may still be deficient, while industry-specific building blocks (including insurance law, regulatory and supervisory framework, data collection and government capacity for risk management) may still be inadequate. Sound macroeconomic management and financially inclusive policies, together with adoption of international best practice insurance principles will provide a launch

pad for microinsurance market development. The ongoing collaborative work program of IAIS and MIN (the Microinsurance Network) on an 'Access to Insurance Initiative' deserves continuing support.

Brief Commentaries (10 minutes each):
Mr. Gil Beltran, *Undersecretary, Department of Finance, and Chairman, National Credit Council, Republic of the Philippines*

The Philippines, with some 27 million of its 90 million population under the poverty threshold, has a relatively sophisticated banking system and a small insurance industry with significant room for growth. There is an embryonic microinsurance sector covering perhaps 2.9m people (little more than 5% of adult population). Of these about 60% have coverage from formal institutions (corporates including banks, mutuals, life insurance associated with credit, etc) and 40% from informal sources such as cooperatives and unincorporated mutuals. A 'National Strategy for Microfinance', which is supported by political will and a relatively strong infrastructure of service providers, has incorporated microinsurance into its program. The regulatory environment of the Philippines also supports financial inclusion and facilitates the growth of microinsurance institutions and products. Specifically, it has defined microinsurance and related premiums and benefits to the minimum wage as benchmarks, facilitated the entry of mutual benefit associations wholly engaged in microinsurance, required the simplification of documentation for microinsurance products, minimised 'know your customer' requirements in relation to AML provisions and permitted major banks to market insurance products on bank premises.

Regulation has played a positive role in that the successes of mainstream microfinance have encouraged operators to branch into insurance. Financial inclusion policy, embodied in the national microfinance strategy, has prompted the regulator to take a proactive stance in regard to microinsurance, while the explicit inclusion of insurance in the regulatory regime has stirred awareness in the industry. Finally, regulatory flexibility has allowed space for innovation. However barriers remain, including the absence of an effective regulatory environment for cooperatives, some of which have unregulated in-house insurance schemes and many of which are weak and prone to failure. There is also a degree of regulatory ambiguity affecting 'pre-need' and health care plans, while well-publicised failures of some pre-need companies have inhibited growth in this area. There is an absence of regulatory incentive to persuade large commercial insurers to offer microinsurance (apart from group life polices) in the low-income market. Further, rural banks are still prohibited from selling microinsurance from within their premises. The Philippines continues to benefit from collaboration with the Japan Fund for Poverty Reduction and the ADB in improving the regulatory framework, strengthening capacities of regulators and service providers and promoting financial literacy in regard to microinsurance. Complementary technical assistance is soon to be provided by GTZ. In terms of national microfinance strategy, the expectation is that if microfinance assists the poor with their present financial needs, then microinsurance will offer a shield for their unexpected and future financial needs.

In discussion the following points were raised: The issue of discrimination affecting certain classes of people for insurance (of any sort); policies of companies may block access. This suggests the need to guarantee access. It may be useful to assemble data on observable exclusion from access to insurance coverage and to conduct pilot programs trialling products and institutions to overcome this problem. There may also be a role for policyholder protection legislation. Mr Beltran reported having some data concerning access to services for the Philippines and noted that microinsurance there arises from a culture of community 'friendly societies'. Another person commented that 'microinsurance' may be altogether too diverse a range of products; it might be better to differentiate products by risk and to start with those products most easily provided.

Thursday, 2 April 2009

SESSION FIVE
RETHINKING GOVERNANCE AND MANAGEMENT OF PUBLIC BANKS TO PROMOTE FINANCIAL INCLUSION

Questions and issues explored during this session:

- Mitigating political influences that hinder sustainable operations and competition.
- Incentivizing and professionalizing management and governance of state banks.
- Managing the evolution of public banks: transitioning from first tier (retail) to second tier (wholesale) activities, market development strategies to attract private players, decisions on reforming v. closure.
- Phasing out subsidies, leaving fair and transparent market-based disclosure and pricing regimes in their place.
- Effective models of public-private partnerships to foster service expansion to the poor.

Session Chair:
Mr. Yo Takeuchi, *Chief Financial Officer and Member of the Board, Development Bank of Japan, Inc.*

Introduction by the Session Chair

Mr Takeuchi referred to his own institution, which played a role from 1951 in the postwar reconstruction of Japan and, having recently become a joint-stock company, is now tracking towards full privatization. It is undergoing a transformation, with a new corporate philosophy and a new business model. During this process he has come to appreciate more fully the need for good governance and commercial orientation, characteristics crucial for the success of any policy-based financial institution. Public banks assume an even more important role under current economic conditions since institutions with a long-term developmental perspective can step in to assure the continued growth of microfinance and have great potential for promoting financial inclusion.

Governance and Management of Public Banks and Financial Inclusion: Case Study from India
Mr. M.V. Nair, *Chairman and Managing Director, Union Bank of India*

India, with more than a billion people and some 630,000 villages, still suffers considerable financial exclusion despite recent rapid economic growth. Thus, among farmers, 86% are excluded from formal credit sources and more than 50% are excluded from any formal financial services. The total unbanked population is some 400 million people, despite a long history of government initiatives aimed at providing access to services. Initial policy (from 1969) was directed to nationalising private banks, to assure provision of services to poor and rural populations. During the 90s the pendulum swung back, with a phase of banking liberalisation. New private sector banks seized the opportunity to grow and innovate, making substantial inroads into the market share of state banks. Also during the 1980s and '90s, state banks commenced new approaches to rural financial inclusion, which were increasingly influenced by microfinance principles (eg, self-help groups). Since 2000 there are signs that the state sector may be reversing the loss of market share. State banks have experienced reforms in corporate governance and incentive structures, and greater operational autonomy, as well as embracing new technologies. Thus Union Bank was the first large public bank to network all of its branches (some 2,600 of them). In parallel with these reforms, recent regulatory and government initiatives are changing the banking landscape, especially in rural areas. Branchless banking has been facilitated by allowing the appointment of banking agents, giving extra reach and faster delivery. Banks have yielded to government by opening millions of 'no-frills' bank accounts for the poor (although results of this innovation appear mixed so far). A target of establishing 100,000 'common services centres' (already one-third fulfilled) has been set to provide rural transactions services. These are open to banking correspondents. A 'National Payment Corporation' set up as a public/private partnership in 2008 will provide a robust retail payment infrastructure nationally. A national identity card, expected to facilitate financial inclusion, is being rolled out for all citizens.

Union Bank, the state bank of which Mr Nair is Managing director, has contributed to recent innovations in financial inclusion. It regards its own fortunes as being closely linked to the success of the financial inclusion enterprise. It has issued biometric financial identity cards to milk collection agents who serve more than 12 million retail 'milk pourers'. This is an agency

financial services model, with the agents handling payment and credit products. The bank has provided cards to 150,000 hawkers (among about 10 million active in India) to allow them to access savings, credit, remittance and micro-insurance products offered by Union Bank. More than a million cards have been issued to recipients of benefits under the National Rural Employment Guarantee Program. The bank has established 200 'village knowledge centres' providing financial literacy training and counselling and facilitating self-help groups. It has partnered a government agency to set up 250 'training-cum-incubation centres' benefiting rural youth.

In terms of further policy and regulatory breakthroughs, Mr Nair believes that government should have land records put onto a technology platform to simplify searches and create a collateral asset or landholders. It should press on to create a unique and trackable identifier for every citizen, enabling cost savings in the delivery of financial products and, in addition, administer all grants and social programs via chip-enabled cards. From the regulatory perspective, all interest rate caps on small loans should finally and comprehensively be lifted. Eligibility for 'business correspondent' status should be reviewed to permit a wider field of recruitment, while restrictions on banks' collaborating with other industries should be eased, to lower distribution costs. All players in the industry should be encouraged to spend more on promoting financial literacy. In conclusion, Mr Nair is convinced that Indian public banks continue to gain strength and confidence and are ready to meet new challenges. The unique Indian public banking model is worthy of wider emulation. 'Don't get rid of your public banks. You may need them one day!'

Governance and Management of Public Banks and Financial Inclusion: Case Study from Mongolia
Mr. Peter Morrow, *Chief Executive Officer, Khan Bank*

Mr Morrow noted the contrasts, in scale and other characteristics, between the Mongolian case and that of India. Khan bank operates in a country of small and sparse population spread across large distances. Population is 2.5 million with 42 million head of livestock. Khan had been a failing state bank whose turnaround was (eventually) executed by a successful privatization and the injection of outside management. Separated from the state monobank in 1991, the bank was notionally privatised and renamed as the Agricultural Bank of Mongolia. This first phase ended in 1996 with the failure of the bank and its recapitalisation by donors. But operations continued as before and by 1999 it was placed in receivership. So dire were its circumstances that its closure was considered. But it was the only bank operating in rural Mongolia, with 70% of the country's bank offices, was essential for pension and budget payments, had 400,000 customers and was politically impossible to shut down. So a compromise 'remediation' program was devised jointly by the GoM and the central bank with the World Bank and USAID. Government reacquired 100% control and agreed to hire external management, to appoint an independent board, to refrain from operational interference and to eventual privatisation. A management contract was awarded to US firm DAI. This provided for two expatriate managers (CEO, COO) with full control, four local executives and 400 days of consulting support. The brief called for the institution to be made financially sound, for rural financial services to be restored and for the bank to be prepared for privatisation. Total cost for 27 months was $2.7m.

The critical challenge for reform lay in the branches, around 270 of them, mostly rural. After study, management determined they had huge 'franchise value' as the only bank in rural areas and the only branch network in the country. Most branches were remote, located in towns of 200 to 500 residents and often 50 to 150 km from the next town. The population was very poor, without telephone or internet, or even roads, and 180 branches had no electricity. Most were losing money (but not much) but operating costs were very low and no lending income was coming in. There appeared to be little sense, and much risk, in closing branches while the upside risk of expansion seemed small and the possibilities were promising. In terms of lending performance the Ag Bank had a bad record. The central bank counselled against resuming lending, but remediation of the bank's condition required lending to recommence.

So a single, simple, pilot product, trader credit, was launched. It presented an attractive alternative to pawnshop lending at 10% per month, on which traders had been forced to rely. All policies and procedures were overhauled, intensive training was done and the product was introduced systematically to the system, accompanied by intensive monitoring. This careful start has since broadened out to a successful portfolio. In the event it turned out that there was a huge pent-up demand for financial services and that repayment performance is good if loans are properly structured.

Bank staff, 75% of them graduates, were long-tenured and very loyal. While tactically excellent they were strategically weak and accustomed to following orders. Saying 'no' was difficult for them. The approach taken was to teach staff new tasks and enforce new policies (eg, transparency), to harness the culture rather than change it, to require quantitative goals to be met and to offer an incentive salary structure, all in the context of intensive training. The idea that an entrenched 'state sector culture' would hold the bank back proved incorrect. The staff turned out to be a source of strength. Marketing also played its part: Ag Bank was rebranded as 'Khan Bank' with new logo, colours and style. The new brand was promoted vigorously and foreign management was presented, successfully, as an asset for the corporate image. Having overcome initial obstacles, attention then turned to the privatisation. As embodied in the project agreement, there was commitment to a transparent process, open to foreign and domestic bidders. There were to be no restrictions on future operations other than required by prudential regulation. A Japanese entity was the highest bidder and in the final outcome a consortium of that bidder together with IFC and local shareholders was formed. DAI was retained as manager with 4% equity. Today Khan is Mongolia's largest and most profitable bank, used by 80% of households, banker to the government, used by most corporates and international agencies and with a credit rating higher than Mongolia's own sovereign rating. It has entered urban and SME markets, has ATMs and POS services, cards and phone banking. Since 2007 it has been involved in investment banking and international capital markets. Key lessons are that to restructure a state bank for high performance requires independent management with power to say no, a strong measure of international support ('conditionality'), the attitude of running 'a bank, not a project', starting with a clean balance sheet and being adequately funded up to the point of profitability.

Brief Commentaries (10 minutes each):
Ms Wajeetip Pongpech, *Financial Institutions Policy Group, Bank of Thailand*

Ms Wajeetip addressed the topic from the perspective of a Thai central banker. She claimed that almost 84% of Thai households use formal sector financial services (including the many rural people who are affiliated with government-funded 'village funds' linked to state banking institutions). Most households use about three or four products. Around 10% of the population, low income people in rural areas who are labourers or economically inactive, do not access institutional financial services. This success is due to requirements imposed on commercial banks and the active role of state institutions. However 4% of households still lack access to deposit accounts due to isolation, high minimum deposit requirements or financial illiteracy, while 15% lack access to formal credit services due to inadequate financial status or collateral or inadequate information and financial understanding. A particular feature of the Thai banking landscape is the set of 'specialised financial institutions' (SFIs). These are state-owned, each with a mandate to serve a particular market segment that might otherwise be underbanked. Two institutions, the Government Savings Bank and the Bank for Agriculture and Agricultural Cooperatives are especially significant in promoting financial inclusion. The promotion of national savings and community stability are particular concerns. They are not regulated by the central bank and regulatory and supervisory authority is spread among a number of agencies.

The SFIs are subject to performance evaluation by a government agency, the State Enterprise Policy Office, which sets performance criteria for these institutions in terms of support for government policy, financial and non-financial performance and governance. Ratings are published annually and the incentives and bonuses of directors and employees are linked to

the outcomes. With regard to issues of political interference in the operations of SFIs, there is a need for transparency. This can be promoted by financial accounting which distinguishes clearly between the public sector activities and the normal business accounts of these banks. It is important that accountability should be clearly identified for any losses arising from government projects carried on the balance sheets of SFIs.

In future it is likely that the SFIs will evolve in the direction of wholesale dealings with community-based entities such as village funds, savings groups and cooperatives. These will need capacity-building to allow them to provide financial services to rural people. While the level of financial inclusion appears satisfactory, a third of Thai households save less than 5% of their earnings. Whether subsidies that currently support the operations of SFIs in rural areas can be phased out and commercial banks can be convinced to provide services in these areas is a major problem. The performance gap between state and private institutions is narrowing and there is an increasing overlap between their respective target markets. The government's 'Financial Sector Master Plan' aims to provide an enabling environment for a commercial banking presence in the countryside and to provide supporting infrastructure. Greater efforts to increase financial literacy will also be needed. A credit guarantee scheme for small business loans may prove to be a model for public-private partnership in rural areas.

Comments: Discussion turned to how financial institutions can help Thai agriculture. A banker commented that strong political will is necessary to improve financial inclusion. In the past, Thai governments offered 'sweeteners' to commercial banks to operate in rural areas and banks were permitted to cross-subsidise their rural operations. The crisis at the end of the '90s forced closures in rural areas although banks are still expected to provide some minimum coverage. They tend to 'horse-trade' among themselves to find ways of meeting these requirements. Ms Wajeetip commented that the expansion of SFIs after the crisis was intended to compensate for the decline in commercial bank presence in the regions but their role must change in future.

A Mexican participant noted that in his country the state bank is currently playing an anti-cyclical role. This has renewed debate on the proper role of such banks: should they be concerned with profit, sustainability or social goals? Do they deserve special treatment in terms of regulation? There is a multiplicity of state programs which can be said to support financial inclusion but there are many overlaps, perverse incentives and instances of local capture. Mr Nair commented that 'efficiency should be ownership-neutral'. He denied that any 'special treatment' occurs in India and. But neither is there a level playing field, since state ownership 'dampens' the decision-making process. However the state banks have an advantage in retaining trust, especially in difficult times.

SESSION SIX

INNOVATIONS IN BUILDING INCLUSIVE FINANCIAL IDENTITIES

Questions and issues explored during this session included:

- Using identification technology, including biometrics, to build inclusive financial identities in unconventional ways.
- Balancing innovation in identification techniques with data privacy protection and security.
- Education and awareness-raising so new identity tools, including customer data, are both trusted and protected.
- Risk-based adjustment of Know-Your-Customer rules to create affordable basic financial services.
- Proactive measures for reducing identity fraud and improve the quality of personal information in credit registers.
- Public-private partnerships to implement and scale-up systems of identification and sharing of customer transaction records.

Session Chair:

Dr. Twatchai Yongkittikul, *Co-Chair, Advisory Group on APEC Financial System Capacity-*

Building; Co-Chair, ABAC Finance Working Group and Secretary-General, Thai Bankers' Association

Building Inclusive Financial Identities
Dr. Nicola Jentzsch, *Senior Research Fellow, Technical University Berlin*

Participants were introduced to 'Regina', a person without financial identity. This is because although she is well known in the village in Bangladesh where she has lived all her life, she has no birth certificate (and nor has anyone else in her family). Her house has electricity, but the account is in her husband's name. How can she secure financial ID in order to apply for credit for the small shop she runs?

An identity is established by a set of 'identification parameters' or features (name, address, phone number, etc …) whose combination is uniquely attributable to just one individual. A financial identity is an identity associated with the financial transaction history of an individual (payment transactions, credit repayment, savings behaviour, etc …). The technical documentation of identities is from official documents (passports, ID cards, driving license, etc) and non-official documents such as worker's ID, utility records, letters of attestation, etc…). Financial identities are built up from public and private information sources, and involve data aggregation and dbase management, together with data analytics. The individual's identity must be established for engagement in such financial matters as transaction accounts, credit facilities, asset management and insurance. Where civil registration is universal, as in most of the developed world, identity is built upon birth registration and the subsequent noting of life events. ID documents (ID card, passport, driver's license) can be issued on the basis of civil registration. Where (as in much of the developing world) there are wide variations in registration rates, the establishment of identity is much more problematic. Financial systems, or individual institutions, may create databases for financial ID in response to central bank concerns (KYC and AML obligations, etc) but obviously this leaves much room for uncertainty. Globally, it is estimated that in 2007 some 350 million working people were unidentified.

In terms of financial identity, international standards have been promoted for 'Know your customer' procedures by the Financial Action Task Force (FATF). Inter alia, these include the requirement to verify clients' identity based on 'reliable independent source documents, data or information [that is] most difficult to counterfeit'. Simplified KYC procedures are available for specific institutions and some transactions judged lower-risk. However grey areas remain in the implementation of these procedures. A pragmatic approach involves risk-adjusting ID requirements to particular bank products and circumstances, with data requirements increasing as a client passes over a series of 'thresholds'. At the lowest level, in the world of informal reputational systems and social networks (such as self-help groups) formal ID parameters are not required to permit customers to deal with institutions. A threshold must be crossed, requiring some minimal ID parameters, to permit low risk customers to open a basic bank account. Further thresholds, with successively more rigorous parameters, must be crossed to permit (firstly) 'normal' customers to engage in standard commercial bank transactions and (next) 'high risk' customers to access services. Simplified KYC requirements introduced by the Reserve Bank of India in 2008 allow customers to be 'identified' for small savings and credit accounts, and allow already 'identified' clients to introduce other clients. Photos are required and client addresses are verified informally. In the Philippines, authorities now accept a variety of credentials, including school, voter and municipal IDs. In South Africa a national ID card is required for a basic account but informal address verification is acceptable and a standard 'risk matrix' is applied to identify low risk customers and transactions. Biometric cards are being issued in Uganda and Malawi, the first a private sector initiative and the second a World Bank field experiment. The costs involved may be too expensive for some countries. Data protection issues also arise in these and other circumstances. Privacy protection is necessary and failure to maintain it can threaten confidence in the banking sector.

The creation of financial identity will increase financial inclusion. It will do so more quickly with further innovations in identification and the more widespread use of biometrics or other reliable techniques. The creation of affordable basic accounts suitable for micro-transactions and reduced ID obligations, mobile banking for such transactions and a greater number and variety of service points at which identity may be established, will all contribute to greater inclusion, increasing the financial status of individuals. However personal data must be protected throughout the ID lifecycle and consumers need to be educated about

privacy issues. Open policy issues include the need for innovative ways to ID persons using local infrastructures, how to create the incentives (ie. useful and sustainable entry-level products) for people to seek ID and how to design optimal private privacy protocols.

Innovations in Building Inclusive Financial Identities: Case study from Indonesia
Mr. Pungky Purnomo Wibowo, *Senior Researcher, Directorate of Banking Research and Regulation, Bank Indonesia*

Title: Increasing financial access for the unbanked by developing financial identities: a concept note.

Mr Wibowo introduced participants to a pilot project to be conducted by Bank Indonesia in conjunction with AFI. With almost 60% of Indonesians unbanked, the project focus is on the lack of 'financial identity' as a factor in their inability to access formal services. There is insufficient information available in most cases to permit identities to be constructed. While another project has been working on a credit rating scheme for SMEs this is not yet available. Obstacles exist to the compilation of necessary data. Community awareness of the value of collecting and using relevant data is limited. Data relating to communities that has been compiled by provincial and local authorities is not online nor is it easily compiled in a central database. Further, there is a lack of coordination between agencies with access to various necessary data elements. The objective of the project is to overcome these difficulties and to create a financial identity database capable of supporting an increase in the level of financial inclusion from the present 42% to 65%. Individuals will be given a 'financial identity number' (FIN) by which they can be identified and their data accessed by authorised financial institutions. An early objective will be to prepare a 'blueprint' for the project in discussion with relevant agencies whose collaboration is essential to the success of the project. Considerable effort will be put into assuring the commitment of all stakeholders. Preliminary surveys will be conducted for pilot projects, each dealing with a particular segment of the unbanked. Examples are people involved in 'arisan' (traditional Indonesian informal savings and loan groups whose membership runs into many millions) and the school savings program, also a mass movement. This is to be done in preparation for the construction of databases for these people, satisfying minimum KYC requirements. At the same time, Bank Indonesia will work with commercial banks to persuade them to design and offer a free basic bank account suitable for these people when they acquire FIN identities. The project will aim to add a million identities to its database annually over a five year pilot project timeframe and to see those people graduate to entry-level bank accounts, while steadily increasing the number of banks that offer such accounts. While work proceeds on creating FIN identities for the unbanked, Bank Indonesia has work underway to create other financial identifiers for people already accessing the financial system. These will include a 'customer ID number' (CIN) for those with bank accounts and a 'debtor ID number' (DIN) for borrowers. It is planned in due course to integrate these data bases with the project's FIN data to create a 'single ID number' (SIN). This will be the key to a unique financial identity for each person recorded in the system. With further growth in coverage this could become a potent instrument for financial inclusion in Indonesia.

Brief Commentaries:
Mr. Tony Lythgoe, *Principal Financial Specialist, Global Credit Bureau Program, International Finance Corporation*

The main problem is not necessarily a lack of ID, but rather inconsistencies in the use of IDs. A unique identifier is what is needed. For example, there are some 22 ID systems in Egypt, with no link, for example, between a person's passport number and an ID number. Without such cross-references it is not possible to have a unique identifier and people may be inclined to use different identifiers for dealing with different banks. Another quite common problem with ID systems occurs when they are kept 'tight', so that it is not possible to check with the issuing authority to validate the client's ID. Technology presents both opportunities and limitations, as seen with biometric IDs which are effective in providing unique identification but vulnerable to technological problems, such as may occur in storing and transmitting data. The condition and performance of telecoms infrastructure may be deficient in many developing country situations. Other problems may be socio-political; for example certain populations may be resistant to biometric or other ID registration (for example, Australia is a technologically-advanced country

whose voters appear to share this aversion).

Mr. Khandakar Muzharul Haque, *Executive Director, Bangladesh Bank*

In Bangladesh biometrics have been used successfully by the Electoral Commission for a national ID card (used for the election in December 2008). However there are challenges in Bangladesh, in the form of overlaps between various databases, which raise the possibility of coordination failure. Authorities are also concerned about privacy issues associated with biometric ID and its use in the banking environment. The state of infrastructure is also a concern in Bangladesh. Investment in the platforms for transmission and storage of biometric data is necessary, especially given problems experienced with electricity supply.

Discussion: Dr Jentzsch said it is difficult for credit bureaus to operate without a functioning ID system and certainly more expensive for banks to conduct their inquiries. The number of documents required is multiplied. If banks are given an efficient system of financial identity and are able to price loans for risk more effectively, then 'risk-based pricing is rent-switching', meaning that cross-subsidies tend to be eliminated. Also, in her presentation she had mentioned the possibility of negative externalities occurring if information is collected for one purpose and then used for others, without consent of the persons concerned. There are pressures to allow 'legitimate' private sector users access to data (banks, telcos, marketers) and a 'bandwagon' effect can occur. There are legislated protections against this now in Europe. She likened the absence of financial identity to a form of exclusion, for example the 'identity exclusion' of pavement dwellers. Socio-political obstacles may exist in a variety of circumstances; Indonesians, for example, appear quite averse to fingerprinting. In order to convince recalcitrant populations, policy must aim to place the balance of advantage quite obviously on the side of accepting the technology. Biometrics are not the only way, or necessarily the cheapest. Indian experience with smart cards may point in an alternative direction.

Raul Hernandez-Coss mentioned that Mexico has IDs but not a national ID system, and that such systems are often associated with dictatorship in the popular mind. But identification is a global problem with many facets; for example, about 10% of Mexican manual labourers don't have a recordable fingerprint. Eduardo Jimenez referred to private credit bureaus which do not communicate with one another and to the real problem of identity exclusion among the poor. Dr Thorat referred to the merging of databases and the need to have privacy protocols to avoid injustice to individuals about whom adverse conclusions might otherwise be drawn. Mr Lythgoe asked 'whose data is it anyway?' if permissions have been given by respondents (although the issue of informed consent may be relevant here). The DVD/Betamax comparison is apt; we need to avoid each agency adopting its own protocol and being unable to talk with the others. He warned that a functioning financial ID system won't necessarily give lenders a greater appetite for risk. Another referred to issues of governance; sloppy supervision of contractors may lead to inefficient implementation. The capacity of bureaucracies to handle the issues is a real problem.

SESSION SEVEN

CONSUMER PROTECTION INNOVATIONS AT THE BOTTOM OF THE PYRAMID

Questions and issues explored during this session included:

- Balancing protection with access through simple, basic rules and principles that keep costs manageable and legal uncertainty to a minimum.
- Translating consumer protection codes into concrete changes in microfinance providers' policies, procedures, and customer interaction
- Fair, accessible recourse and redress, especially when judicial options are limited. What is the most suitable and effective enforcement model?
- Technology solutions to improve consumer protection and informed choice.
- Using credit information and other data sources to monitor indebtedness trends and abuse in credit markets.
- Policies that are effective in preventing excessive lending to poor customers resulting in over-indebtedness.

- Financial education programs to initiate inexperienced customers to new ways of saving and managing risks.
- Detection and prevention of common financial fraud schemes and consumer education on warning signs for fraud (e.g. financial pyramids)

Session Chair:
Dr. Yashwant Thorat, *Regional Associate, Alliance for Financial Inclusion*

Introduction by the Session Chair

Dr Thorat introduced the topic by listing an 'overarching set of principles' for consumer protection at the bottom of the pyramid. First: the need for education and publicity. Poor and marginalised consumers need to understand the products presented to them, and especially so in the case of financial products. For this reason organisations catering to the financial needs of the poor normally have induction or education programs prior to offering services, and especially loan services. The Reserve Bank of India has launched a mass financial literacy program with picture books in major communal languages to explain financial services. Mass media (TV, radio) and public events are employed for consumer education. Second: the principle of transparency (a small word with multiple dimensions). In the financial sector this encompasses easy-to-understand contracts with the most important provisions brought specifically to the attention of the customer. To enhance transparency, can we think of a 'code of commitment' that banks could accept, adherence to which would be monitored and enforced, either by self-regulation or by an enforcement agency? Third, the principle of reasonableness or fairness: Contracts must be fair and not loaded against the consumer; charges should not be excessive or usurious and should bear a reasonable relationship to the matrix of cost and normal profit; an approved and transparent policy for interest rates should treat equally all customers who are placed equally. From a normative perspective, those at the bottom of the pyramid deserve some degree of concessionality. Perhaps the state should make subventions to reduce the transaction cost and risk premiums applying to services for the poor, while designing such subventions to avoid their being misused. Fourth, regarding responsibility for the actions of agents and outsourced services: Banks should accept responsibility to compensate, fairly and transparently, customers who suffer due to the mistakes or misdeeds of agents or outsourced services, or the failures of IT systems. Added risks arise in the case of branchless banking and these must be addressed by the banks. Fifth, there are issues arising from the need for fair recovery practices: Separating the functions of selling and recovery can create biases in favour of irresponsible marketing and harsh recovery. Regulators need to review the incentives offered to agents by banks and MFIs. Here also there is a case for a 'code of commitment' eschewing any resort to violence in words or action or other forms of harassment. Finally, there are issues related to redress for complaints or grievances: machinery for the redress of client concerns may be internal or external. In some countries a Banking Ombudsman exists for redress of grievances not dealt with internally by banks. However, considering the numbers of clients involved, their often low levels of education and access to formal procedures, more innovative approaches may be called for. Perhaps local 'awareness camps' can be convened, to be attended by bank staff responsible for handling grievances and staff of the Ombudsman, together with customers wishing to air grievances. In-camera sittings might be arranged where reconciliation can be managed and rulings given in simpler matters. The Ombudsman could have Q&A sessions, via newspaper columns or talkback radio and TV. These could be valuable in tracking trends in bank practices and management of customer grievances as well as in informing the public.

Consumer Protection Innovations: Case Study from Peru
Dr. Fernando Arrunategui Martinez, *General Manager for Consumer Products and Services, Superintendency of Banks, Insurance and Private Pension Funds, Peru*

The confidence of consumers is a key element in financial inclusion and transparency is more powerful than regulation in securing that confidence (though both are necessary to consumer protection). The Superintendency does not solve consumer complaints but regulates the policies and procedures followed by financial institutions themselves in order to receive, manage and resolve complaints presented by consumers. Other recourse mechanisms are available to consumers unsatisfied by the responses of financial institutions. Apart from the courts, these are the Financial Ombudsman of the banking association and a consumer protection agency. The better managed complaints are, within the offending

institutions, the fewer will be referred on to these third party agencies. Close to 400,000 complaints were directed to financial institutions in 2008 of which only a tiny proportion proceeded on to the Ombudsman or consumer agency because they were unresolved. The role of the superintendency (SBS) is to take preventive, or ex ante, measures to assure resolution of difficulties. It aims to provide adequate regulation and constant supervision efforts, together with promoting increased financial literacy to reduce complaints. It focuses on what it does best, regulating and supervising institutions so as to decrease the potential reputational risk they might suffer through consumer malpractice, as with any other possible source of risk. To this end, SBS drafts and approves appropriate regulation, carries out supervision, conducts information campaigns and financial literacy projects and engages in consumer orientation and inquiry-solving processes. For greater information transparency and consumer protection, it has consolidated all relevant regulations in a single document. This includes the obligations of institutions to provide all relevant information and to install an in-house 'user services system' to assure consumer protection and information transparency. Institutions must calculate and publish 'comparison' rates for credit and deposit products that show costs and yields after all relevant charges are taken into account. In regard to branchless banking, regulations now prescribe the public disclosure required of agents when dealing with the public. As E-banking products and services have grown in importance, internet services must be backed by institutional websites with full disclosure of necessary information. As phone and mobile banking are more recent, no special regulations exist yet for these procedures, although for the time being operational risks and informational disclosures of these services are covered by general regulatory provisions. Where new regulation is thought necessary SBS is required to 'pre-publish' new or amended regulations to permit comment.

Supervision is conducted off-site, on-site and unannounced. For the first of these, SBS constantly checks information published by institutions (websites, mass media, price lists, complaint reports) to assure disclosure of relevant information. A 'consumer risk model' is used to identify financial institutions requiring guidance. The model is a rating device that employs statistical scoring and combines quantitative and qualitative information about compliance with the consolidated regulatory document. SBS conducts information campaigns, publishing market average interest rates which are carried by mainstream media, also comparative information on other costs on a comparative basis. More recently this information has been presented, with real-time updates, on the SBS website. Advertising campaigns refer consumers to the information on the website and issues are picked up in the media, increasing visibility and awareness. Financial literacy is encouraged by the insertion of elements into high school curricula and teacher training programs, and by targeting various social groups. These efforts are spreading in scope and numbers of people contacted. Much attention is given to producing attractive and informative materials. A 'virtual classroom' CD is distributed to teachers for lesson preparation and is to be made available online. A 'financial literacy plan' is being developed for the period 2009-11. This will commence with baseline measures of financial literacy in six target audiences, then conduct widespread 'propagation' action to reach these audiences, followed by a closing measure of literacy levels. SBS has opened three 'Offices for User Services' to provide information and take part in campaigns and consumer protection fairs. All this activity has produced some lessons. Ex-ante action is a more cost-effective way of protecting consumers than attempting to resolve their problems directly. Regulation and oversight are key tools for consumer protection just as for other areas of supervisory concern. When financial services are extended through non-traditional channels, this requires review of consumer protection rules as well as operational procedures. Transparency in information is not a natural process and requires regulatory attention. Financial literacy is an efficient way of empowering consumers, a tool of economic policy against financial crisis and a means to increase awareness of new service channels. Finally, partnership with educational authorities and mass media is essential.

Consumer Protection Innovations: Case Study from Malaysia
Ms. Koid Swee Lian, *Director, Consumer and Market Conduct Department, Bank Negara Malaysia*

To have well-informed and empowered consumers of financial services and to assure their fair and equitable treatment is to support the broader stability of the financial system. Achieving these ends in a changing financial system requires correcting information asymmetry and improving transparency levels. These tasks are complicated by the introduction of innovative and complex financial products, by changing delivery channels and the trend towards growing consumer debt and lower household saving

levels, as well as by attitudinal changes especially among the young. Low levels of financial literacy and the prevalence of scams create problems while extended life expectancies and higher expectations impact on financial needs and behaviour. Regulators operate in an arena of competing expectations and pressures from various stakeholders and a balance has to be struck between protecting consumers and allowing innovation. Regulation must be both appropriate and avoid imposing excessive costs, while key stakeholders have to be brought along with the process at all times. Market conduct regulation is a tool for balancing bargaining power between consumer and service provider by reducing information asymmetry between them, requiring plain language in contracts and other documentation and exerting market discipline on providers. Surveillance of conduct and enforcement of breach remedies are part of the regulation package. Ensuring fair treatment of consumers and market integrity requires specific regulation as well as intelligence gathering by means of attention to customer complaints and 'mystery shopping', 'name and shame' publicity and reprimands and penalties where appropriate. Close attention is paid to assuring effective product disclosure, providing consumers with the information to make informed decisions and facilitating comparison of alternatives. In regard to fees and charges, an effort is made to take a balanced approach with due regard to market forces, but applying guiding principles and requiring a basic framework of services. Institutions are required to provide access to a minimum level of financial products and services at reasonable cost, obligations which are spelt out in detail.

The Consumer and Market Conduct department also accepts responsibility for enhancing consumers' financial capability by developing and disseminating financial information via print and electronic media and in schools and community groups. Apart from the general community there are also outreach activities for the visually impaired, both adults and children. Action has been taken to create and publicise avenues for consumers to seek help and redress. Financial institutions must have a complaints unit and there are specific services such as the Credit Counselling and Debt Management Agency which targets youth, the Financial Mediation Centre which has financial industry involvement and a Small Debt Resolution Scheme. The central bank has its own focal point, an Integrated Contact Centre', for complaints management and advice. Other institutional infrastructure has relevance for consumer protection, including deposit insurance to which all banks subscribe and a credit information database (the Central Credit Information System) designed to facilitate credit risk management and promote a more efficient credit process as well as to avoid consumer over-indebtedness. Identities of individuals are assured by collaboration with national registration authorities, company details are provided by the companies commission of Malaysia and 64 participating financial institutions report data to the system, which also draws upon the information base of a private credit reporting provider.

Consumer Protection Innovations: Case Study from South Africa
Ms. Nomsa Motshegare, *Chief Operations Officer, National Credit Regulator, South Africa*

This presentation describes the evolution of a regulatory framework for microfinance lending in South Africa from the late 1990s to 2006. The impetus for regulation came after a period in which micro-lending activity had proliferated. In 1999, a 'Usury Act exemption Notice' was issued, with the effect of regulating both commercial and NGO lenders while exempting them from the interest rate cap applicable under the Usury Act. The Microfinance Regulatory Council (MFRC) was appointed to the regulatory task. The MFRC's mandate covered the regulation of the micro-lending industry, facilitation of increased access to finance and consumer protection. The Exemption Notice made it a condition of all micro-lender operations (those who extended credit up to a new maximum of R10,000 at rates above the statutory cap) to register with the MFRC. In 2002 it became compulsory for all suppliers of microfinance to register with the National Loans Register (NLR). The NLR is a database that records all loans disbursed by lenders registered with the MFRC. Under the Exemption Notice lenders were obliged to comply with certain conditions. These included protections for borrowers: that loan agreements must be in writing, rules of disclosure under loan agreements, that lenders must not use client's bank card or pin to collect money, that lenders must have complaints procedures, and that agents used by lenders are managed in accordance with MFRC stipulations, in terms of training, registration and contracts with agents. There were also provisions designed to prevent 'reckless lending'. Lenders must have policies to prevent this; they must consider the ability of borrowers to repay and they must make enquiries on the National Loans Register before final approval.

Subsequently the National Credit Act of 2005 was enacted to provide comprehensive legislation for

micro-lending. The National Credit Act aims to regulate the granting of consumer credit by all credit providers, including microlenders, banks and retailers. This new legislative framework created formal bodies, the National Credit Regulator and the National Consumer Tribunal, to play a vital role in ensuring enforcement, promotion of access to redress and to deal with breaches of the Act. Credit providers, credit bureaux and debt counselling services are obliged to register under the Act. However the Act applies generally, irrespective of registration status. Credit providers under a (quite low) threshold are exempt, but such providers are unable to advertise and their agreements are unenforceable. The Act does not apply to borrowers classed as ‘juristic persons’ with assets or turnover above $100,000. There is an informal complaints resolution process, telephone-based in the first instance. The approach to enforcement is to require letters of undertaking, or compliance notices may be issued or matters may be referred to the National Consumer Council. The NCR has an active program of stakeholder outreach and uses the media actively to propagate its messages. It has a research capacity, with particular interests in access to finance issues, socio-economic impact and over-indebtedness. It takes active measures to combat reckless lending, by requiring lenders to make ‘affordability assessments’ of clients. If lenders are judged to have infringed reckless lending provisions the courts may suspend enforcement and may refer consumers to debt counsellors. The NCR makes efforts to achieve fairness in credit marketing, by prohibiting automatic increases in credit limits, by requiring a standard 1 page pre-agreement quote on all agreement. It has prohibited ‘single premium’ credit life insurance, required crucial disclosures and created a register of credit agreements while regulating credit bureaus. In conclusion, the NCR operates to monitor the conduct of all registered entities to ensure compliance with the Act. While consumers must accept responsibility for their actions, the credit industry has been too willing to push the limits. South Africa has to develop a market where consumers can benefit from access to credit without being damaged by it. The Regulator’s priority is to engage constructively with banks to achieve constructive working relationships and to balance consumer rights with the requirements of the industry to the benefit of all players.

Financial Education for Consumer Protection

Ms. Monique Cohen, *President, Microfinance Opportunities*

Financial education communicates the knowledge, skills and attitudes that people need to adopt good money management practices for earning, spending, saving, borrowing and investing. A core curriculum for financial education would include budgeting, savings, debt management, bank services and financial negotiation. It could be supplemented by specialised modules for topics such as risk management and insurance, remittances, consumer protection and perhaps current concerns such as mobile banking. Some emphasis on youth and money management would also be useful. But it’s important not to forget that MFIs and their clients have different perspectives and that MFIs also need education and attitudinal change. MFIs may feel satisfied with their focus on concerns such as quality of service, good treatment of clients, avoidance of over-indebtedness, fair pricing, transparency and appropriate debt collection practices. From a client perspective, while there is a degree of correspondence in terms of these issues, there are often significant differences in emphasis. Issues of respect and truthful information, and mechanisms for redress of grievances, also feature among their concerns. ‘Transparency’ may have a different meaning for the clients who have difficulty understanding what is written on the whiteboard. They see ‘transparency’ in terms of what they can understand and they may fear to ask questions for fear of being denied a loan. When repayment terms are explained they will likely focus simply on the monthly cash obligation. They may be embarrassed to show their ignorance of interest rates. However difficult the task, it is necessary to present the material to them in a fashion they can grasp and their passivity should not be interpreted as inability to understand. While privacy is often overrated as an issue of concern for borrowers, they may be unsure of what constitutes inapropriate collection behaviour. Complaint mechanisms are often a difficult area ; the channels are not always obvious and few ever attempt actually to use them. Fear of blacklisting is again a factor here. Underlying all these attitudes is a lack of confidence and the belief that lenders tend to hold the cards.

Financial education can be seen as making customers aware of their rights and responsibilities as users of financial services. They have the right to be treated with respect, to decide for themselves, to receive information, and the right to be heard. They have the responsibility to treat others with respect, to evaluate offers made to them conscientiously, to comply with terms and conditions and to provide true and timely

information. They are entitled to consumer protection, but also to understand that this is a matter of balancing rights and responsibilities. They need some technical understanding : judging which financial product suits their needs, understanding flat and declining interest rates, having a sense of the debt level they can afford, whether debt collection practices are appropriate or not, where and how to complain.

While everyone agrees that financial education is important, some parties feel threatened by it, for reasons discussed above. It can be argued that the function should be performed by central banks or regulatory agencies, or by MFI associations, or within individual MFIs. Perhaps it is a task for community or consumer organisations or media or training organisations. While all these candidates have claims they are also likely to have biases, conscious or not. In any case it is not desirable to give an exclusive franchise to any entity. There are choices to be made concerning modes for training delivery, whether face to face or via the mass media, whether direct to consumers or via 'training of trainers'. Other presentations have shown a range of approaches to these issues adopted in various countries. Whatever choices are made, financial education is a process, while financial literacy is the desired outcome. On the last topic, of responsibility for financial education, an Indian participant commented that while India has a National Alliance for Financial Literacy representing a range of stakeholders, the task is too large to be done by a single entity. The central bank is also taking a constructive interest.

Friday, 3 April 2009

SESSION EIGHT

THE ROLE OF REGIONAL CAPACITY-BUILDING AND PUBLIC-PRIVATE PARTNERSHIP IN PROMOTING FINANCIAL INCLUSION

Questions and issues explored during this session included:

- The role of regional cooperation in capacity-building and the involvement of the private sector in promoting financial inclusion in Asia and in Latin America.
- Effective strategies for extending the reach of microfinance to population segments that remain financially excluded and for strengthening microfinance institutions.
- Policies and regulations that facilitate the banking sector's participation in microfinance.
- Strategies to promote private sector investment in microfinance and financing through capital markets.
- The role of technology in the development of microfinance and its implications on policies to promote financial inclusion.

Session Chair:
Dr. Matthew Gamser, *Principal, Advisory Services, East Asia and the Pacific, International Finance Corporation*

Introduction by the Session Chair

Regional Capacity-Building and Public-Private Partnership to Promote Financial Inclusion: An Asian Perspective
Mr. Craig Wilson, *Executive Director, Foundation for Development Cooperation*

The Foundation for Development Cooperation (FDC) is active in regional capacity-building in the Asia-Pacific. Its expertise lies in the fields of ecooonomic development and assessment, policy analysis and strategic research. It operates through partnerships and leverage, grassroots-based community initiatives, advocacy, consulting and advisory services. It has created, or is associated with, a number of partnerships or networks that span the region and include significant public and private sector entities working together to build capacity for development activities in microfinance and financial inclusion. From offices in Brisbane (Australia), Singapore and Suva (Fiji) it manages the Asian regional 'Banking with the Poor' Network and the Pacific islands network 'Microfinance Pasifika', as well as a consortium of national-level microfinance networks drawn from APEC developing economies.

FDC sees the need for a similar organisational approach to be taken to the APEC initiative for financial inclusion, with an operational committee capable of convening private sector interests in banking and technology at the highest level, to establish the business case for involvement. Central banks and international financial institutions should also be drawn into activities mandated by the APEC finance ministers. Under the leadership of Singapore in 2009 APEC should initiate a set of activities in support of greater financial inclusion in APEC developing economies. In Asia, given that human resources are the biggest constraint, capacity-building and technical assistance will be crucial to the success of efforts to expand the frontiers of financial inclusion. This will require the participation of both public and private sectors and the dissemination of best practices in microfinance partnership-building. Notwithstanding present difficulties, support can be tapped from a variety of private sector sources, especially in banking and information technology, with motives including commercial gain, corporate social responsibility and philanthropy. Public sector initiatives will deal with financial education, with regulatory environments (eg, for microfinance and IT), financial inclusion targets and the role of public sector banks. They should draw upon the outcomes of the UN High Level Commission on the legal empowerment of the poor. Such an APEC initiative will benefit from broadly-based ownership, good management, a clear mandate and brand. It will require measurable targets for its outputs and need to identify appropriate technical solutions, together with the capacity to engender policy responses and achieve external recognition.

Regional Capacity-Building and Public-Private Partnership to Promote Financial Inclusion: A Latin American Perspective
Dr. Carlos Moya, *President, Banca de las Oportunidades (Colombia)*

Despite its name, the *Banca* is not a bank, but a program, designed to bring excluded population segments within the net of financial services. It involves a public/private alliance with government offering an appropriate regulatory framework and incentives to service providers, while private operators react by increasing their institutional outreach and range of services. Regulatory reforms have included the promotion of agent banking, the development of electronic accounts for small balance savings, a product geared for low-income clients with lower entry barriers and costs, and simplified procedures, and interest rate reforms. The project supports financial education activities, provides support to NGOs that have business development programs and has arranged a public guarantee program for credits to the vulnerable population. It has been active in supporting the development of new financial products, including mobile banking and microinsurance. It has given particular support to M-banking with external support from the IDB-Korea fund. In the first phase, this required an enabling environment to be created for M-banking, in terms of legal, regulatory and institutional framework. An action plan detailed necessary legal and regulatory reform and actions required to assure the participation of key players and to overcome identified bottlenecks. This involved international information exchanges. A second phase saw pilot projects in which incentives for financial institution participation were trialled. Target markets were poor families in marginal city areas and the poor in rural areas. After evaluation, lessons learned were applied on a larger scale. Another activity has been concerned with developing micro-savings facilities, especially for poor families receiving cash transfers under a government program. This is being trialled with the objective of extending the service to 3 million families in due course. Similarly, attention is being given to micro-insurance for families receiving cash transfers.

When the provision of enabling frameworks appears not enough incentive to persuade institutions to expand into marginal areas and populations, government has offered monetary subsidies for the purpose. ‘Dutch auctions’ are conducted, to determine levels of subsidy acceptable to institutions as incentive to initiate, for example, non-bank agencies, micro-credit NGOs, financial cooperatives or commercial finance companies in particular areas. Technical assistance has been given to the voluntary sector to initiate self-help group banking models in low-income population. Similarly, technical assistance is given to commercial

banks for the implementation of microcredit technologies (with USAID), to financial cooperatives (WOCCU) and to microcredit NGOs for institutional strengthening. In the case of non-bank agents, results have been encouraging. Some 5000 agencies were established, offering deposits, withdrawals, collections and transfers, in an 18 month period. Banks had only succeeded in opening some 4300 branches in the previous 130 years! Agencies are located in a wide variety of commercial establishments and the effect on the 'bancarization' of the population has been obvious. Over a two year period the proportion of adults with banking relationships rose from 47% to 55%. Substantial increases have been recorded in the numbers of micro-entrepreneurs accessing credit, in the volume of credit advanced and in the value of other microfinance transactions.

Enhancing the Private Sector's Potential to Promote Financial Inclusion: The Experience of the World Savings Bank Institute

Ms Anne-Francoise Lefevre, *Head, Institutional Relations, World Savings Banks Institute*

The WSBI, headquartered in Brussels, regards itself as the global voice of savings and retail banking. It includes 109 individual banks and banking associations from 92 countries, both developing economies and mature markets. It makes use of that wide reach to conduct comparative studies of various aspects of financial inclusion, from the perspectives of both developed and developing countries. Among its findings are, that of 1.4 billion institutional accounts in developing economies, some 1.1 billion are held in savings banks. Indeed, savings banks have greater outreach among the poorest households than most other pro-poor institutions. WSBI membersin general have the mission to bank the unbanked; they are typically 'double bottom-line' institutions, concerned with social as well as commerciual objectives. They have commitment to local communities, including to the expansion of services to the unserved. For this reason, they use the term 'proximity banking' to describe their outlook and rationale. They regard their accessibility, proximity and capacity to adapt products to local needs as key success factors. Often they possess extensive distribution networks, with low requirements for potential customers to access services and facilities to accommodate low-income clients. They offer basic products, including passbook savings accounts and over-the-counter settlement of bills. They are responsive to market conditions, building on their strengths to diversify products and on their banking relationships to offer multi-channel distribution. They add competitive pressure to many market situations.

Certain key barriers to financial inclusion remain, institutional, governmental and market-based. The drive for institutional improvements in product design, delivery channels, operational procedures and staff capacities must be continuous. Policy and regulatory barriers such as restrictions on investment, stringent prudential requirements and AML measures must be removed. Market obstacles, including the lack of information and trust for banks, misconceptions regarding the role of financial institutions and outdated views of the capacities of 'proximity banks' must be overcome. Better data on the extent of exclusion and unmet demand for services would assist in making the business case for a pluralistic banking system. An enabling environment with proportionate and adapted rules is necessary for further progress by this element in the banking industry. It is helpful to document the business case for institutions taking the 'long view'. Strategic alliances with public and voluntary agencies hold promise. WSBI contributes to these processes by providing a platform for information exchange, training and publication of learnings, as well as for dialogue with policymakers and stakeholders. Research done in collaboration with regional and international organisations provides opportunities to contribute to the policy and regulatory debate. WSBI has the vision of doubling the number of savings accounts in selected member institutions within five years, on a sustainable commercial basis (with Gates Foundation support) and to spread lessons from this experience more widely in years to come. The focus on savings is justified because they are the key asset to finance productive activities, a safety net available in emergency, and a resource for financial intermediation and long-term growth. WSBI members will be challenged to join this enterprise from October 2009.

Discussion: Mexico, like Colombia, offers incentives to financial institutions to move into

underserved territories. But these have proved vulnerable to politicisation; politicians like to preside over the opening of branches, whether or not they subsequently prove viable. How can such schemes be protected? Dr Moya gave more details of the Colombian process and explained the Dutch auction procedure. Successful bidders accept an obligation to operate for at least two years and sites are chosen for potential to break even in three years. Some agencies have been transformed into branches because of the potential unveiled by the process.

Key Issues: Expanding Access
Dr. John Conroy, *Consultant,Rural- and Micro-finance*

We need to remember that a majority of people in developing economies are still financially 'excluded'. ABAC has decided to press the APEC Finance Ministers for recognition of 'financial inclusion' as an essential element in financial development. It has nominated microfinance as the appropriate policy tool for achieving inclusion. Access to financial services is important because it supports economic efficiency, distributional equity, and even financial stability to some degree. Important also in these troubled times is the fact that financial inclusion supports social cohesion. Some financial exclusion exists in all economies, though (significantly) many countries are unable to produce the data. Among APEC economies the range is from 98% inclusion in Singapore to only 8% in Papua New Guinea. In developing economies, poor households suffer particularly from exclusion, but even many non-poor people in the SME sector are excluded in some countries. Poor households need access to deposit services, remittances and payments and (lastly) credit. The 'excluded non-poor' in the SME sector may have personal access to some financial services, but are often excluded from formal credit for working and investment capital. Significant differences in the financial service needs of household enterprises and SMEs, together with major differences in their cultures and modes of operation, suggest that the two should be analysed and dealt with separately. The paper considers the argument that the poor will benefit more if the credit needs of SMEs (as employers) are given priority. It rejects this as 'credit-centric' thinking which fails to appreciate the needs of the poor for a wide range of financial services other than credit, and undervalues the significance of savings mobilisation among poor households.

The paper considers how access to financial services for the poor can be expanded. It discusses six 'policy solutions' for microfinance nominated by ABAC for consideration by the APEC Finance Ministers. These are agent and mobile banking, the diversification of service providers, reform of public banks, financial identification and consumer protection. These measures are categorised as being primarily supply side initiatives, although at least one, the establishment of financial identity, has implications for both the supply and demand sides of the industry. The initiatives are considered in terms of their characteristics: whether they are largely regulatory in nature or require either technological or managerial 'fixes'. While some element of each of these is found in every solution, regulatory considerations are clearly of primary importance overall. Technological and managerial considerations appear of about equal weighting. In only one case, reform of state banking, are management considerations of primary importance. Finally the six measures are examined in terms of whether they appear to offer 'economy-wide' benefits (or positive externalities). These are found to exist in a number of cases. All, for example, are judged to support financial deepening. One helps create a regulatory public good, another, an informational public good, while at least three support increased competitiveness overall. One initiative, the introduction of 'mobile' banking, is judged to have the potential for broad macroeconomic stimulus. The menu of policy reforms offers insight into dynamism and creativity emerging in the microfinance industry due to the combination of regulatory innovation, technological change and managerial advances. A striking feature of the industry is its internationalisation, especially in terms of the rapid diffusion of ideas and technology. More problematic is its internationalisation in terms of capital flows. This is so to the extent that cross-border flows may tend to diminish the incentive to mobilise domestic resources and discourage savings

mobilisation, which is the financial service of greatest value to the poor.

Key Issues: Facilitating Banking Sector Participation
Mr. Chandula Abeywickrema, *Chairman, Banking with the Poor Network and Deputy General Manager, Hatton National Bank*

Microfinance has matured greatly after almost four decades of initiative and innovation. There is greater awareness of the potential for the marginalised to become 'banked'. Growing financial literacy among the people at the bottom of the pyramid has made them more responsive to opportunities to promote their own economic wellbeing through access to microfinance services. Commercial bankers are realising that, as traditional markets become more crowded, growth opportunities are now found outside their comfort zones. The entrepreneurial poor must be regarded as a bankable community and ways must be found of achieving this. Technological changes now make it possible to deliver services to more people in more places and at lower transaction costs. Banks will increase profitability by setting out to 'graduate' microfinance customers to the next level of activity, while the growing importance of migrant labour and the swelling volume of remittances offer new business opportunities. Many models now exist to guide commercial banks in down-scaling operations: in retail banking by reaching down to the level of the micro-entrepreneur, in wholesale banking by partnering with MFIs, and through franchise or agent banking by employing technology and managerial innovation. Commercial banks need to facilitate four main microfinance products. These are micro-savings, micro-credit, remittance/microfinance linkages and micro-insurance. Mobile phones have revolutionised communications in emerging economies, they must now do the same for financial services by facilitating partnerships between banks and telecommunications operators. This will be facilitated by new regulatory and supervisory tools to enable traditional restrictions to be overcome.

A commercial bank may have the opportunity to facilitate 'owner-managed micro-banking units' by allowing them to operate under its banner in a franchise banking model. Such a model may enable regulatory hurdles to be overcome since commercial banks already have permission to operate in areas where franchising arrangements could be extended. Allowing a franchisee to be treated as a bank branch, with the commercial license-holder accepting responsibility for operations conducted under its franchise, could become a widely accepted model for low-cost expansion of commercial bank outreach. Low-cost deposit mobilisation in virgin territory is not the least of the attractions of such a model for a commercial bank. The franchise model is more effective than agent models in mobilising savings since deposits are backed by the name of the bank and depositors regard it as 'safe'. Estimates of remittance flows suggest annual volumes around $300million, perhaps half of which moves through informal channels. If banks are able to lower costs and increase the accessibility of their remittance services for migrants they will capture a larger proportion of these flows and migrants are likely to be better served. Moreover, despite the large funds at their disposal, in aggregate, migrants have limited access to other formal financial services, either at home or in the countries where they work. International banking partnerships and cross-border collaboration on removing regulatory obstacles will help to improve this situation. In fact, there are numerous elements in current regulatory arrangements, including Basel II risk weightings and AML requirements, which impede an efficient and profitable response to the opportunities represented by microfinance and financial inclusion. Since much of this is unintended there are grounds for optimism that solutions can be found. Access delayed is access denied; the hopes and dreams of the poor ride on finding just and equitable solutions.

Key Issues: Mobilising private finance for inclusion
Mr. Matthew Gamser*, Principal, Advisory Services, East Asia-Pacific, International Finance Corporation*

The IFC: who we are, what we do. IFC is an arm of the World Bank group which invests, mobilises capital for investment, and advises private sector entities in developing economies. There has been an increasing emphasis on capital mobilisation over time due to the realisation

that private capital resources will always dwarf whatever IFC has at its own disposal. IFC also has a structured finance department which devises risk-sharing instruments to attract private capital resources into projects considered marginal in conventional terms, including agricultural supply chains. IFC is owned by its 181 member countries. It has offices in 100 countries and is increasingly focussed on 'frontier' markets and IDA countries. It aims to build long-term relationships with emerging market players, promoting private sector growth and developing local financial markets.

IFC's investment services include loans and intermediary services, equity and quasi-equity, syndications, structured and securitised products, risk-management products, trade finance, subnational finance and treasury operations. It has five main lines of action, concerned with the business enabling environment, access to finance, corporate advice, environmental and social sustainability and infrastructure needs. In fiscal 2008 it made 372 new investments in projects in 85 countries, while providing advisory services for some 300 projects in 75 countries. It raised $16.2bn in financing, including $4.8bn in external resources, with IDA countries accounting for 45% of investments. IFC's risk-sharing facility is intended to improve access to financing and improve financing conditions for more marginal investments. By offering to share risks on loan portfolios IFC can persuade banks to support the growth of the Corporation's lending to IFC priority sectors, while improving the banks' origination and monitoring capabilities. For other clients, risk-sharing helps to support the growth of their business and to transfer the responsibility for managing loans. IFC risk-sharing arrangements have, or will, assist in financing schools in Ghana and Kenya, student loans in Indonesia and Chile, loans to SMEs and to health facilities, to agricultural supply chains (in PNG) and for cellphone distributors (East Africa, Pacific). A variety of arrangements involving acceptance of 'first loss' risk by various parties can be agreed.

Key Issues: Promoting the Use of Technology in Microfinance
Mr. Alberto J. Jimenez*, Global Business Advisor, FSS, IBM Global Services*

Mr Jimenez briefed participants on IBM's microfinance 'processing hub' capacity and its potential to support financial inclusion. IBM sees potential for the profitable provision of appropriate 'back-end' technology to the microfinance industry. Observing the growth of the microfinance industry, the scale of the potential market, and current inefficiencies in the business models of banks and MFIs, the company feels that access to processing hubs can assist microfinance service providers to overcome cost hurdles holding back the advance of financial inclusion. In the case of traditional banking channels, costs of distributing services to remote locations in low volumes are high. Provision of credit in the micro-market is fraught with uncertainty because of the lack of formal credit histories. Low literacy rates in the target market make conventional documents less useful and place greater burdens on staff to educate consumers verbally, while the physical security of cash may be problematic in remote locations. Thus the conventional retail banking model is inappropriate for microfinance operations. Partnerships with MFIs might offer some solutions to these problems, but limited transparency of MFI operations discourages banks from committing resources to them. On the other hand, current operating models of most MFIs are deficient in terms of capacity to supply the growing demand for micro-financial services. The vast majority do not have access to appropriate back-end technology. Microfinance leaders acknowledge that cost control, management of technology, and product development are the principal challenges for the industry.

In summary, while today's banks often have difficulty reaching the poor, today's MFIs have innovative ways to reach them but are challenged in scaling up to the task. MFIs are burdened by inflexible back offices, with 45% of them using paper or spreadsheets. Larger MFIs use traditional application, but these are expensive and lack full support for microfinance functionality. The banks and MFIs represent a 'financial ecosystem' which can be integrated using the IBM processing hub. The hub provides modern, economical and appropriate 'back

office' services to MFIs, with the potential to overcome the high volume, low value drawback to processing MFI transactions. It provides an interface between the banking system and the MFI sector and gives banks access to the networking and distribution possibilities of MFIs. The Hub could also assist in linking MFIs with other key economic actors, including regulators, international payment networks, credit bureaus, Telcos, and NGOs and the donor community. Based on experience in India and Latin America, IBM is currently establishing MF processing hubs in five regions to meet the IT needs of financial institutions serving the low-income markets. These promise to lower the processing costs of MFIs dramatically, offering them scale advantages enjoyed by traditional banks by creating an 'end-to-end' technology solution for low-income retail banking institutions. Hubs will be accessed by various channels to permit 'many-to-many' interactions. All applications will employ VPN (virtual private network) communications to some degree. Some end users, for instance those using M-banking, will connect directly to the hub via VPN. Transactions of the clients of an MFI will be transmitted to the hub from the MFI office. Larger MFIs will link their branches in, also by VPN. Apart from the case of M-banking, there will be a physical connection with the customer at the last link in the chain. This generates the data to be transmitted to the hub for processing. Institutional users of hub services will buy access to the system from 'resellers'. These will stand in relation to IBM as retail Telcos relate to wholesale telecommunications service providers.

Discussion: Mr Gamser was asked about the impact of the current crisis on the availability of capital for IFC investments. He agreed that the phenomenon of 'financial protectionism' is impacting the availability of capital negatively at present. IFC is deploying a recapitalisation fund to assist selected banks and is active in supporting trade finance in certain countries whose exports are threatened by lack of access to facilities. Mr Jimenez stated that IBM could develop hub capacity to serve 400 institutions within five years. He was asked whether his diagrams embodied the assumption that the hub would facilitate a 'top-down' financial relationship with external funds being channelled to the micro-financial system on the periphery and with no obvious place for savings mobilisation among the poor. Mr Jimenez replied that the diagrams reflected the value chain of technology that would be created, rather than a flow of funds diagram. It was suggested that in their present form the diagrams appeared not to reflect the role of savings in the 'financial ecosystem'.

CLOSING SESSION

Session Chair:
Dr. Masahiro Kawai, *Dean, Asian Development Bank Institute*

Closing Remarks
Mr. Yoshihiro Watanabe, *Chair, ABAC Finance and Economics Working Group and Managing Director, Institute for International Monetary Affairs*

Mr Watanabe congratulated the sponsors and organisers on the importance and timeliness of the workshop, because he believes the people at the bottom of the pyramid will suffer most under present world circumstances. He welcomed the recent G20 declaration, which included a number of important measures, including the allocation of $50bn for social protection measures and commitments to prevent damaging trade measures being adopted by leading economies. The world needs continuing efforts to secure financial inclusion, especially in view of the reduction in international capital flows to support this. ABAC will continue to press the issue. He intends to brief ABAC colleagues at their meeting in Brunei in May on the outcomes of this meeting, with a view to taking the case to the APEC Finance Ministers when they meet in Singapore later in the year. He hopes the Finance Ministers will respond by endorsing an APEC financial inclusion initiative.

Dr. Twatchai Yongkittikul, *Co-Chair, Advisory Group on APEC Financial System Capacity-Building; Co-Chair, ABAC Finance Working Group and Secretary-General, Thai Bankers' Association*

Speaking for the Advisory Group, Mr Twatchai offered a brief summary of lessons from this workshop and what ABAC will carry away from it: Concerning agent banking, innovative policy and regulation can bring many into the financial sector using a variety of channels and with fruitful public/private collaboration. Concerning mobile banking: its explosive growth has facilitated a range of transactions, but also presents challenges as it crosses regulatory domains and raises issues of data privacy and consumer protection. Diversifying providers is a solution that requires initiatives to lower regulatory barriers to innovative start-ups. The costs and benefits of such measures have to be evaluated carefully to assure a net benefit to the economy. Concerning public banks, it has been shown that they can play an important and productive role, but policy must give most careful attention to issues of governance and management. In the matter of financial identity, it is clear that this reform increases access, but regulatory frameworks must have the necessary flexibility and maintain protection of privacy. Consumer protection raises the important issues of fair treatment of microfinance clients, the protection of their information and the importance of campaigns for financial literacy. Finally, today's program has underlined the importance of public/private collaboration. All of these matters are of considerable interest and value to the ABAC Advisory Group on APEC Financial Sector Capacity Building and will influence its future deliberations.

Dr. Alfred Hannig, *Executive Director, Alliance for Financial Inclusion*

Dr Hannig said in his view this had been a great event, and a worthy preliminary to the AFI Global Policy forum to be held in Nairobi in September.

In his view, ABAC should accept certain priorities: first to define financial inclusion for its purposes, then to consider how the challenge of inadequate data might be addressed and how standards for data collection might be agreed. With respect to regulation, ABAC should examine regulation of services with particular attention to risk profiles. It should accommodate the desire of regulators to communicate more closely with the industries that are drawn together into the web of microfinance, especially telecommunications companies. We at AFI 'feel encouraged to start the work with you'.

Closing Remarks by the Session Chair

Dean Kawai congratulated organizers, sponsors and participants on the success of the workshop and expressed pleasure that the Asian Development Bank Institute had been able to facilitate the event.