INTERNATIONAL DIALOGUE

THE FUTURE OF MICROFINANCE AND FINANCIAL INCLUSION

October 11 - 12, 2012

Lima, Peru

SUMMARY OF DISCUSSIONS AND PROPOSALS FOR POLICY AND ACTION

Representatives of financial institutions, subject specialists, senior officials of regulatory and supervisory agencies, and representatives of multilateral organizations dedicated to strengthening microfinance and financial inclusion in the region, met in Lima on October 11th and 12th, 2012 to analyze the evolution of these activities in the region and assess their future prospects.

Under the meeting "The Future of Microfinance and Financial Inclusion," organized by the Association of Bank Supervisors of the Americas (ASBA), with the support of the Superintendencia de Bancos, Seguros y AFP of Peru, and the Multilateral Investment Fund, a member of the IDB Group, participants made strategic recommendations and established lines of action aimed at policy makers and private sector executives to support the sustainable and stable development of microfinance and financial inclusion.

The representatives were personally invited; thus, they expressed their own views during their participation and did not involve a commitment by the institutions or organizations to which they belong.

The discussion was organized in four panels intended to promote concrete discussions in response to an initial presentation by an expert on each subject included on the agenda[1]. These panels analyzed the challenges to be overcome in the region, the necessary policy and regulatory frameworks, expectations about private actions, and the expansion of market coverage on the basis of microfinance experiences and financial inclusion practices.

I. Challenges: To reduce poverty, promote savings, and control over-indebtedness

1. Poverty is a complex problem whose solution involves dealing with several shortcomings. Despite the improvements shown in the levels and distribution of income in recent years, Latin America remains the most unequal region in the world, with higher poverty levels in the rural sector.

2. Going forward, the challenges for microfinance and financial inclusion processes will become increasingly difficult to overcome. The groups not reached by the financial sector register the most

[1] See the agenda in Annex 1.

critical levels of poverty and are located geographically further away from urban centers. The scenario for deepening financial operations involves developing its actions in a regional context characterized by the persistence of structural problems, lack of basic infrastructure, insufficient education level, high informality, and low population density.

3. Savings capacity constitutes one of the main elements, if not the most important, that drives people out of their state of poverty. It is therefore imperative to develop measures to encourage higher savings rates among clients of microfinance institutions, strengthening the long-term relationship between credit and savings products.

4. The over-indebtedness of clients should be recognized as a risk that can affect the sustainability of financial institutions engaged in microfinance and financial inclusion activities. This problem must be addressed not only individually, but also as a collective management problem that can generate financial and reputational risks at a system level.

II. Barriers to financial inclusion and to the development of the financial market

5. Amongst the main obstacles that restrain the expansion of financial markets, especially the demand for micro-financing and small-amount services, we can mention low income levels and scarce resources of the target population, which in turn hinder their ability to save money. In addition, the absence or inexistence of guarantees or collateral elevates credit risk by not allowing institutions to mitigate losses arising from default. On the other hand, a limited financial culture and education in general, as well as high levels of informality, precariousness and instability of employment, dispersed location and small scale of the target population, all hinder the expansion of financial services and products supply to an important segment of the population. These obstacles are magnified in rural areas, of which we have little knowledge about their needs for financial services and products.

6. Regarding the ability to offer financial services, it is recognized that, despite the existence of a large number of financial operators, many of them are small and fail to promote wide competition, restricting dynamism in the market, price reductions, and the possibility of extending coverage to more dispersed populations. Also, there is a certain level of informality in the management of institutions that provide financial services to segments with insufficient access. Many of these institutions have yet to develop a corporate culture, implement management systems - that overcome their current rudimentary features - and invest in technological developments.

7. In several countries, there are still barriers arising from a weak institutional and regulatory framework of the financial sector. In this regard we can mention: the absence of a specific legal framework for microfinance transactions, and for products, services and channels that contribute to financial inclusion; difficulties in managing guarantees, as well as property rights and records; absence or inadequate management of credit bureaus; volatility in the macroeconomic and political environment; as well as high levels of informality that require public policies and corporate actions that contribute to their progressive incorporation into the formal financial market.

8. To the barriers mentioned above, we can also add public policies that propose establishing ceilings on the cost of money, promoting credit rationing, directing lending to specific sectors, and requiring products and services to be subsidized, among others. These actions seek to support segments of the population with limited resources and limited access to the financial sector. However, the result is the opposite to the extent that these actions affect the provision of services by raising financial

products and services' prices, and discouraging competition. The experience of several Latin American countries, in which the State intervened with the laudable goal of expanding the coverage of financial services and ended up exacerbating the crisis in this sector, should serve as an example of the risks that exist when other interests are prioritized over technical aspects.

III. Response to challenges and obstacles

9. Access to the financial sector can help alleviate the problems of poverty through the creation of mechanisms that promote savings, the expansion of productive credit supply, and avoiding over-indebtedness through the provision of adequate financial education and demanding transparency in the provision of information to clients in the region. Although access to financial products, services and channels is not the only way, it would become an important ally in the process of supporting individual endeavors. The evidence of recent decades shows that there is an exponential relationship between financial access and economic development. The positive correlation between the two variables is much greater given higher levels of development.

10. However, it is recognized that not all access to credit or to the financial market results in development "per se." In order for a person with financial access to exit a situation of poverty, proper management of his or her resources is required in order to generate a higher income stream and provide the economic basis for his or her own development through savings. For that, it is necessary to encourage measures designed to promote productive finance, understood as a way to fund activities that seek to generate new wealth, making revenue streams sustainable for families at the base of the population pyramid.

11. Given the high levels of poverty in the region, as well as the low rate of access to formal banking, there is a large segment of the population that could improve their quality of life by accessing the financial system. Therefore, it is necessary to expand the current coverage and scope of the financial sector, including rural areas, in a sustainable way - stable over time and with enough capital support. This can materialize through a regulatory and supervisory framework that takes into account the particular characteristics of financial products and services that are likely to increase the levels of financial inclusion.

12. To achieve greater financial inclusion, it will be necessary to support the efforts of technological development - leading to lower operating costs of products, services and channels - to achieve economies of scale. The cooperative and proactive role of the sector will be essential to achieving sustainable levels that allow for affecting and reducing transaction costs.

13. Greater financial inclusion requires a more active role on the part of financial consumers. To achieve this, adequate conditions should be in place which contribute to reducing information gaps and promote the standardization of practices and frameworks for information disclosure that allow for an effective comparison of conditions and prices of products, services and channels being offered by the market. This process must be complemented by effective financial education systems that allow consumers to exercise their rights and obligations in a transparent way in their interactions with the financial system.

IV. Recommendations for the Development of Policies and Inclusive Actions

14. To achieve greater coverage in the financial sector, it will be necessary to converge towards a scenario of balance between the optimum number and type of institutions and the appropriate level of competition. This would benefit the financial system's clients through an adequate supply of products and services at competitive prices. Market deepening should not be used as a reason to set aside minimum levels of quality, either at the level of customer service, credit evaluation or human resource management. Therefore, the following include recommendations regarding the role of the State and the development of public policy; the regulatory framework; strengthening of market participants; and the expected behavior of the entities providing services that contribute to the inclusion and expansion of microcredit.

Role of the State and Public Policies

15. It is essential to determine the State's role in promoting and protecting innovation in microfinance or processes that contribute to financial inclusion. While this has enabled a deepening of the market into areas not previously served, its abuse may constitute a risk that could generate market distortions. The challenge will be to establish sufficient flexibility to enable progress in expanding into new market segments, but without neglecting its sustainability and stability.

16. The State should be considered as a facilitator of financial markets' development and strengthening. Therefore, it is expected for the State to push forward actions that promote financial inclusion through the adoption of a legal and regulatory framework, appropriate to the current and expected profile of the market and to its effective and efficient implementation.

17. When performing its role as a facilitator of financial inclusion, the State must consider the following as necessary conditions: the implementation of coordinated policies (political relevance of the various State institutions in order to move in the same direction), the development of actions that promote greater levels of formality, the adoption of a system of identity registration, access to timely and high quality credit information (developed through credit bureaus), the establishment of mechanisms for the protection and education of financial services' users (to balance expectations), and the provision of rules that allow for the transparent operation of the market, in an environment free of price fixing.

Effective Regulation and Supervision

18. In principle, it should be recognized that the main role of regulatory and supervisory authorities is to ensure the stability of the financial system. However, their actions must also include initiatives to promote inclusion of sectors outside the financial system, creating the conditions for them to develop sound business practices that promote the participation of the financial institutions.

19. Therefore, it is necessary to promote financial regulatory and supervisory systems that guarantee the sustainability of microfinance systems and financial inclusion activities, as well as establish actions to encourage savings and discourage borrowing that exceeds a client's ability to pay.

20. Regardless of the models to be developed to promote greater financial inclusion, there should be strict compliance with regulation and supervision of the following areas: (i) credit and operational risks; (ii) transparency and financial integrity; (iii) adequate levels of capital; (iv) corporate governance practices; (v) provisioning rules; and (vi) the prevention of over-indebtedness.

21. To facilitate the work of financial regulatory and supervisory authorities, their work should be performed under appropriate levels of autonomy, so that their actions are not subject to political or economic interests.

22. To achieve an adequate understanding of the risks in markets that serve segments with low payment and savings capabilities, it is necessary to evaluate two fundamental aspects. On the one hand, the socially acceptable level of default in the face of over-indebtedness risk, which could affect the sector and threaten the sustainability of the financial activity. On the other hand, the economic rates of return necessary to enable participating institutions to face the challenge of expanding the market to population groups that carry higher risk.

Essential infrastructure

23. The expansion of productive credit and financial inclusion makes it necessary to develop credit bureaus, which have centralized and integrated databases to provide up-to-date and historic information – both positive and negative - to audiences that require it with a legitimate interest. Evidence indicates that this information allows for better understanding of customers and reduces the risks and costs of intermediation. At the same time, the good performance of a credit bureau facilitates credit offering to the population at the base of the pyramid and especially helps mitigate over-indebtedness risk.

24. Credit bureaus play a more effective role if they work under a specific regulatory framework and have access to current and historical information, which is mandatorily reported, both at the level of companies and people. The information they manage should include positive and negative data about clients, they should have adequate quality controls, and incorporate information from any creditworthy person. It is also favorable for the sector to have consumer protection policies and centralization of information to avoid costs for double consultations.

25. In the case that two or more credit bureaus exist, whether public or private, they must allow access to all operators and persons with a legitimate interest and provide services as if their databases were integrated.

Education of Financial System Users

26. Financial education, understood as financial capacity building and carried out through the implementation of a national financial education strategy that integrates both educational and financial authorities creating a space for coordination to maximize results, is part of the foundations that provide support to the development of microfinance and financial inclusion activities in the region's markets.

27. Financial education should become a means to provide maturity to the microfinance market and to develop greater financial inclusion levels. Therefore, it is essential to promote financial education activities that allow users to gain a greater control over the management of their financial resources, as well as the measurement of their coverage and impact.

28. It is recommended to promote joint activities among multilateral agencies, supervisory authorities and financial institutions to advance financial education programs, with the objective of improving the structure and effectiveness of the program's delivery. For this purpose, not only should the most

appropriate contents be considered, but also the delivery models, with standardized indicators as a point of comparison between the various programs to verify the financial capabilities created.

Protection of Financial System Users

29. The protection of financial users, which includes on the one hand promoting transparency, the diffusion of information and guidance on financial transactions, as well as ensuring clients face adequate conditions, such as the protection of contracts, revision of clauses and establishment of mechanisms for complaint and conflict resolution, is an essential element to ensure a stable financial sector inclusion.

30. It is necessary to promote practices and policies aimed at financial consumer protection and defense, preferably driven by an independent agency dedicated exclusively to consumer protection. The design and implementation of these actions should consider the roles played by the various market participants, in order to prevent the distortion of their original objectives.

31. In the case of microfinance institutions, although they must fulfill their respective missions, they must also have sufficient vision and responsibility to avoid promoting business practices that distort market conditions or have adverse impacts on their users.

Transparency and Disclosure of Information

32. In support of developing active and healthy competition, where market discipline is incorporated progressively, it is recommended to promote actions that lead towards greater transparency in the financial sector, enabling users to access accurate and timely information on the costs and conditions of financial products and services offered by the system. In this context, key principles include: transparency of products and prices, transparency of financial information, free pricing, use of credit bureaus, financial consumer protection, and the establishment of a financial safety net, which includes a deposit insurance fund within the framework of supervised operations.

33. Competition conditions should be promoted between microfinance institutions, such as reporting through credit bureaus, both positive and negative information on customers, with high quality and timeliness. In this manner, good-paying customers can build an intangible asset with their credit behavior, which will potentially allow them to obtain better financial conditions, promoting their inclusion into the formal financial system.

34. In some institutions, irregular accounting practices aimed at creating greater opacity about their true financial situation, are also evident. These practices include the sale of troubled loan portfolios to a subsidiary in an effort to hide the risks faced by the parent company, or carelessness in separating the accounting for loans paid from salary from those assumed with income from productive activities.

Market Structure and Conduct

35. There is a need to evaluate the structure of the microfinance market, which has a growing presence and participation of stakeholders, and to analyze the establishment of some type of limitation that would ensure minimum levels of capital, pointing towards a consolidation of the sector. It is important to consider that when no adequate regulation on resolution or orderly market exit is in place in the event of a problem institution, the situation may reach a point where drastic decisions must be made, generating a higher cost to the system.

36. Business practices that undermine the market structure and hence its sustainability should be discouraged. For example, credit card offering without further risk assessment should be discouraged; other example would be to consider unused credit lines as contingent assets, which would require no capital allocation.

37. Situations of rapid growth, given a large supply of funding at low cost, have led some institutions to develop their businesses beyond adequate levels of capital and to expand their activities into consumer lending, and small and medium scale enterprises, without knowing how to measure the risks involved in these businesses. In these situations, it will be necessary to adopt measures that allow for an orderly and stable restructuring by the competent authorities.

V. Embracing Opportunities

38. The potential for expanding microfinance and financial inclusion activities is quite high in Latin America and the Caribbean. It is estimated that 65% of adults in the region, representing about 250 million people, do not use financial services. In addition, microfinance institutions in Latin America are characterized by a low penetration in areas of extreme poverty (21%) compared to total customers, in comparison with other regions, such as Asia where this figure reaches 74%. That is, small improvements in the sector can lead to large advances in incorporating low-income citizens into the financial system and supporting them to improve their socioeconomic status.

39. Mobile banking is a sector with great potential as a channel or medium to disseminate microfinance services. The implementation of financial services through this channel would require a major coordination effort between financial sector and telecommunications sector supervisory authorities. The fundamental condition for the use of this market segment will be to ensure an effective oversight process that supports the principle that public's interest is properly protected by the State.

40. At the same time, non-banking agent models are a very attractive mechanism to be incorporated into the process of access and subsequent use of financial services by the population. Therefore, regulatory frameworks should also cover this type of channel, which can be very efficient in accessing rural areas.

41. Despite what was mentioned above, it should be recognized that the dynamism of microfinance and financial inclusion activities creates risks that must be properly monitored. These risks can derive from individual business management practices, from practices developed by the financial industry itself, and from actions relating to banking supervision or State policies that, while they may appear innovative or inclusive, have opposite impacts that must be properly evaluated, as they can cause damage to the system in the medium to long term, generating a high social cost and mistrust in the financial system by a significant proportion of the population.