Policy Principles for Expanding Financial Access

Report of the CGD Task Force on Access to Financial Services

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POLICY PRINCIPLES
FOR EXPANDING FINANCIAL ACCESS

CGD Task Force on Access to Financial Services

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POLICY PRINCIPLES FOR EXPANDING FINANCIAL ACCESS: SUMMARY

Despite the rapid growth in finance worldwide over the past quarter-century—now interrupted by the global financial crisis—many low-income households and small firms remain excluded from access to many financial services, especially in developing countries. While traditionally seen by many financial-service providers (FSPs) as less attractive customers, a growing number of mainstream FSPs have joined microfinance firms in extending the range of their service provision, and important advances have been made in expanding access.

At a time of increased focus on financial-sector policy and of regulatory tightening, it is important not to lose sight of the goal of increasing the access to appropriate financial services essential to the escape from poverty and the achievement of firm growth. It is in this spirit that we propose 10 principles for financial-sector policymakers—including national authorities, donors, private-sector participants, international financial institutions, and others—on the facilitation, regulation, and direct provision of financial services.

I. INSTITUTIONAL INFRASTRUCTURE FOR PROMOTING ACCESS

Principle 1: Promoting entry of and competition among financial firms

Policy should encourage competitive provision of financial services to customers such as low- and middle-income households and small firms. Policy should favor entry of qualified suppliers that are likely to improve the quality and price of services to such customers (in a manner consistent with financial stability and consumer protection). Competition policy should empower the active investigation of anticompetitive behavior.

Principle 2: Building legal and information institutions and hard infrastructure

Policymakers should work with market participants to eliminate barriers and identify gaps in the institutional infrastructure relevant to small-scale supply. This includes ensuring that payments and collateral systems and hard infrastructure elements for retail transactions are available and have a low unit cost. In particular, collateral and information infrastructures need modern supportive legislation and regulations. The state has a central role in ensuring the availability and maintenance of much of this infrastructure. (Where appropriate, the public sector can provide administrative and financial support to help create such infrastructures.)

Principle 3: Stimulating informed demand

As a complement to other consumer protection activities, policymakers should facilitate education and confidence-building measures among those currently excluded by coordinating, setting standards and curricula, and possibly cofunding private efforts. Financial-service providers play a crucial role in fostering informed consumers, among others, by making information available in a manner suitable to small-scale clients.

II. REGULATION OF FINANCIAL-SERVICE PROVIDERS (FSPs) AND FINANCIAL SERVICES

Principle 4: Ensuring the safety and soundness of financial-service providers

The rules and procedures for prudential regulation of financial-service providers should be carefully designed for consistency with financial-service provision at a small scale. In particular, regulation should be assessed for its impact on access and should reflect the risks faced by low-income households and small firms. Prudential regulation need not be restricted to deposit takers. To avoid regulatory arbitrage undermining sustainable access, consistent protection should drive cross-agency regulatory harmonization.

Principle 5: Protecting low-income and small customers against abuses by FSPs

Low-income and small customers need regulatory protection against abuses by service providers. FSPs should be subject to legislation designed to ensure that they do not sell customers products that are unsuitable for their needs. Market conduct and other regulations in this area (including anti-money laundering and combating the financing of terrorism, AMF/CFT) need to minimize compliance costs while retaining effectiveness.

Principle 6: Ensuring usury laws, if used, are effective

Regulated ceilings on interest rates have often proved to be an ineffective or even counterproductive measure against predatory lending and have often tended to work against increasing access. Where such ceilings are retained, they should be pitched at realistic levels in relation to FSP costs in each market segment and adjusted over time, in line with movements in the wholesale cost of funds.

Principle 7: Enhancing cross-regulatory agency cooperation

Where regulation of financial firms or services is split, agencies should cooperate in policy/regulatory development and supervisory practices to ensure consistent standards of consumer protection, especially of activities related to low-income households and small firms. Even if some FSPs are not covered directly by a regulator, policymakers should ensure that access-related issues relating to those FSPs are not neglected.

III. DIRECT POLICIES USING PUBLIC RESOURCES

Principle 8: Balancing government's role with market financial-service provision

The design of any direct government interventions should seek to respect the commercial market logic as much as possible—especially in regard to cost-effectiveness—and avoid damaging distortions to market functioning.

To facilitate maximum scale through leverage of private capital and initiative, the design of policies and interventions to increase access should avoid stifling private provision.

Some forms of direct government involvement in financial-service provision may be justifiable—for example, when it is otherwise difficult to overcome market failures or to deal with incompleteness of private market provision. Generally such problems require only temporary and catalytic interventions, and they should be explicitly time-bound.

There need to be safeguards at state firms against political interference, especially where credit is being extended. Governance of such firms should be transparent to the public, modeled on best practices for non-government-owned firms. Any noncommercial objectives of such firms should be publicly known, quantified, and costed.

All policies for improving access should have clear and measurable objectives and their effectiveness should be quantitatively monitored with transparent public reporting.

Principle 9: Using subsidies and taxes effectively and efficiently

While some permanent element of subsidy can in some cases be necessary to foster access, the design of subsidies should, where possible, be time-bound and aimed at making institutions and access self-financing and sustainable. All forms of subsidies and policy costs should as far as possible be accounted for and be itemized clearly in the national budget. Any government-provided or -directed credit or other (implicit or explicit) subsidy should be free of political influence, particularly in the credit underwriting process. The taxation of financial services should be access-friendly.

Principle 10: Ensuring data collection, monitoring, and evaluation

Governments should ensure collection of sufficient data to
—allow for the determination of the gaps in access to financial services that will facilitate private-sector solutions;
— provide accountability of public policy for monitoring and evaluation of the effectiveness of pro-access policies; and,
—help build a better, research-based understanding of what works in relation to access.

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THE PROBLEM

The crucial importance of a well-functioning financial system for supporting economic activity and generating economic growth has been forcefully illustrated by recent events. Today, policymakers everywhere are struggling to ensure an adequate flow of credit and other financial services without compromising financial stability.

The objective is reaching those currently excluded and underserved
Although mainstream finance over-reached itself in recent years, it still failed to serve much of the world's low-income households and small firms. In the median country, fewer than one in three households have an account at a formal or semiformal intermediary. Even middle-income households have access to at best a very limited range of financial services. Fewer than one in five small firms use external finance; and limited access is almost the top growth constraint mentioned by small-business operators.

These categories of customers—excluded or underserved low- and middle-income households and small firms—are generally seen as *marginal customers* by traditional financial firms. While they are unlikely ever to be large parts of financial systems, these groups' access is key to economic development and, in many ways, to social and financial stability.

The crisis must not trigger a backlash against inclusive finance
While some progress was being made in improving access in many countries during the past decade—building on advances in microfinance and a growing interest among mainstream financial firms in access—the danger now exists that the global downturn will reverse these advances. Indeed, the often misunderstood role played by mortgage loans provided to low-income households in the United States in triggering the crisis has cast an unjustified shadow over the agenda of increasing financial access. In fact, it was abuses in loan origination, securitization, and distribution, rather than underlying flaws in the technology of financial-service provision to the currently excluded, that led to the widespread losses in U.S. securitized mortgages and other structured financial products.

The key lesson from the current financial crisis is that, in a context of deficient regulatory, supervisory, and corporate governance practices, financial innovation can have large adverse systemic impacts. A related lesson is that a financial crisis, as with many previous occasions, can have dreadful effects on the sustained access of large segments of the population to financial services and their welfare. Another lesson of the saga of improperly sold mortgages is the need for better regulation of retail lending.

While regulatory reform is needed, its design must leave room for innovation and the continued expansion of access on a sustainable basis to creditworthy borrowers, especially at low income levels. After all, the flaws related more to the poor incentives for due discipline by loan originators and poor risk modeling of complex mortgage-backed derivatives than to the low and volatile incomes of borrowers.

It would especially be a tragedy if the crisis were to curtail access for underserved households and firms in developing countries, on the poorly founded premise that these are subprime borrowers that "caused" the crisis and need to be regarded with suspicion. On the contrary, expanding access to these borrowers contributes to financial stability, provided it is achieved by using sound principles.

Expanding access will require both correcting misaligned policies and adopting new approaches

Even before the crisis, and despite the significant potential benefits of greater access (box A), policy in this area has not always been constructive (box B). Unnoticed and unintended side-effects of policies aimed at other goals, poorly balanced policy trade-offs, and some well-intended but misguided policies still undermine the expansion of access in many countries. There are faults of omission and commission.

Infrastructure and competition

Although building and strengthening financial infrastructures has been a priority for many countries, too often the emphasis of policy has been on large-scale finance, as with the creation of robust wholesale payments systems and accounting and auditing rules aimed for large firms. Complementary institutional development needed at the retail end, including through the extension of credit registries to small loans and to small-scale providers, has tended to be neglected.

Policy attention has often focused on large, incumbent FSPs, considered too large to fail, whereas the promotion of competition, not least through entry of new FSPs on a sound basis, would do more to improve access. The overall institutional environment needs to encourage, not inhibit, competition. For instance, the potential provision of key financial services by nonfinancial providers, including mobile-phone companies and supermarkets, has often been inhibited by ill-considered and arbitrary regulatory obstacles.

Inadequate consumer protection and poorly structured prudential regulation

Few countries have really effective policies in place to protect the poorly informed against abuses of their trust. Too many unregulated Ponzi schemes have been tolerated in practice, even if outlawed in theory. Insurance companies have too often run away with the money. Worse, predatory lending has destroyed the economic lives of the vulnerable.

Even when policy has been targeted at protecting the ill-informed or vulnerable, regulatory measures have often been suboptimal or even counterproductive, as with some too-constraining interest-rate ceilings. Needed regulation against money laundering and terrorism financing has in some cases imposed a prohibitive burden on FSPs wishing to provide services on a smaller scale. More nuanced reforms are needed.

Subsidies and direct state involvement

The role of public subsidy and state-owned financial-service providers has been a source of continuing controversy. Large and poorly designed subsidies delivered by heavy-handed and poorly managed, state-owned entities have choked off private provision in some countries, while channeling a disproportionate amount of the subsidy to relatively

prosperous and politically well-connected users. But, when left to itself, the private financial system has often been far from effective in reaching the potential clientele. A better balance between public- and private-sector provision is centrally important.

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PURPOSE OF THE PRINCIPLES

Enhancing access to finance
Quite a lot has been achieved over the past quarter-century in improving access to marginal customers through financial innovation and expanding the margin of financially viable outreach through cost control—first by the microfinance revolution and the financial cooperative movement, and then by mainstream banks and other financial intermediaries. Although much remains to be done, many lessons have been learned.

The important role of policy in enhancing access has been increasingly recognized over the past several years. Given the complexity of the issues, however, and the fact that access is often not the main priority of relevant policy actors, there is a clear need for a set of principles to guide the policy development in this area. The danger of inappropriate policy reactions to the financial crisis poses another reason for policy guidance.

Good policy principles
In many areas of finance—banking, securities and insurance, payments systems, and money laundering and countering the financing of terrorism—policymakers worldwide have found it useful to codify what are widely accepted as broad principles that should govern policy design and implementation.[1] The current principles are proposed as a contribution to this effort as regard the issues of access to financial services. Because responsibility for policy regarding financial access typically cuts across many government departments and public policies, in no country is there a single label defining such principles. In addition, no international association of financial access policymakers exists to draw up these principles—hence the present document by an international task force of (former) policymakers, academics, and practitioners.

Each principle is accompanied by a brief commentary highlighting and clarifying aspects that the task force considers likely to be of particular relevance in many countries. Although examples are mentioned to illustrate certain points, in general the task force prefers setting out principles rather than endorsing or critiquing particular cases.

The principles do not amount to a detailed specification of laws and regulations, procedures, and policies, but instead represent an underlying framework that needs to be adapted to local conditions when implemented. Correspondingly, assessing existing policies against these principles can only be done by reference to the national context.

The audience
These principles focus on actions by governments and government agencies, donors (including and multilateral organizations), other policy advisors, and private-sector

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[1] Basel Committee on Banking Supervision: Core Principles for Effective Banking Supervision (originally dating from 1997); IOSCO: Objectives and Principles of Securities Regulation and IAIS Core Principles Insurance Core Principles; CPSS Core Principles for Systemically Important Payment Systems; FATF: The Forty Recommendations of the Financial Action Task Force / 9 Special Recommendations Against Terrorist Financing.

actors. Hence, these principles are directed primarily to financial-sector policymakers charged with improving financial access or whose activities impinge on financial access offered by any type of FSP. While our recommendations are not addressed to direct-service providers, but more to public-policy actors, they are based on the philosophy, strongly supported by empirical evidence, that private financial-services provision is a key to sustainable access.

In contrast to other documents describing best practices, the target audience here is not confined specifically to promoters of microfinance or agencies specifically charged with regulating microfinance.[2] Instead, complementing those other documents, these principles should apply to policymakers generally, including those whose main focus is not on providing financial access, but whose policies and actions can influence access. These include the prudential and market-conduct regulators of of financial markets and of banks and other financial intermediaries, including financial cooperatives; competition and licensing authorities; and the ministries concerned with legislation governing debt recovery, interest-rate ceilings, and AML/CFT (anti–money laundering and combating the financing of terrorism) policies. The principles are also addressed to multilateral organizations and donors that play a central role in designing, advocating, and, in many cases, financially supporting relevant policy initiatives.

The goals and outline of the remainder

While generally agreed, it is worth repeating the goals (often assumed implicitly). A natural goal for any policy framework aimed at improving financial access is to maximize, on a sustainable basis, the availability to as wide a range of users as possible of suitable financial products at affordable prices. It is equally crucial, however, to ensure that this improved access is compatible with FSPs' soundness and stability of the financial system (recognizing also that stability and access can be mutually supportive) and users' welfare maximization. Finally, policy should ensure that direct government and donor involvement is constructive and cost-effective (see boxes C and D).

Based on these goals, in what follows we present the ten principles that we propose should guide policy to ensure that financial access is expanded. The principles are presented in three sets. The first set deals with policies that *promote* competition and the supply of services, that help *build* the infrastructure and *stimulate* informed demand; the second set, with the *regulation* of FSPs and of financial products and services; the third set, with the *direct use of public resources* to promote access. No principle should be read in isolation from the others—they are complementary and should be considered together.

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[2] Thus it differs from, for example, the Microfinance Pink Book *Good Practice Guidelines for Funders of Microfinance (the Microfinance Consensus Guidelines)*, published by CGAP October 2006, 2nd edition ("Thirty years of lessons learned, translated into operational advice for development agencies, foundations, social and commercial investors, international NGOs, and others that help build financial systems that work for poor people."). It also differs from the 200-page UNDP/UNCDF 2005 Blue Book *Building Inclusive Financial Sectors for Development,* which assembled the opinions of many practitioners on the question, "Why are so many people and firms in developing countries excluded from full participation in the financial sector?" Finally it differs from analytical documents such as the World Bank's 2008 *Finance for All? Policies and Pitfalls in Expanding Access*, which aimed to summarize research evidence on the importance of access and what works best.

POLICY PRINCIPLES FOR EXPANDING FINANCIAL ACCESS

I. INSTITUTIONAL INFRASTRUCTURE FOR PROMOTING ACCESS

Principle 1: Promoting entry of and competition among financial firms

Policy should encourage competitive provision of financial services to customers such as low- and middle-income households and small firms. Policy should favor entry of qualified suppliers that are likely to improve the quality and price of services to such customers (in a manner consistent with financial stability and consumer protection). Competition policy should empower the active investigation of anticompetitive behavior.

A broad range of FSPs is important for access as each type of provider may bring its own methods for reaching particular types of client and allows for a diversity of skills and products catering to the varying needs of clients. Microfinance institutions (MFIs) are only one among many types of financial-service providers contributing to access. (MFIs, for example, have shown little ability to serve small enterprises above the micro level; hence the importance of encouraging entry of a variety of different types of FSP.)

A competitive marketplace can include providers not normally thought of as financial institutions, but which have extensive business networks and can meet appropriate criteria. For example, telecommunications companies are making increasingly credible bids to participate in the money-transfer business in some countries, raising the possibility of extending access to payments service to millions of cell-phone subscribers. Attempts by incumbent banks to block such developments should be resisted by policymakers; they rather should be favorably inclined toward licensing entry into consumer banking by nonbanks (subject to consumer protection and prudential safeguards).

Promoters and management of FSPs specializing in marginal customers should be screened for suitability. The general criteria governing what kinds of promoter may be eligible for a license to provide financial services (and de-licensing criteria) should be qualitatively similar, irrespective of the scale of operation and clientele envisaged. Criteria need to be applied, however, in an institutionally neutral manner and proportionate to the complexity and scale of operation. Thus, the definition of required qualifications for entry should not be such as to exclude credible local or foreign entrants likely to open up supply to an underserved or normally excluded clientele. But neither should de-licensing criteria favor the continuation of unsustainable FSPs, even of they cater to underserved or excluded clientele.

Principle 2: Building legal and information institutions and hard infrastructure

Policymakers should work with market participants to eliminate barriers and identify gaps in the institutional infrastructure relevant to small-scale supply. This includes ensuring that payments and collateral systems and hard infrastructure elements for retail transactions are available and have a low unit cost. In particular, collateral and information infrastructures need modern supportive legislation and regulations. The state has a central role in ensuring the availability and maintenance of much of this infrastructure. (Where appropriate, the public sector can provide administrative and financial support to help create such infrastructures.)

The infrastructure needed to support financial access ranges from information databases, such as credit bureaus and credit, collateral, and other real estate registries, to legal and social institutions needed for speedy and fair settlement of debt disputes, to the physical, such as electronic networks for payments system. The state has a central role in ensuring the availability and maintenance of much of this infrastructure.

Soft infrastructure

(a) Legal and judicial

A balance has to be struck between the rights of collateral holders and their clients, recognizing that a heavy presumption in favor of clients may have the perverse effect of reducing access. The large differences across countries in the costs of securing property rights and collateral, with proven consequences for access to financial services, suggest much scope for policy interventions.

Judicial efficiency, including improvements in court procedures, can help lower the cost of debt recovery, thereby facilitating access. Specialized commercial courts or debt-recovery tribunals may help expedite justice and ensure well-informed judgments; if well designed, their effectiveness need not be limited to high-end and complex cases. A financial services ombudsman can make a valuable and relatively low-cost complementary contribution.

Clarification of tax treatment of financial products and providers, ranging from basic matters such as returns on bank deposits to leasing and loan-loss provisioning, can enhance supply.

(b) Information

The collection and availability of information through credit registries and credit bureaus can greatly enhance the ability of the creditworthy to establish their credentials as suitable borrowers. Ideally, both negative and positive information is available on a wide category of borrowers and other financial-services users, including small-scale users. The provision of negative information is commonly easier; positive information often requires legal changes, including on data sharing among and within financial intermediaries. Standardization of accounting, audit, and firm-disclosure rules can also help.

Government's involvement can be crucial in establishing the infrastructures and procedures for unique identification of individuals (perhaps using biometrics) and firms, facilitating their access to credit.

Since incumbent lenders have little incentive to share information they have on borrowers, there might be a need for policy intervention, including legislative underpinning, to get a credit registry established and ensure it has access to relevant information. This is a business that has characteristics of a natural monopoly. While in some countries a government-run registry has worked well for assembling basic information, a private registry may be better in offering a wider range of alternative or complementary value-added information services, provided that competition policy ensures that access to it is not hindered.

Hard infrastructure

Hard infrastructure is also needed. Ensuring the secure operation of a wholesale payments system is generally accepted as a function calling for central policy. Less widely acknowledged, but even more important for access, is the need to ensure the infrastructure for retail-payment systems. This includes not only traditional aspects such as facilities for handling and storing currency notes in remote areas, but also the development of an extensive electronic retail-payment system that all FSPs and their customers can use at fair prices. This requires, at least, an electronic communications network, interoperability of switches, and establishment of technical standards for retail payments. The government's convening role in achieving this key infrastructure—indispensable for cell-phone banking—can be critical.

Another example of government role in information provision relates to weather and disaster insurance. Here the needed government action can be as basic as maintaining infrastructure—for example, rainfall gauges—so that insurers have reliable information on which to base policy payouts.

Principle 3: Stimulating informed demand

As a complement to other consumer protection activities, policymakers should facilitate education and confidence-building measures among those currently excluded by coordinating, setting standards and curricula, and possibly cofunding private efforts. FSPs play a crucial role in fostering informed consumers, among others, by making information available in a manner suitable to small-scale clients.

Although having educated consumers is not an adequate substitute for effective regulation and consumer protection, it can help ensure not only that consumers are not exploited but also that they take appropriate advantage of available financial services. FSPs play a crucial role in fostering informed consumers, among others, by making information available in a manner suitable to small-scale clients. The government can play an important role in encouraging private-sector education initiatives. For some education and confidence-building measures, however, the government is best placed to take the initiative.

Key gaps in financial literacy
Inadequate planning for old age or illness, overindebtedness, and lack of understanding of relevant financial products (and of their usefulness in managing household and business affairs) are among the most serious financial-education gaps. Often there are also deficiencies in making complex price comparisons and budgeting. But financial education is not just a question of communicating facts. It should also address the lack of informed demand deriving from distrust, a history of being discriminated against, lack of reliability, and cultural issues. Education and public information campaigns focused on financial literacy thus need to take a broad perspective. Mechanisms of social mobilization for building trust and confidence can also play an important part.

Designing program content
Designing good, cost-effective financial literacy programs requires consultation with FSPs and their industry associations to make sure that the messages are couched in terms that are well adapted to local market conditions. For example, the particular risk of getting into an overindebted situation could depend on the pattern of charges and terms made by FSPs and the volatility of individual income and spending needs. Potential borrowers need to be informed about the workings of the credit-information system so that they can avoid behavior that might unwittingly exclude them from credit access.

Methods of dissemination
Many countries have now adopted financial literacy programs using different channels and adapted to national and local market realities. There is still limited evidence on the effectiveness of different approaches, however, and further research is needed. Moreover, it is well known that information is not enough to ensure that individuals will make rational financial decisions; complementary policies may be needed.

II. REGULATION OF FINANCIAL-SERVICE PROVIDERS AND FINANCIAL SERVICES

Prudential regulation and supervision of FSPs is essential to ensure a safe and stable overall financial system and healthy FSPs, and, by extension, sustainable access. The principles proposed here are meant to complement—not be competitive with—those set out under Basel II on capital adequacy requirements, by the Basel Core Principles for Effective Bank Supervision, the CGAP Guiding Principles on Regulation and Supervision of Microfinance (July 2003), and others. Within these frameworks, it is possible to design policies with an eye toward expansion of access.

Principle 4: Ensuring the safety and soundness of financial-service providers

The rules and procedures for prudential regulation of financial-service providers should be carefully designed for consistency with financial-service provision at a small scale. In particular, regulation should be assessed for its impact on access and should reflect the risks faced by low-income households and small firms. Prudential regulation need not be restricted to deposit takers. To avoid regulatory arbitrage undermining sustainable access, consistent protection should drive cross-agency regulatory harmonization.

The goal of prudential regulation and supervision is to ensure the safety and soundness of FSPs and thereby ensure the protection of depositors, money-transfer users, and overall financial stability. Regulation and supervision includes capital-adequacy requirements, governance and management issues, reporting and auditing, and many other aspects.

Prudential regulation is as important to small customers as it is to large ones: good prudential regulation and supervision of formal financial intermediaries will enhance sustainable access. Expanding access to a wider clientele will not necessarily entail heightened risks for the financial sector; on the contrary, failing to do so can be destabilizing in other ways, from financial, economic, and social points of view.

Where the risks lie

Prudential regulation should address the question, "Who is taking the risk on whom?" Deposit-takers present risks to their depositors; borrowers present risks to their lenders; and loan officers and intermediary agents can present risks both to ill-informed borrowers and to lenders. Within these categories there will be differences—for example, among the regulation of full-service banks, NGO-run microfinance firms, or credit unions.

The focus of prudential regulation has traditionally been on deposit-taking institutions, but it is also applicable to other FSPs, including insurance companies. Attention needs to be given to each of the main financial services: deposits, payments, credit, and insurance.

Access-friendly regulation

The access agenda must not erode prudential goals, but regulation and supervision need to be access-friendly. Where access has expanded on a more sustainable basis, it has often been underpinned by a responsive policy framework geared toward improving access. This means, among other things, that regulation and supervision modalities need

to be adapted to the risks and scale of small-scale service provision and small financial firms. However, in all of this, rules and their operation have to be examined and monitored systemically to ensure that they are not vulnerable to misuse or regulatory arbitrage.

The costs of supervision and limited supervisory capacity need to be recognized in regulatory design; there is little point in regulating what cannot be supervised. Policymakers need to find ways of ensuring in practicable and cost-effective ways that small-scale FSPs operate in a sound manner. In particular, the extensive reporting burdens that are applied to complex, full-service banks in their conduct with costumers should not be applied in the same way to relatively simple FSPs focusing on small-scale customers and simple products. Applying different reporting requirements is a practice followed in many advanced economies, with good outcomes.

Many other examples can be provided of how regulations governing such FSPs embody rigorous standards of safety and soundness while making adjustments for the nature of the business. Prudential regulation of small loans can be lighter than that of large loans, especially given the generally low correlations among risks on individual transactions. Many MFIs and some commercial FSPs operate at too small a scale to reach the minimum capital sum required for a standard deposit-taking license. By lowering the minimum capital *amount* while requiring a high minimum capital *ratio* and adopting other safeguards, such as limiting the scope of activities, prudential goals can still be achieved. (However, moves in this direction need to respect the indivisibilities and minimum scale involved in safe provision of deposit and insurance services, for example). Such innovative design can offer protection that in the context of MFIs is both more effective and more easily complied with than normal banking rules.

Financial integrity regulation (for example, AML/CFT) is a particular case where special treatment for providers of small-scale financial services is appropriate. National AML/CFT regulations and procedures should be adapted (while ensuring achievement of their main objective) in the case of small-scale transactions so that they do not create a severe barrier to access. Effective alternatives to the traditional ways of establishing identity, income, and so forth need to be developed for low-income groups, as has already been done successfully in several developing countries.

Regulatory arbitrage

Regulatory arbitrage occurs when differences in the regulation of various types of FSP or financial services are exploited to evade the purpose of the regulation. Given the many organizational forms that exist among FSPs catering to low-income people and small firms, the danger of regulatory arbitrage is ever present. As far as possible, similar products should be regulated in a way that is consistent across different FSPs. This requires close coordination among different regulators.

Since nonfinancial firms can play important roles in the provision of financial services, they too may need to be regulated. The scope and applicability of rules, however, will need to be adapted to local market conditions. Regulatory provision for third-party bank

agencies in Brazil and money transfer through cell phones in Kenya and elsewhere are examples of this.

To best use limited supervisory resources, entities that are not systemically important should be supervised lighter. It is also important that unwarranted regulation does not discourage healthy entrants or useful innovations (as have occurred in unregulated entities). Regulation of some categories of FSPs, such as those that lack complexity in governance, operations, or risk, or that are exclusively funded by strictly regulated entities (or NGOs funded by donors), can therefore be lighter. However, no major category of FSPs should be wholly outside regulatory and information systems. And cross-agency cooperation is essential to reduce transaction costs and avoid coordination failures.

Ensuring that the content of regulations is beneficial for access
Notwithstanding recent conspicuous regulatory failures (including the failure to detect vast, fraudulent pyramid savings schemes) the potential benefits of regulation for depositors and investors are clear. But some difficult judgments are to be made when it comes to regulating the degree of risk taken by a FSP. The treatment of repayment delinquency is an example.[3] Ensuring that relevant regulations balance the benefits of improved access with the heightened risks requires careful experimentation and monitoring.

Principle 5: Protecting low-income and small customers against abuses by FSPs

Low-income and small customers need regulatory protection against abuses by service providers. FSPs should be subject to legislation designed to ensure that they do not sell customers products that are unsuitable for their needs. Market conduct and other regulations in this area (AML/CFT) need to minimize compliance costs while retaining effectiveness.

Consumer protection and market-conduct regulation should aim to ensure that the design, pricing, and marketing of products offered to low-income households and small firms is not exploitative of market power and of these consumers' limited ability to verify in advance the appropriateness, risks, and value for money of financial products. Consumer protection is of special importance for this segment, especially for credit and insurance products. Unregulated credit providers have been documented to offer credit products that impose heavy individual penalties for delinquency to vulnerable customers with low, fluctuating incomes. Indeed, unscrupulous FSPs may design their pricing and charging structures with the deliberate intention of exploiting such users' naiveté.[4] Likewise

[3] As a matter of credit control, many MFIs react energetically to even a single day's delinquency, and this practice has sometimes been translated into official provisioning rules. However, such a rule may encourage lenders to impose such severe delinquency penalties that a brief episode of delayed payment can push borrowers into eventual default. This is an example of prudential regulation working against both sustainable access and safe financial intermediaries. In contrast, some rural microlenders expand sustainable access by adapting the repayment schedule of loans to the crop cycle by lengthening loan maturity to the benefit of borrower and lender.

[4] In contrast, well-motivated MFIs have adopted good-practice, pro-consumer principles such as those agreed in 2004 for the ACCION Network and the Microfinance Network, covering quality of service,

customers may be offered insurance against risks that are irrelevant to them, with exemptions that prohibit them from making successful claims, or at premiums that are disproportionate to the risks that they generate.

Responsibility of FSPs
A basic requirement is that FSPs are truthful and transparent in the way they represent the products to the clients. This includes full disclosure of interest rates and charges. Better financial literacy and consumer information can help prevent misuse (*cf.* principle 3), but in many cases reliance on those approaches will be grossly insufficient. Experience shows that even for a simple loan product, many consumers cannot make the relevant calculations and are swayed by simple rules of thumb, such as the initial weekly repayment required on a loan—even when that repayment is sure to balloon later. For more complex products such as derivative-based commodity-price insurance (potentially very useful for small farmers), essentially none of the target consumers can make an evaluation of value for money.

For these reasons, primary responsibility must be placed on FSPs to ensure that they do not sell products that are unsuitable for customer's needs, lend more than the customer can service, or explain products inadequately. FSPs should also be required to ensure ethical staff behavior, avoid coercive collection practices, and have adequate mechanisms for the redress of customer grievances.

Privacy
While privacy of customer information is also an important protection against damaging abuses, overly complicated privacy legislation can inhibit access. In many countries laws complicate the process of authorizing the sharing of a borrower's personal and financial information, and in the extreme, privacy laws can prevent the emergence of effective credit registries. Privacy aspects need to be balanced with increasing access.

Ex ante and ex post enforcement
Ideally, consumer protection and market conduct should be policed by preauthorization of FSPs and services, combined with continuous public inspection. In some countries with a good institutional environment and high level of public enforcement, such *ex ante* enforcement can work, especially if legislated penalties are sufficient. But in many countries, it has proved difficult to adopt effective legislation and proper enforcement. Furthermore, in many countries, especially those with limited institutional development, the cost of *ex ante* enforcement can be prohibitive in practice. Pursuing abuses *ex post* (whether through the courts or by enforcement action by a regulator following a complaint) with high penalties and/or liabilities, may be the only practicable way of proceeding. While less effective in redress, not least when consumer ignorance is a source of the problem, it can have a high deterrent value. At any rate, disclosure standards about the nature of the products and the risks and costs associated with them should be high, yet simple enough for less sophisticated consumers.

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transparent and fair pricing, avoiding overindebtedness, appropriate debt collection practices, privacy of customer information, ethical behavior of staff, feedback mechanisms, and integrating pro-consumer policies into operations.

Application to nonfinancial firms
Nonfinancial firms also can play important roles in facilitating the provision of financial services. Services provided through third-party bank agencies, money transfer through cell phones, and consumer credit provided through retail stores are examples. Business-conduct rules may therefore need to apply to these entities as well. Specific regulations could include protocols for real-time fund transfers, ensuring no commingling of customer and provider funds, along with mandatory training and certification of staff handling financial services in nonfinancial firms. Truth-in-lending and anti-tying regulations need to ensure that financial firms do not exploit their role in financial services provision as a way of forcing purchases of their nonfinancial products.

Principle 6: Ensuring usury laws, if used, are effective

Regulated ceilings on interest rates have often proved to be an ineffective or even counterproductive measure against predatory lending, and have often tended to work against increasing access. Where such ceilings are retained, they should be pitched at realistic levels in relation to FSP costs in each market segment and adjusted over time, in line with movements in the wholesale cost of funds.

Given their profile, usury laws and other administrative ceilings on interest rates warrant a separate principle. Although a case can be made for controlling the abuse of monopoly power or information asymmetry through interest ceilings, the objectives of usury laws can often be better achieved by a combination of the other principles.

With administrative costs high as a fraction of loan size, break-even interest rates on small loans tend to be high even for well-managed and cost-conscious MFIs and other providers of small loans. Real (inflation-adjusted) lending rates in the range of 15 to 40 percent per annum or even higher can be required to cover costs. As a result, imposing unduly low administrative ceilings can—if they are effectively enforced—prevent unsubsidized lending to certain target groups. The potential of MFIs to offer relief from the often oppressive and exploitative practices of illegal or unregulated lenders can then be limited by the imposition of unduly constraining interest-rate ceilings. Paradoxically, tighter interest-rate regulation can result in overindebtedness, as low-income consumers unable to access legal sources of credit end up using more expensive illegal alternatives.

An additional difficulty with administrative ceilings is that they are often made ineffective by opaque loan-pricing structures, including heavy penalty fees for delayed repayments, that result in total costs of credit greatly exceeding that envisaged in the ceiling even when the interest rate, narrowly defined, complies with the regulation.

Most developed countries have greatly liberalized such laws, allowing extensive exemptions. Some have finessed the issue by establishing multi-tiered usury ceilings with a much higher ceiling for microfinance, but this has the perverse effect of excluding other providers not so classified.

Principle 7: Enhancing cross-regulatory agency cooperation

Where regulation of financial firms or services is split, agencies should cooperate in policy/regulatory development and supervisory practices to ensure consistent standards of consumer protection, especially of activities related to low-income households and small firms. Even if some FSPs are not covered directly by a regulator, policymakers should ensure that access-related issues relating to those FSPs are not neglected.

The architecture of regulatory agencies differs from country to country, and has been changing quite a lot in recent years. Some countries centralize prudential and consumer protections, others separate them; some have separate regulators for different forms of FSP (banks, insurance, capital markets, MFIs, and so on—the so-called "silo" approach), while others have a single supervisory authority.

No clear guidance exists on what structure is best for financial-sector stability, efficiency, or access. Whatever the architecture, rules should be as consistent as possible across financial-service providers and instruments, so that providers offering and services performing the same function are treated similarly. This applies not just to regulation and supervision, but also to consumer protection, taxation, and subsidies.

Special attention needs to be given in this context to cross-selling and bundling of products. While simplicity is often a virtue in product design for low-income households and small firms, valuable product innovation addressing important needs of this market segment sometimes entails the bundling of products from different suppliers (for example the selling of insurance by banks). Achieving a good balance here can require close cooperation between different regulators.

There is no clear presumption as to whether responsibility for consumer protection should be within the same organization as the prudential authority. Having both functions together can facilitate coordination, though perhaps at the cost of consumer protection being subordinated to prudential considerations. Whatever the structure, the agency administering consumer protection regulation should have sufficient powers, resources (subject to competing budget claims) and standing compared to other financial regulators.

Regardless of structures, supervisory authorities need to work together actively to aim to achieve financial inclusion. Special tax and regulatory privileges granted to one form of FSP regarding their access work (as may happen more likely with a silo approach) can have the effect of shutting off potentially innovative competition from other FSPs. This needs to be guarded against.

III. DIRECT POLICIES USING PUBLIC RESOURCES

Market failure is a pervasive and well- and long-acknowledged problem in finance. The worldwide financial crisis has dented confidence in previous beliefs that reliance could be placed solely on market solutions for access to financial services. It has triggered a range of public initiatives designed to protect or relaunch the flow of credit to various purposes and sectors. To a remarkable extent, old ideas for direct government action, often using public resources, have resurfaced. Yet there is no reason to suppose that a cure has been found for the government failures that have been pervasive in finance over many decades. Accordingly, intervention design remains important to ensure that (new) measures do not distort or suppress what can be achieved without government funds, and that government funds generate adequate value for money.

Principle 8: Balancing government's role with market financial-service provision

The design of any direct government interventions should seek to respect the commercial market logic as much as possible—especially in regard to cost-effectiveness—and avoid damaging distortions to market functioning.

To facilitate maximum scale through leverage of private capital and initiative, the design of policies and interventions to increase access should avoid stifling private provision.

Some forms of direct government involvement in financial-service provision may be justifiable—for example, when it is otherwise difficult to overcome market failures or to deal with incompleteness of private market provision. Generally such problems require only temporary and catalytic interventions, and they should be explicitly time-bound.

There need to be safeguards at state firms against political interference, especially where credit is being extended. Governance of such firms should be transparent to the public, modeled on best practices for non-government-owned firms. Any noncommercial objectives of such firms should be publicly known, quantified, and costed.

All policies for improving access should have clear and measurable objectives and their effectiveness should be quantitatively monitored with transparent public reporting.

Disappointing experiences of direct government provision

The disappointing experiences of so many government attempts to enter directly the business of financial-service provision cannot be ignored. Efforts have all too often resulted in a dilution of public resources and disappointing overall results. Few such attempts have achieved broad-based, sustainable access. Quite apart from political manipulation of government FSPs for short-term political advantage, incompetent managers of government FSPs have too often been protected from the consequences of their incompetence. Accordingly, a high threshold of proof is required before direct government provision can be recommended—especially where credit is concerned.

Gaps in private provision still exist
Nevertheless, gaps in private-sector provision, and the potential for economies of scale and coordination, mean that a case can be made in certain circumstances for having government-owned or -controlled intermediaries involved in access to financial services for special groups, at least for an interim period. Ensuring robust and transparent governance systems, insulated as far as possible from narrow political pressures, is a prerequisite for an effective role in direct service provision. Any such institution should be made subject to clear and explicit governance procedures, strict auditing and reporting (including of all type of contingent risks), and a high level of public transparency, including explicit and formal rules dealing with political directives to management.

Guidelines for public provision
Direct government involvement, whether through government-controlled FSPs, administrative mandates, or taxes and subsidies (principle 9), should be guided by clear objectives and be delivered in the most cost-effective way. The goal of each intervention should be clearly understood. Special-purpose government agencies need to be confined to achieving the objectives set for them, and not be allowed to pursue a wider agenda of their own. Any noncommercial objectives of such firms should be publicly known, quantified, and costed. Where the problem is seen as transitory, there should be a time-bound exit plan for any state providers.

Commercial logic should be pursued as far as possible, with special allowance made only for the clearly identified market failures that prompted the intervention. This logic will facilitate identification of what can best continue to be provided by the private financial system, and what calls for government provision. Since access will only be extended widely if service delivery becomes cost-effective, a top priority for any government provision in this area must be cost-effectiveness in delivery.

One valuable service that government-owned firms may offer is to be the provider of last resort for such services as basic payments service or basic bank accounts, which are less subject to political capture and can have economies of scale. Alternatively (and probably more efficient and practicable), this function can be mandated to the private sector (see principle 9).

Where public and private providers operate side by side, governments have tended to favor the public entities; this should be avoided. Indeed, despite the errors made by private financiers in the recent crisis, it can be argued—and ample evidence supports—that in its normal everyday functioning, much of finance is inherently better suited to private-sector provision. In order to facilitate achievement of maximum scale through leverage of private capital and initiative, the design of policies to increase access should avoid stifling private provision or undermining the framework that supports them.

Donor issues
Donor agencies have played an important role in promoting access—for example, by their support of early microfinance experiments. However, donors must ensure that they

do not excessively subsidize interventions and create unfair competition, thereby undermining the performance of providers that do not receive preferential support and discouraging them from expanding to less easily served customers.

In general, therefore, the principles proposed above for government also apply to interventions made or funded by donor agencies. Indeed, some donor agencies have already defined principles for their financial support to ensure that they complement financial development more generally. Furthermore, donors need to be accountable both to their own taxpayers and to the governments and public of the country they operate in. In addition, different donors should ensure coordination with each other so that their interventions are compatible among each other and with government initiatives. In particular, they should not undermine the well-designed interventions of others.

Principle 9: Using subsidies and taxes effectively and efficiently

While some permanent element of subsidy can in some cases be necessary to foster access, the design of subsidies should, where possible, be time-bound and aimed at making institutions and access self-financing and sustainable. All forms of subsidies and policy costs should as far as possible be accounted for and be itemized clearly in the national budget. Any government-provided or -directed credit or other (implicit or explicit) subsidy should be free of political influence, particularly in the credit underwriting process. The taxation of financial services should be access-friendly.

An alternative to using state-owned financial intermediaries to deliver financial services or to channel investable funds to favored sectors is to employ subsidies or guarantees concessions for the same reason. Directed credit and other mandates can be thought of as a related type of policy (quasi-tax). And the taxation of financial services should be access-friendly.

Subsidies

Subsidies can help develop markets and institutions providing access to financial services. Subsidies can be useful on a transitory basis, in getting institutions up and running. The process of learning about the scale and nature of markets and about the kinds of products that can cater to the needs of those currently excluded can take time and entail costs that private providers are reluctant to incur. Subsidies, potentially including the funding of government agencies to help, can be useful in achieving such goals.

In some countries, to reach some categories of marginal customer currently excluded, subsidies might be necessary for the foreseeable future. At times, a case can be made for indefinite retention of subsidy-based policies that are effectively targeted at the poor (though their cost-effectiveness relative to subsidies delivered directly to the poor through nonfinancial channels needs to be verified).

The existence of subsidized products can undermine the viability of the financial intermediary's business model and threaten financial discipline generally. Therefore, unless impracticable, there should be a time-bound exit strategy for subsidies.

Guarantees
Partly because their true costs are hard to foresee and because they crystallize only after an interval, governments often underestimate the cost of credit guarantees and accordingly favor such guarantees over grants. This makes it even more important that any such scheme is carefully designed. The pricing of any government-sponsored credit-guarantee scheme should be realistic and responsive to experiences of actual defaults. And schemes should make the most of the participation of private intermediaries—for example, by ensuring that the intermediary lender retains a sizable portion of the credit risk.

Politically motivated debt forgiveness and amnesty programs have not only been very costly but have also harmed credit discipline.

Both explicit and implicit subsidies—through capital support, tax relief, and so forth—should be fully accounted for in the budget and subject to regular cost-benefit analyses.

Mandates
Mandated service provision or requirements for lending to priority sectors can be thought of as quasi-taxes designed to achieve social objectives. The record of effective targeting here is very mixed, though in ideal conditions mandates may succeed in nudging private FSPs toward providing greater access without imposing undue costs or risks on them. Likewise, arranging for payments of government salaries, pensions, social benefits, and so on through banks (using negative bids) can be an inexpensive way of introducing low-income users to banking. Such schemes can also be extended to private enterprises.

Product design
Developing and adapting standards and products to users' needs is a function largely best done by market suppliers. The design of appropriate products can in some circumstances, however, call for collective action. A fragmented market may benefit from the government coordinating and convening research of product needs and ensuring product development. Where necessary to overcome coordination problems, it can be useful for policymakers to work directly with FSPs to adapt standards and products to user needs.[5] Policymakers can also approve specific products as meeting quality-assurance standards, which can assist in consumer protection (principle 6). A key goal of such efforts would be to make it feasible and profitable for mainstream FSPs to cater to the excluded.

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[5] The idea of simplified basic bank accounts is a case in point. Individual FSPs may not wish to develop a basic account, since returns are too low, given a high probability of delinquency. And unscrupulous financial-services providers may have an incentive to design products for poor people with a low basic charge, but with high maintenance fees. Therefore it can be desirable for a common standard to be adopted for the industry as a whole, defining a basic bank account suitable for poor people. Without a common standard, poorly informed persons could be exploited, or alternatively might reasonably avoid the risk of adopting potentially unsuitable products. Suitability will include low transactions costs and reduced risk of unintended overdrafts. Other examples in which the government can play a useful coordination role include remittances and other payments services given their large network externalities.

Taxation
The design of taxation of financial intermediation should also be access-proofed. For example, taxes imposed as percentages of interest rates on loans tend to be anti-access (given the higher pretax rates of interest involved). Financial-transactions taxes also may discourage the use of formal financial intermediaries, thereby limiting access. Where tax falls unevenly on different classes of service providers, competition can be distorted and even eliminate the profitability of pro-access initiatives if more heavily taxed.

Principle 10: Ensuring data collection, monitoring, and evaluation

Governments should ensure collection of sufficient data to
—allow for the determination of the gaps in access to financial services that will facilitate private sector solutions;
—provide accountability of public policy for monitoring and evaluation of the effectiveness of pro-access policies; and,
—help build a better, research-based understanding of what works in relation to access.

At the most basic level, baseline and regularly updated data are needed on the (lack) of access to financial services. Governments can play an important role here, for example, by conducting household surveys with specific requests for information about access to financial services, and by requiring financial institutions to report on a regular basis on financial-services outreach. Where quantitative access targets are imposed or adopted there is even more need for data that verify compliance. As much as possible, these data need to be internationally comparable.

Impact evaluation needs go beyond these data. Ideally the quantitative base for policy should be analyzed at the design stage with rigorous methodologies, using pilots, baseline surveys, and control groups. Different types of data are needed for this: benchmarking, micro-impact studies, and financial literacy studies. This should determine the size and distribution of the policy's costs and benefits. Studies should be published, so that their findings can be accessed internationally.

Any government costs, direct (for example, subsidies for access) or indirect (for example, tax waivers) should be accounted for, in order to help ensure a proper discourse on the cost and benefits of specific government interventions.

Regulatory impact assessments (RIAs) are increasingly being employed for financial and other regulatory policies; these, too, should be *access-proofed*. Explicit mandatory attention to the impact on access would become part of such RIAs where they are used.

Box A: Importance of access to financial services

Finance is an essential part of the development process, and modern development theories emphasize the key role of access to finance. Access to finance makes transactions quicker, cheaper, and safer, because it avoids cash or barter payments. Greater access to financial services enables poor people to plan for the future and invest in land and shelter, and to utilize productivity-enhancing assets, such as fertilizer, better seeds, machinery, and other equipment. In accumulating financial assets and availing themselves of insurance to smooth their income, households and small firms can reduce their vulnerability to unfortunate events such as economic instability, drought, disease, or death that are part of daily life in many developing countries.

Finance can contribute not just to income growth and poverty reduction, the most important of the Millennium Development Goals (MDGs), but also to MDGs such as improving education, gender equality, and health, with some goals more specifically affected. More investment and higher productivity translate not only into more income and therefore better nutrition and health; it also enables parents to send their children to school instead of merely regarding them as a source of labor. Moreover, access to finance creates equal opportunities for everybody. Access to financial services helps women in determining their own economic destiny and increases their confidence and "say" in their households and communities. More sophisticated financial markets discriminate less; they provide capital to those with attractive investment opportunities, regardless of other characteristics—for firms, size, ownership, and profitability do not matter; for households, current income, wealth, education, gender, and ethnicity are irrelevant. Indeed, financial development can reduce inequality as it broadens opportunities.

There is a growing body of empirical evidence—in-depth country studies and cross-country statistical studies, case studies, and more recently, experimental analyses—that confirms these analytical predictions and documents how financial-sector development and access to financial services significantly contribute to reaching the MDGs.

Box B: Shortcomings exist in each area of financial-service provision

In each of the four key financial services—payments, savings, credit, and insurance—increasing access confronts particular market failures, and has exhibited particular policy challenges and deficiencies. A few of these can be highlighted illustratively:

Remittances/Transfers/Payments
Payment is the most basic financial service provided—as the existence of money shows—although it often receives little attention. While technology offers potential for great improvements here, its use has sometimes been delayed by unnecessarily restrictive interpretation of banking laws inhibiting the provision of cell-phone payment services by nonbank telephone companies (South Africa provides an example). Ineffective, over-elaborate AML/CFT procedures have sometimes increased the cost and restricted the provision of low-value payments services without truly improving financial integrity. For example, prior to reforms, AML/CFT controls had unintended negative impacts on access to and use of financial services by low-income people in Indonesia, Pakistan, Kenya, South Africa, and Mexico.

Savings
Market failures are most evident here when savings literally are stolen. (The Albanian Ponzi scheme of the mid-1980s, which lured gullible low-income and middle-class clients, is a classic example more relevant to access issues than the recently famous case of Madoff.) It is worth bearing in mind, though, that government action also has often wiped out savings, through high inflation (for example, Zimbabwe) or forced conversions (for example, Argentina).

Despite the acknowledged shortage of interested potential service providers, heavy-handed regulations have further inhibited entry and innovation in the provision of savings services. For example, the franchising by banks of nonbank agencies (as collectors of funds and providers of some basic transaction services) in remote locations can be a very effective way of increasing outreach and has been implemented safely and on a large scale in some countries, such as Brazil. But this has been prevented by unimaginatively and unnecessarily restrictive prudential regulations in other countries, including advanced countries. Many MFIs have been prevented from offering deposit services by onerous minimum-capital requirements. The potential for using networks of post offices in similar ways has often been left unexploited.

There are also market failures in product design, likely reflecting the limited incentive for any one bank to attract the limited market of marginal customers. Traditional savings products of the banking system are often not suited to low-income households. For example they can entail high minimum charges and bundle services that are not needed by—and are risky for—such households. They also miss out on desirable commitment features. Beneficial experiences with simple savings products, such as those traditionally offered by savings banks and giro-based systems in advanced countries, have not spread universally.

Loans

Limited access to credit not only prevents many productive investments by marginal customers, but also inhibits the ability to smooth consumption in case of health emergencies or for the purchase of key durables. Formal financial intermediaries are reluctant to enter this market if the judicial system is dysfunctional and/or credit information infrastructures are nonexistent. (The consumer-lending crisis in Bolivia, for example, exposed the inadequacies of credit information; lenders got into trouble when clients took out multiple loans from different lenders). Entry can also be discouraged when subsidized provision of loans is made to the largest and most creditworthy borrowers, reducing the scope for profitable provision to lower-income people. The capture of the banking system in Mexico in the 1990s by large, politically connected borrowers crowded out many others and led to high fiscal costs in the effort to resolve the resulting nonperforming loans.

Attempts by government to improve credit availability through the establishment of state-owned development financial institutions have had a mixed record, to put it mildly, not least because of political pressures to use loanable funds as covert grants. The Nigerian experience, though perhaps extreme, is cautionary: although intended to operate on a self-financing basis, the seven DFIs accumulated losses equal to almost half of their aggregate assets; one of them had failed to make a single loan in its seven-year history, despite employing 261 staff in 21 offices. Evidently direct government involvement in financial-service provision is fraught with pitfalls.

Lack of availability is not the only problem plaguing the credit market for marginal customers. All too often loan providers exploit the ignorance and vulnerability of borrowers, making loans with opaque terms that are not understood, and that are often designed to exploit predictable behavior patterns, such as hidden charges, escalating penalties for delinquency, teaser or misquoted interest rates, and balloon payments. Regulation all too often provides insufficient consumer protection against abuse of knowledge differentials. Unduly constraining interest-rate ceilings can push small-scale lending to marginal customers underground, thereby exposing borrowers to worse abuses, such as enforcement of loan contracts through violence by criminals. The U.S. subprime mortgage crisis of 2007–2009 is a stark reminder of these risks.

Insurance

Widespread underusage of insurance in developing countries reflects several distinct problems. First, customers often do not trust the insurance companies, and this lack of trust is too often validated by the legalistic trickery of those insurance companies that refuse to pay on claims. Second, some people misunderstand risks, probabilities, and premium costs. This leads to low demand for potentially helpful services, and in some instances has allowed unscrupulous insurance agents to sell policies with terms and exclusions that make a successful claim all but impossible to pursue (even in advanced economies). Third, adverse selection and moral hazard play are often much greater in developing countries than elsewhere, and can only be partly alleviated by the substitution of, say, weather insurance for traditional crop insurance. Fourth, prices are often high, partly to compensate for insurers' inability to accurately predict risks in new markets.

excessively slow to pay claims, and premiums are too often charged in lump sums rather than as a series of small installments that better accommodate customers' cash flow patterns.

Box C: Access issues: users, products, and providers

Access to finance is about who gets offered what products at what price. Limited access to financial services reduces welfare and slows firm growth; in addition, it can increase the risk of financial instability as the poor seek to develop their own means of informal access. Access for low-income households (or individuals) and small firms is more limited than it should be because of information frictions, distorted incentives, and, above all, disproportionately high transaction costs. Some of these can be alleviated through policy actions, and some may be worsened by side-effects of poorly designed policy.

Depending on the point of view of the user or the provider, the problem of access looks different. Implementing product designs that meet the needs of both can be the key to improving access.

Users

Access has many dimensions: services need to be available when desired, and products need to be tailored to specific needs; the prices for these services need to be affordable, including all nonprice costs, such as having to travel a long distance to a bank branch; and, most important, it should also make business sense, translate into profits for the providers of these services, and therefore be available on a continuous basis.

All of this means that access is different than use. Access essentially refers to the supply of services, whereas use is determined by demand as well as supply. Not all households and firms should be able to borrow unlimited amounts at prime lending rates or transmit funds across the world instantaneously for a fraction of 1 percent of the amount. Even if service providers are keenly competitive and employ the best financial technology, prices and interest rates charged for financial-services liberalization in a market economy will necessarily depend on demand factors. For example, the size of loans or insurance coverage on offer will depend on the creditworthiness of the customer. In turn, financial inclusion—or broad access to financial services—does not imply that everyone uses financial services; it does mean an absence of unnecessary price or nonprice barriers in the use of financial services.

Products

Lacking financial access means being excluded from products that help individuals, households, and firms cope with risk, accumulate for the future, pursue income-generating enterprises, and manage their cash flows. A fundamental but often overlooked function is to facilitate payments transactions. The classic financial products are savings, credit, insurance, and payments; in practice, though, a specific financial product will bundle together many different aspects: a transactions account with a bank may bundle payments services, security against theft of cash, and even a line of credit. Though convenient for middle-income customers, such bundling may add costs and risks for the poor.

All effective financial products must deal with the problems of confidence and trust. These are at the heart of finance: a customer will be reluctant to deal with an FSP that might go broke, might fail to protect the customers' privacy or treat them with lack of respect, or might impose heavy unanticipated charges. This is especially the case with poorly educated and vulnerable customers. Conversely, an FSP will be reluctant to lend to customers without sufficient indication of their ability and willingness to repay, or to insure customers when the customers are better informed than the service provider about their own risks. The cost and difficulty of overcoming lack of confidence and trust is a major obstacle to expanding the use of formal financial services, not least because this cost tends to be high especially for customers whose potential scale of business is low.

Providers

Many service providers long neglected the challenge of adapting product design and cost to low-income and small-scale customers, and such neglect still limits the outreach of many of the larger banks and FSPs (though some indirectly support outreach by offering relevant wholesale services to micro-oriented providers). Recent experiences show, however, that FSPs can overcome these obstacles and reach small, remote, or disadvantaged clients through innovative product design adapted to the clients' needs and constructed with a view to minimizing unit costs. Various service providers that have developed a range of products to help accomplish these tasks now exist in all countries. The type of provider ranges from large international banks and insurance companies, through national, regional, and local savings banks and credit unions or cooperatives (with varying degrees of formal organization), to specialized microfinance firms, money transmission agencies, and—for some services—nonfinancial firms such as supermarket chains. In a more limited way, less formal entities ranging from licensed credit cooperatives to unlicensed money collectors and rotating savings and credit associations can offer similar, albeit more limited and sometimes less reliable, services. Unfortunately, there have always been some providers that have exploited vulnerable customers with fake "access" to inappropriate or overpriced products, or simply fraud and theft

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Box D: Goals for access policy

Goal 1: Availability of suitable products at affordable prices
This is the primary goal of any access policy. Evidently, the terms “suitable” and “affordable” are shorthand for much detail, relating to such aspects as sustainability, cost of provision, and soundness of the providers.

Payments services
Payments services, including remittance services, should be reliable, speedy, and low-cost—even for small transactions. Technological and other standards can facilitate this.
Savings services

Basic accounts offering a (constrained) range of essential services appropriate to the needs of poor households should be available at affordable price—and where appropriate bearing interest— and convenience, and the integrity of the funds saved should be ensured.

Credit services
The range of creditworthy borrowers who can obtain credit at reasonable terms should be as wide as possible. And the poorly informed should be protected from unscrupulous or reckless lenders who may induce customers to become more heavily indebted than they can support and/or impose hidden and unwarranted costs in the event of delinquency.

Insurance services
The reach of affordable formal insurance should be as wide as is consistent with sustainability, ensuring both sustained financial health of the providing companies and protection of the interests of the insured. Medical emergencies, disability, death, and weather, auto, household, and fire risks are among the key risks for which adequate insurance should be available.

In all cases adequate information should be available to potential users about the alternatives and their costs. To support this, the market for such services should be transparent and have adequate consumer protection.

Goal 2: Access with stability
An important goal of specific policies with respect increasing access is to ensure that constraints are addressed in ways that do not threaten the stability of the financial system. Instead they should build a competitive industry supported by a sound infrastructure.

Goal 3: Wise use of government and donor support
The budgetary costs of public interventions to promote financial access need to be commensurate with the benefits gained. The design of such interventions needs to consider moral hazard and other adverse side-effects, including systemic effects. Moreover, interventions should be designed to avoid chilling private innovation that might have more sustainable long-term effectiveness.

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