

**Access to Finance, Microfinance, and International Capital Adequacy Standards for Banks: A New Approach to Development**

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**Abstract**

International banking regulation comprises, *inter alia*, transnational quasi-legal standards concerning the capital adequacy of internationally active banks, though their usage is normally much wider. These standards originate from the Basle Committee on banking supervision. The main rationale for their emergence has been the fashioning of national and transnational regulatory systems that are adept at preventing systemic crises and protect bank depositors from bank failures. This article suggests that, in addition to systemic stability and depositor protection, international capital adequacy standards may be utilized to facilitate access to finance. The degree of access to finance is a major criterion of financial sector development (FSD). FSD is generally viewed as an essential ingredient of sustained economic growth and thus a very effective means to foster development and fight poverty in developing countries. The first step in utilizing international capital adequacy standards to facilitate access to finance is through the assignment of lower capital requirements to private development finance loans under the Basle framework, in order to reflect their very low default rate. Such an amendment of the Basle framework would give international banking institutions a clear incentive to be involved in private development lending lowering interest rates for microfinance and other similar schemes. Relevant lending would be greatly facilitated by the

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intermediation of centralized country schemes that would on-lend funds to the end lenders.

## **1. Introduction**

The objectives of growth and poverty eradication in developing countries have been central to all attempts to rebuild the post-war world. Already among the biggest legitimating reasons of the anti-colonial struggles, they acquired increased prominence in the past two decades, because they became inextricably woven to the fabric of all discussions concerning the good and evil of globalization. They are also considered issues of fundamental importance for the future of mankind.

Conceived respectively as pillars of international monetary stability and economic development, the International Monetary Fund and the World Bank gradually became seriously involved in prescribing the economic policies that had to be pursued by borrower countries. Since the early 1980s, the economic policies advocated by the two organizations (and the US Treasury), were based on an ultra-liberal interpretation of the economic process, so-called Washington Consensus. Arguably, those policies led to economic hardship and social discontent in many of the developing countries that adopted them.<sup>1</sup>

Thus, the development agenda in the post-Washington consensus era is struggling to address the issues of development and poverty eradication by devising innovative approaches that can withstand the scrutiny of empirical testing, without repeating the mistakes of Washington Consensus policies. Widening access to finance by ensuring

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<sup>1</sup> Avgouleas, E. (2005). 'The Washington Consensus' and the EU-US Relationship, in Kotzias, N. *et al*, (eds), *EU-US Relations, Repairing the Transatlantic Rift*. New York: Palgrave, Macmillan, pp. 163-165.

greater use of financial services in the developing world, one of the main ingredients of Financial Sector Development (FSD) - the most recent acquisition in the armoury of development policies - has come to be considered as key tool in the struggle for growth and eradication of poverty. It is in this context that microfinance schemes have become a potent weapon in fighting poverty and fostering development in a number of developing countries (chiefly Indonesia, Bangladesh, and Vietnam). Indicative of the significance of microfinance is that the most prominent of its pioneers Muhammad Yunus,<sup>2</sup> the founder of Grameen bank in Bangladesh, was the sole recipient of the 2006 Nobel Prize for Peace.

Policies that facilitate access to finance are of great importance<sup>3</sup> in the achievement of the United Nations Millennium Development Goals (MDG).<sup>4</sup> An

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<sup>2</sup> Grameen (meaning 'Village') Bank was established in 1983 following a field trip to a poor village in southeastern Bangladesh by Muhammad Yunus, a young Bangladeshi economist in 1976. This is how Eichfeld & Wendt describe the humble beginnings of Grameen in post-Independence Bangladesh: 'Yunus and his students came upon a woman named Sufiya Begum making bamboo stools. She had to borrow the raw materials from a trader, who dictated the price he paid for the final product, leaving her with just a few pennies of profit. Faced with this example of the depressing cycle of poverty, Yunus began experimenting with ways to make small loans available to the poorest of the poor and gave a total of less than \$27 from his own pocket to forty-two individual basket weavers. Finding not only that they survived with so little help, but also that his capital ignited the spark of personal initiative, enterprise, and hope that enabled them to lift themselves out of poverty, he began providing 'microloans' to the very poor in neighbouring villages. In 1983, Yunus formed Grameen. . . Bank. Its business focused entirely on providing very small loans to impoverished people, mostly women, who organized themselves into small groups of five to help, reinforce, and supervise one another. Loans were typically less than \$80 for first-time borrowers, in contrast to commercial loans that would typically be larger than \$800.' Eichfeld, R. & Wendt, H. (2006). *Building on Success, The Next Challenges for Microfinance*. 4 *Development Policy Outlook* 1 (American Enterprise Institute), pp. 1-2, [hereinafter, Eichfeld & Bendt, *Building on Success*]. Today Grameen Bank has 1,512 branches, with 15,000 staff members. It serves 6 million borrowers in 52,829 villages in Bangladesh. On any working day, the bank collects an average of \$1.3 million in debt-payment installments. *Id.*

<sup>3</sup> See Littlefield, E., Morduch, J. & Hashemi, S. (2003). Is Microfinance an Effective Strategy to Reach the Millenium Development Goals? GCAP, Focus Note 24. On microfinance, in general, see section 3 below and Morduch, J. (1999). The Microfinance Promise. 37 *Journal of Economic Literature* 1569. [Hereinafter, Morduch, *The Microfinance Promise*].

<sup>4</sup> In 2000, in a set of historic agreements, all the countries in the United Nations (UN), with the support of the International Monetary Fund (IMF), the World Bank, the OECD, the G7, and the G20, signed up to a set of Millennium Development Goals (General Assembly Resolution 55/2). The MDGs seek to: (a) reduce

important part of MDGs is the call to create a global partnership for development. Steps towards establishing a global partnership for development, one of the main MDGs, were taken at the 2002 *International Conference on Financing for Development* in Monterrey, Mexico.<sup>5</sup> Direct access of poor people to financial services through, *inter alia*, microfinance schemes received particular attention in the conference.

In an attempt to contribute to the debate on how to broaden access to finance in developing countries, this article explores the possibility of utilizing international capital adequacy standards as a tool to this effect, especially as regards the provision of incentives to major international banks to lend microfinance institutions (MFIs) and participate in national private development finance schemes.

International capital adequacy standards originate from the Basle Committee on Banking Supervision. They are part of a larger body of transnational standards that comprise International banking regulation, which deals with the prudential regulation of internationally active banks. The main rationale of the use of capital adequacy standards by international banking regulation is to fashion national and transnational regulatory systems that prevent bank failures in order to: (a) avert systemic crises both at the national and global levels and (b) protect bank depositors. This article argues that, in

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extreme poverty and hunger by halving, between 1990 and 2015, the proportion of people whose income is less than one dollar a day and the proportion of people who suffer from hunger; (b) achieve universal primary education by ensuring that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling; (c) reduce by two thirds, between 1990 and 2015, the under-five mortality rate and reduce by three quarters the maternal mortality rate, while combating HIV/AIDS, malaria, TB and other diseases; (d) ensure a sustainable environment, and (e) halve by 2015 the proportion of people without sustainable access to safe drinking water and sanitation. More information about the MDGs can be found in Human Development Report (2003), Millennium Development Goals: A Compact Among Nations to End Human Poverty. UN Development Programme.

<sup>5</sup> See Monterrey Consensus of the International Conference on Financing for Development, United Nations 2003, [hereinafter, *The Monterrey Consensus*]. The *Monterrey consensus* calls for developing countries to improve governance and policies aimed at increasing economic growth and reducing poverty, and for high-income countries to provide more and better aid and greater access to their markets.

addition to systemic stability and depositor protection, international capital adequacy standards may be utilized to facilitate access to finance. It is proposed that a class of corporate credits, called here private development finance loans, should be treated as a separate asset class within the Basle II framework<sup>6</sup> and be assigned favourable risk weightings, in order to reflect their very low default rate. Low regulatory capital requirements for such loans would provide incentives to international banking institutions, which are also the largest, to participate in schemes that provide private development finance to the poor.

The term private development finance is understood to extend to all microfinance and mainstream finance schemes utilized by low-income individuals or SMEs in poor countries with the obvious objective of acquiring a productive asset and may not be confused with development finance loans or aid provided by multilateral development banks, donor organizations, or foreign governments. Moreover, it does not include transfer of funds in the context of Foreign Direct Investment schemes. This definition enables the present proposal, discussed analytically in section 5, to avoid unnecessary distinctions between mainstream finance and microfinance schemes, allowing it to focus on the purposes sought to be served by every collective or individual financing project used by the poor.

Given the amorphous nature of the socioeconomic literature dealing with issues of access to finance and the operation of microfinance schemes and of MFIs, the arguments set out in this article will not be fully understood without properly explaining the relevant concepts. For this reason, the article provides a systematic treatment of the meaning of

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<sup>6</sup> On the workings of the Basle Committee on International Banking Supervision and the content of the Basle I and Basle II Accords on the capital adequacy of internationally active banks see section 4 below.

access to finance and a comprehensive analysis of the nature of microfinance schemes. It also explains the impact of FSD on economic growth and poverty eradication.

The remainder of the article is divided in five sections. Section 2 discusses the meaning and role of FSD and of access to finance. Section 3 provides an overview of the origins, nature, and operation of MFIs. In addition, it discusses the observed results of the use of microfinance schemes and of the constraints that limit MFI expansion. Section 4 provides a concise *tour d' horizon* of the Basle capital adequacy framework. Section 5 provides an analytical exposition of the proposal set out in this article. Section 6 brings the straddles of the present discussion to a comprehensive conclusion.

## **2. The Impact of FSD and Access to Finance on Growth and Poverty Eradication**

### 2.1 What is Access to finance?

Financial sector development through, *inter alia*, the broadening of access to finance, achieved via microfinance schemes and/or free and open capital markets, is the most recent addition to the armoury of development policies in the post-Washington consensus era. The biggest contribution of the relevant theoretical debate that is based on solid empirical findings is that growth and poverty eradication are intertwined goals and may be achieved concurrently by developing a country's financial sector and broadening access to finance.

Access to finance is a very difficult term to define and, perhaps, in the case of the poor, not even the most appropriate one. Normally, access to finance is taken to mean access to certain institutions, such as banks, insurance companies, or microfinance institutions; or access to the functions (services) that they provide, such as payments

services, savings or loans and credits, or use of certain financial products such as credit cards, mortgage and insurance products.<sup>7</sup> A more conceptual approach would take access to mean<sup>8</sup>: (a) the availability of financial services and reliability of financial services (namely, whether finance is available when needed/desired), (b) convenience, which is the criterion that, apart from geographic access, measures the degree of ease of access and its continuity; can finance be accessed repeatedly? (c) geographic access, namely, how far or near a consumer is from the point of service and proximity or accessibility of financial advisers to community-based infrastructure, (d) the cost/price at which financial services are available; this criterion is also called affordability of financial services, which is measured by the cost of basic access relative to income, (e) the quantity, type and quality of financial services offered, and (f) flexibility, namely, is the product tailored to the needs of the users?

Most of the above criteria allow for an objective measurement of access.<sup>9</sup> Yet, even if access can be measured it may not be the right criterion.<sup>10</sup> First, there are many dimensions to access, making it more difficult to establish the degree of access, or lack of

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<sup>7</sup> Chidzero, A., Ellis, K. & Kumar, A. (2006). Indicators of Access to Finance, Through Household Level Surveys, Comparisons of Data from Six Countries. Paper presented in the World Bank conference: *Access to Finance: Building Inclusive Financial Systems*, 30 May 2006, p.1, [hereinafter, *Indicators of Access to Finance*].

<sup>8</sup> See, in general, Claessens, S. (2005). Access to Financial Services: A Review of the Issues and Public Policy Objectives. World Bank Policy Research Working Paper 3589, pp 6-12 [hereinafter, Claessens, *Access to Financial Services*]; Porteous, D., (2004). Making Financial Markets Work for the Poor, p. 31 [hereinafter, Porteous, *Making Financial Markets Work for the Poor*]; de la Torre, A., Gozzi, J. C. & Schmukler, S. L. (2006). Innovative Experiences in Access to Finance: Market Friendly Roles for the Visible Hand? World Bank mimeo, pp. 10-18 [hereinafter, de la Torre *et al.*, *Innovative Experiences in Access to Finance*]. In describing the criteria of access this article draws on the above papers.

<sup>9</sup> See Chidzero, Ellis and Kumar, *Indicators of Access to Finance*, n 7 above, p. 4.

<sup>10</sup> Porteous, *Making Financial Markets Work for the Poor*, n 8 above, p. 10. According to Porteous, the access frontier 'is the maximum proportion of usage possible under existing structural conditions (of technology, infrastructure and regulation)'. *Id.* p. 3.

it. Second, even if there is a market, where some financial services are accessible, poor people may still choose not to use it. Accordingly, an alternative approach, which measures not so much access, but usage of financial services, may be more appropriate in the case of the poor.<sup>11</sup> Usage can be measured quite easily using historical data. It can also be compared across sectors, since the usage patterns of particular markets can be tracked over time. Therefore, a market which works for the poor is one in which usage of the service by poor people is increasing over time. Increasing usage clearly implies both accessibility and appropriateness, without the need to define either too closely.<sup>12</sup> As a result, if the proportion of poor customers to total customers in a particular market segment increases over time, then relatively more poor people are using the products provided by that market.<sup>13</sup>

It should be noted here that the strong influence that availability of finance is shown to have on growth and poverty eradication, discussed in paragraph 2.3 below, does not necessarily mean that universal usage of/access to financial services is the immediate goal. Unlike other services such as basic health services, primary education, water sanitation, universal access to financial services may not prove beneficial in all instances. First, like other services provision of financial services has its own demand and supply curves and there might be no demand for such services. Poor households may choose not to have a bank account, as they do not engage in a volume of financial transactions that is high enough to justify demand for financial services. For instance, they might not collect

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<sup>11</sup> For the complex relationship between access and usage see Chidzero, Ellis & Kumar, *Indicators of Access to Finance*, n 7 above, p. 3.

<sup>12</sup> Porteous, *Making Financial Markets Work for the Poor*, n 8 above, pp. 10-11.

<sup>13</sup> *Ibid.*



wages in cash or cash their checks. Second, firms without use of external credit may choose to remain so, as their rates of return on capital are too low to justify formal finance, or because they are not willing to provide the necessary information on their business to banks, and by implication to others, including tax authorities. The above may mean that a country requires a certain overall level of development before moving to more universal access. Third, unrestrained borrowing to finance consumption has the potential to ruin very poor households, which have inherent weaknesses in terms of financial management skills or simply lack the resources to repay those loans, given also the very high interest rates of such loans. Thus, some restraint, say until financial literacy is more adequate, may well be welfare enhancing.<sup>14</sup>

## 2.2. Access/Usage barriers

### *i. Constraints relating to financial institutions*

Explanations of the lack of access to/usage of finance fall into two broad categories: (a) financial institutions' specific constraints and (b) barriers arising from the overall institutional environment prevailing in each country.<sup>15</sup> The following access/usage barriers may be regarded as constraints relating to financial institutions<sup>16</sup>: (a) access exclusion, (b) condition/product exclusion, (d) marketing exclusion: with some people

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<sup>14</sup> Claessens, *Access to Financial Services*, n 8 above, pp. 6-7.

<sup>15</sup> *Ibid.* p. 12.

<sup>16</sup> The systematic categorization offered here draws on, but does not fully endorse, relevant classifications, in a number of works including Kempson, E. *et al.* (2000). In or Out? Financial Exclusion: A Literature and Research Review. Report prepared for the UK's Financial Services Authority, pp 21-29; Porteous, *Making Financial Markets Work for the Poor*, n 8 above; Claessens, *Access to Financial Services*, n 8 above. See also the papers presented in the 1<sup>st</sup> session (What is Financial Access and How Can it be Measured?) of the World Bank Conference, 'Access to Finance: Building Inclusive Financial Systems', 30 May 2006.

effectively excluded by marketing and sales targets, (e) cultural exclusion due to ethnic and class biases, (f) self-exclusion: some persons do not seek to obtain financial services in the belief that their application would be refused.

Access exclusion may be the result of many factors. For instance, through risk screening banks may consider some households and firms as less attractive customers and are, therefore, not willing to extend financial services to them. This is an especially strong barrier as poor customers are not usually able to provide collateral, which could be used for risk mitigation. In addition, access exclusion may be due to difficulties to provide physical infrastructure in rural areas or limited security of cash transfers.

Condition/product exclusion means that there is a lack of products that suit the needs of the poor or of small firms. Households and firms in developing countries may seek financing or insurance for specific purposes (major life events such as marriage, health or specific crop insurance), for which contracts are difficult to design. Firms may be underserved for the same reasons. Small firms seek different products than large enterprises, as are, for instance, payment services for small amounts. Thus, banks may not consider small firms as sufficiently attractive clients. Moreover, if the size of the market is such as to be difficult to develop/reap economies of scale, it becomes unprofitable for financial institutions to offer new products specifically for that market.<sup>17</sup>

Cost/price exclusion may also be due to a variety of reasons. High transaction costs for small volumes are often mentioned as constraining financial services providers from broadening access. Small borrowers need to borrow frequently and repay in small instalments. They consequently do not want financial products with high per unit costs,

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<sup>17</sup> Glaessens, *Access to Financial Services*, n 8 above, p. 13.

yet for banking institutions the costs per transaction are often similar regardless of the size of each transaction. The fixed costs of financial intermediation make the provision of financial services to small clients and in small markets very hard, even if specialization and increasing volume absorb some of this cost.<sup>18</sup> Furthermore, high minimum deposits, the high administrative burden of applying for and maintaining an account, and account/transaction fees may deter poor households from entering the financial system. Obtaining a loan can be an especially cumbersome and costly process for the poor, taking into account the small size of the loan applied for, the high fixed costs of such application, and the potentially high rejection rates, given the absence of collateral.

Finally, formal financial services provision may entail other, non-pecuniary barriers, such as requiring (greater) literacy. In such cases, households and firms will not seek financial services from formal financial institutions and will instead opt for informal sources of finance, such as family and friends. For instance, people wanting to transmit payments to their relatives, whether domestic or international may rely on informal networks, although at higher costs. This is most obvious in the transmission of international remittances, where unit costs can be very high when informal mechanisms are used.<sup>19</sup> Yet, these informal mechanisms are often preferred due to non-pecuniary barriers. This lack of demand is also a powerful explanation of why usage is not universal: many households and firms may not use financial services, although they do have access to some financial services.

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<sup>18</sup> *Ibid.* pp. 13-14.

<sup>19</sup> Solo, T. M., Caskey, J. & Durán, C. (2004). *The Unbanked in Mexico and the USA: Five Questions Addressed*. Mimeo, World Bank, Swarthmore College, Universidad Nacional Autónoma de México.

*ii. Institutional Constraints: Institutions Matter*

Institutional barriers of access to/usage of finance usually refer to the low quality of legal systems, uncertainty regarding the enforceability of commercial contracts and of property rights, low level of protection for minority shareholders,<sup>20</sup> and the absence of institutional mechanisms for the gathering of reliable information. Levine, Loayza and Beck (2000) show that legal and regulatory changes that strengthen creditor rights, contract enforcement, and accounting practices boost financial intermediary development with positive repercussions on economic growth.<sup>21</sup>

In environments with weak legal institutions, contract writing and enforcement is difficult and publicly available information is scarce. As a result, agency problems tend to be mitigated through arrangements between private parties that rely heavily on personalized relationships, fixed (preferably real estate) collateral, and group monitoring. Provision of collateral secures repayment, as it aligns better the incentives of lenders and borrowers.<sup>22</sup> However, in an environment where collateral repossession is unduly cumbersome, opacity is high, accounting rules are unreliable, and asset markets are illiquid, formal financial institutions will only accept fixed collateral, preferably real estate, which the poor usually will not be able to provide. Even group monitoring - a

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<sup>20</sup> La Porta, R., López-de-Silanes, F., Shleifer, A. & Vishny, R. W (1997). Legal Determinants of External Finance. 52 *Journal of Finance* 1131; La Porta *et al.* (1998). Law and Finance. 106 *Journal of Political Economy* 1113. And for more recent studies strengthening the argument about the fundamental role that institutions play in economic development, see Beck, T., Demirgüç-Kunt, A. & Levine, R. (2003). Law and Finance: Why Does Legal Origin Matter? 31 *Journal of Comparative Economics* 653 and Acemoglu, D., Johnson, S., Robinson, J. (2005). Institutions as the Fundamental Cause of Long-Run Growth, in Aghion P. & Durlauf, S. (eds), *Handbook of Economic Growth*. Amsterdam: Elsevier.

<sup>21</sup> Levine, R., Loayza, N. & Beck, T. (2000). Financial Intermediation and Growth: Causality and Causes. 46 *Journal of Monetary Economics* 31. See also Demirgüç-Kunt, A. and Maksimovic, V. (1998). Law, Finance and Firm Growth. 53 *Journal of Finance* 2107.

<sup>22</sup> de la Torre *et al.*, *Innovative Experiences in Access to Finance*, n 8 above, pp. 10-14.

device frequently used by MFIs to mitigate agency problems in an environment of weak institutions - may not remedy this situation. On the one hand, the potential of implicit side-contracts among group members lowers information costs and leads to effective enforcement of social sanctions between group members,<sup>23</sup> raising repayment rates. On the other hand, group members, because they are collectively liable for payment failure of any fellow borrower within the group, may exclude risky borrowers from participating, depriving the very poor from group loan facilities.<sup>24</sup>

Furthermore, there is ample empirical evidence on the importance of institutional barriers, especially as regards the financing of small firms.<sup>25</sup> Evidently, small firms and firms in countries with poor institutions use less external finance, especially less bank finance. It also appears that substitutes to bank finance are imperfect. For example, small firms do not use disproportionately more leasing or trade finance compared to larger firms.<sup>26</sup> Thus, the existence of a high quality institutional environment increases external financing of small firms significantly more than that of large firms.

Moreover, it is clear that certain regulations, such as minimum or maximum interest rate policies and lending restrictions, can hinder access to the banking system, as they make it hard for financial services providers to profitably offer saving or lending

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<sup>23</sup> For example, Avner Greif has provided an illuminating analysis of how the Maghribi traders were able to monitor agents involved in distant trading by forming a community of merchants who were mutually bound by a set of rules (the Merchant's Law). See Greif, A. (1993). Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders' Coalition. 83 *American Economic Review* 99.

<sup>24</sup> Morduch, *The Microfinance Promise*, n 3 above, pp. 1580-82 and 1598-1599.

<sup>25</sup> Beck, T., Demirgüç-Kunt, A. & Maksimovic, V. (2005). Financial and Legal Constraints to Firm Growth: Does Size Matter? 60 *Journal of Finance* 137; Manuela, F. & Kumar, A. (2004). Enterprise Size, Financing Patterns and Credit Constraints in Brazil Analysis of Data from the Investment Climate Assessment Survey. Washington, DC: World Bank. This survey found that size in Brazil affects access to finance stronger than performance.

<sup>26</sup> See further some of the papers presented at a recent World Bank SME-conference, [http://www.worldbank.org/research/projects/sme\\_conference.htm](http://www.worldbank.org/research/projects/sme_conference.htm).

instruments. Similarly, bank account opening procedures can be complex, requiring among others proof of identity, address, or income. Many countries have customer identification requirements, so called 'Know Your Customer' rules, which limit their ability to offer simple banking products. Also, anti-money laundering and counter-terrorism financing legislation may provide rules that can adversely affect the provision of financial services. Other examples are costly or distortive rules that exhibit a gender bias. For instance, in some African countries permission from a male household head is necessary for a female member of the household to open a bank account.

### 2.3. Access to Finance, Growth, and Poverty Alleviation

#### *i. The Link between FSD and Growth*

Over the recent years a large number of studies have been undertaken examining the link between FSD and growth.<sup>27</sup> Thus, a large body of evidence now supports the theory that the deeper a country's financial system the higher its growth potential.<sup>28</sup> This is due to many reasons. First, according to the Schumpeterian theory of 'creative destruction',<sup>29</sup>

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<sup>27</sup> For an overview of relevant studies see Levine, R. (2005). *Finance and Growth: Theory and Evidence*, in Aghion, P. and Durlauf, S. (eds), n 20 above. Policy Division Working Paper (2004). *The Importance of Financial Sector Development for Growth and Poverty Reduction*. Department for International Development (UK), pp. 7-15.

<sup>28</sup> Rajan, R. & Zingales, L. (1998). *Financial Development and Growth*. 88 *American Economic Review* 559; Calderon, C. & Liu, L. (2003). *The Direction of Causality between Financial Development and Economic Growth*. 72 *Journal of Development Economics* 321. For an overview of relevant studies see Honohan, P. (2004). *Financial Development, Growth and Poverty: How Close Are the Links?* World Bank Policy Research Working Paper 3203.

<sup>29</sup> See Schumpeter, J. A. (1912). *Theorie der Wirtschaftlichen Entwicklung* [The Theory of Economic Development]. Leipzig: Dunker & Humblot, translated by Rredvers Opie for the English edition (1934), Cambridge MA: Harvard University Press. According to Schumpeter, innovative entrepreneurship leads to gales of 'creative destruction' as innovations cause old inventories, ideas, technologies, skills, and equipment to become obsolete. The question, as Schumpeter saw it, is not 'how capitalism administers

while finance allocates resources to their most productive use it allows for the renewal of a country's economy by pulling funding from underperforming or ageing sectors and pouring them to newer, more innovative and promising ones. Second, finance helps growth through facilitation of raising and pooling of funds to undertake risky investments and through the creation of innovative instruments, which can be used for risk mitigation.

One of the first studies to find empirical evidence of the close correlation between financial sector development (FSD) and the overall rate of a country's economic growth was undertaken by Goldsmith (1969).<sup>30</sup> Using data from 35 countries covering the period between 1860–1963, Goldsmith found evidence of a relationship between economic and financial development over long periods, and that periods of rapid economic growth have often been accompanied by an above average rate of financial development. Other empirical studies have provided further evidence of the positive relationship between financial sector development and growth. For example, King and Levine (1993a,<sup>31</sup> 1993b,<sup>32</sup> 1993c<sup>33</sup>) examined 80 countries over the period 1960–1989. After controlling for other factors affecting long-run growth, they examined the capital accumulation and productivity growth channels separately and used various different measures of the level of financial development. They found evidence of a strongly positive relationship

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existing structures . . . [but] how it creates and destroys them.' He believed that 'creative destruction' caused continuous progress and improved standards of living for everyone.'

<sup>30</sup> Goldsmith, R. W. (1969). Financial Structure and Development. New Haven: Yale University Press.

<sup>31</sup> King, R. G. & Levine, R. (1993a). Finance and Growth: Schumpeter Might Be Right. 108 *Quarterly Journal of Economics* 717.

<sup>32</sup> King, R. G. & Levine, R. (1993b). Finance, Entrepreneurship, and Growth: Theory and Evidence. 32 *Journal of Monetary Economics* 513.

<sup>33</sup> King, R. G. & Levine, R. (1993c). Financial Intermediation and Economic Development, in Mayer, C. & Vives, X. (eds), Financial Intermediation in the Construction of Europe. London: Centre for Economic Policy Research 156.

between the various financial development indicators and growth.<sup>34</sup> By themselves, however, these results do not necessarily imply that FSD leads to higher growth. It may be that growth leads to FSD, as it generates greater demand for financial services that induces an expansion in the financial sector. As a result, many researchers have examined this issue explicitly.

King and Levine (1993b) found that, even after controlling for other factors that may affect growth, the relationship between the initial level of financial development and growth is large. Subsequent studies, such as Levine, Loayza, and Beck (2000),<sup>35</sup> have confirmed that FSD exerts a large positive impact on economic growth. Calderon and Liu (2003) also adopted an innovative econometric technique to analyse this issue,<sup>36</sup> using data from 109 countries over the 1960-1994 period. Their results showed that there was bi-directional causality: FSD has a causal impact on growth and growth has a causal impact on FSD. However, the impact of FSD on growth is more important than the impact of growth on FSD. In fact, Calderon and Liu's study suggested that financial sector under-development is more likely to hold growth back in developing countries.

Furthermore, Berthelemy and Varoudakis (1996)<sup>37</sup> suggested that financial sector underdevelopment could be a serious obstacle to growth even when a country has established other conditions necessary for sustained economic development. For instance, they found evidence that countries with a high level of educational achievement, but a

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<sup>34</sup> King & Levine (1993b), n 32 above.

<sup>35</sup> Levine, Loayza & Beck, n 21 above.

<sup>36</sup> Calderon and Liu, n 28 above.

<sup>37</sup> Berthelemy, J. C. & Varoudakis, A. (1996). Economic Growth, Convergence Clubs, and the Role of Financial Development. 48 *Oxford Economic Papers* 300.



low level of FSD, were trapped in relatively low standards of living compared to those countries with a similar level of educational attainment, but a more developed financial sector. Moreover, they found that educational attainment had no significant impact on growth in countries where FSD was weak. This result implies that the lack of a sufficiently developed financial system may compromise the positive contribution of education to growth.

*ii. Availability of Finance and Poverty Alleviation*

It is certain that the availability of financial services has a direct impact on poverty at the micro level, primarily by affecting the ability of poor people to accumulate usefully large lump sums—whether for life cycle, emergency, or opportunity investment purposes.<sup>38</sup> Thus, access to credit, insurance, and savings facilities can reduce the vulnerability of the poor to a number of external shocks, including bad harvests or health difficulties. The mobilisation of savings also creates an opportunity for re-lending the collected funds into the community strengthening community ties.

Availability of finance has special importance for poor households and smaller firms in a number of other ways. For instance, availability of credit can strengthen the productive assets of the poor by enabling them to invest in productivity-enhancing new ‘technologies’ such as new and better seeds, work equipment, or fertilizers etc., or to invest in education and health, all of which may be difficult to finance out of regular

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<sup>38</sup> Hardy, D. C., Holden, P. & Prokopenko, V. (2002). Microfinance Institutions and Public Policy, IMF Working Paper 02/159; Honohan, *Financial Sector Policy*, n 48 below; Hoff, K. & Stiglitz, J. (2001). Modern Economic Theory and Development, in Meier, G. & Stiglitz, J. (eds), The Future of Development Economics in Perspective. Oxford: Oxford University Press.

household income, but which could provide for a higher income in future. The availability of credit can also be an important factor in the creation or expansion of small businesses, thus generating self- and wage-employment and increasing incomes. Eswaran and Kotwal (1990) have argued that just the knowledge that credit will be available to cushion consumption against income shocks, should a potentially profitable but risky investment turn out badly, can make the household more willing to adopt more risky technologies.<sup>39</sup> Such behaviour will lead to increased use of modern technologies boosting productivity, and hence enhance income. For the same reason, access to credit and other financial services is likely to decrease the proportion of low-risk, low-return assets held by poor households for precautionary purposes (such as jewels), and enable them to invest in potentially higher risk and higher return assets, (such as education, or a rickshaw), with serious long-term income enhancing results.<sup>40</sup> Similar are the results of the availability of insurance for the poor,<sup>41</sup> as it protects them from financial vulnerability due to external shocks such as an illness or a bad harvest.

Remittances from abroad and domestic transfers are also an important source of income for the poor and provide an additional means for them to diversify their sources of income, reducing thus their financial vulnerability. The use of financial services leads to lower costs in this area, more secure and rapid transfers, and easier access to transferred funds, all of which present significant benefits to poor recipients. So, though the scale may be different (*e.g.*, investing in a new tool rather than a new factory), the

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<sup>39</sup> Eswaran, M. & Kotwal, A. Y. (1990). Implications of Credit Constraints for Risk Behaviour in Less Developed Economies. *Oxford Economic Papers* 473.

<sup>40</sup> Deaton, A. (1991). Saving and Liquidity Constraints. 59 *Econometrica* 1221.

<sup>41</sup> See for the importance of micro-insurance for poverty alleviation Morduch, J. (2003). Microinsurance: The Next Revolution? New York University, mimeo.

same channels through which the financial sector can increase overall growth (*e.g.*, savings mobilisation, risk management, facilitation of transactions) also serve to reduce poverty, though for the poor there may be more emphasis on reducing vulnerability and risk.

At the macro level, finance may have an impact on poverty both directly, by raising the income of the poor and making more equal income distribution, and indirectly by stimulating overall economic growth. Cross-country studies on the link between finance and poverty studies have examined the reverse causality between availability of finance and poverty and found that financial development caused smaller income inequality.<sup>42</sup> Clarke, Xu, and Zou (2003) find that inequality decreases as finance develops and, the more concentrated income is the higher the country's level of poverty. The fact that finance helps to distribute income opportunities more evenly becomes a significant factor in poverty reduction.<sup>43</sup> In the same mode, Beck, Demirgüç-Kunt and Levine (2004/6), using a broad cross-country sample, have shown that financial development not only raises disproportionately the income of the poor reducing income inequality, but also that countries with better-developed financial intermediaries experience faster declines in poverty and income inequality.<sup>44</sup>

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<sup>42</sup> Beck, T., Demirguc-Kunt, A. & Levine, R. (2004). Finance, Inequality and Poverty: Cross-Country Evidence', World Bank Policy Research Working Paper 3338. See also Claessens, S. & Perotti, E. (2005). The Links between Finance and Inequality: Channels and Evidence. Background paper for the 2005 World Development Report, World Bank, University of Amsterdam.

<sup>43</sup> Clarke, G. Xu, L. C. & Zou, H. (2003). Finance and Income Inequality, Test of Alternative Theories. World Bank Policy Research Working Paper 2984.

<sup>44</sup> See updated version of the paper of Thorsten Beck, Asli Demirguc-Kunt & Ross Levine, Finance, Inequality and Poverty: Cross-Country Evidence, submitted to the World Bank conference, Access to Finance: Building Inclusive Financial Systems, 30 May 2006.

Beyond (the largely unmeasured) direct impact of access to/usage of financial services on poverty, the indirect impact of FSD on poverty is certain through its impact on growth. For instance, as economic production is changing and countries are liberalizing their real economies, it has become clearer that the degree of financial development greatly influences the ability of countries, firms, and individuals to make use of (new) growth opportunities. However, the poor in developing countries often do not have access to a continuous and formal stream of financial services, and are forced to rely instead on a narrow range of often expensive and more risky informal services.

In addition, the availability of finance has, as mentioned above, a disproportionate effect on the growth opportunities of SMEs. Beck, Demirgüç-Kunt and Levine (2005) showed that, while large SME sectors are characteristic of successful economies, SMEs do not ‘cause’ growth, nor do SMEs alleviate poverty or decrease income inequality.<sup>45</sup> Yet, finance accelerates growth by removing constraints on small firms, more so than on large firms. Finance allows SMEs to operate on a larger scale and helps leveling the playing field among firms in terms of financing opportunities.<sup>46</sup>

Finally, access to finance may become a good agent of economic and social change that improves governance structures decreasing some of the causes of poverty. Recently, two leading economists: Raghuram Rajan and Luigi Zingales, who have endorsed the Schumpeterian view of creative destruction, suggested that access to finance through, *inter alia*, free and open capital markets are the only means to erode the power

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<sup>45</sup> Beck, T., Demirguc-Kunt, A. & Levine, R. (2005). SMEs, Growth, and Poverty: Cross-Country Evidence. 10 *Journal of Economic Growth* 197.

<sup>46</sup> Claessens, *Access to Financial Services*, n 8 above, p. 4.

of incumbent elites.<sup>47</sup> Normally, such elites have a vested interest to push back economic growth, which would entail the empowerment of the disenfranchised parts of society (normally its biggest part), and thus the erosion of their privileges. An even more realistic path for the facilitation of access to finance for the disenfranchised is the provision of credit and of other financial services to poor households and micro-entrepreneurs. For this reason, the next section discusses the most important aspects of the microfinance industry.

### **3. Microfinance and its Impact on Growth and Poverty Eradication**

#### **3.1 The Development of Microfinance**

The term microfinance is mostly used to describe the provision of financial services, such as micro-credit or micro-insurance, to the poor. Yet it is an elastic term and its exact content often differs from country to country.<sup>48</sup> As in developed countries the financial system does offer financial services to the poor, diminishing the need for microfinance,<sup>49</sup> the majority of microfinance schemes have operated in the developing world. Though the operating principles are quite similar with mainstream financial institutions, MFIs have focused on the poor and very poor segments of the population which are not usually reached, for the reasons explained above, by mainstream financial institutions.

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<sup>47</sup> Rajan, R. and Zingales, L. (2003). *Saving Capitalism from the Capitalists*. New York: Random House.

<sup>48</sup> Honohan, P. (2004). *Financial Sector Policy and the Poor: Selected Findings and Issues*. World Bank Working Paper No 43, p. 3, [hereinafter, Honohan, *Financial Sector Policy*]. For instance, one area of doubt is whether small-scale finance provided by mainstream financial institutions should be included or not in the definition of microfinance.

<sup>49</sup> Claessens, *Access to Financial Services*, n 8 above, pp. 15.

The main characteristic of microfinance schemes has historically been diversity and experimentation.<sup>50</sup> Even the origins of microfinance present differing departure points, depending on the geographic region. For instance, in Asia, the primary incentive for the establishment of Grameen Bank was the ideal of development, whereas in Latin America the principal purpose of MFIs such as Prodem (now BancoSol) in Bolivia was fighting urban unemployment.<sup>51</sup>

In the 1970s and 1980s, the focus was on credit to the productive poor, following the public success of the early micro-credit models of Grameen Bank and BancoSol. Also Grameen Bank primarily targeted women, because Yunus found them to be more likely than men to use the loans for productive purposes and repay them. They also tended to reinvest their profits and use them to improve the lives of their families. The technique mostly used by these institutions in the early stages was that of group loans. The marked success of group loans gave force to the proposition that poor people can repay credit, and that appropriate credit can become an effective tool in the fight against poverty. As a result, MFIs started using more innovative techniques, such as loans where the progressive increase in the amounts lent to individuals or group members followed due repayment of previous loans, non-traditional collaterals (notably those that likely to be of more value to the borrower than the lender), and mechanisms incorporating high frequency of repayment instalments.<sup>52</sup>

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<sup>50</sup> See for the history of the microfinance movement and a discussion of the development of the most important institutions Morduch, *The Microfinance Promise*, n 3 above, pp. 1573-1579; Eichfeld & Wendt, *Building on Success*, n. 2 above.

<sup>51</sup> Weiss & Montgomery, *Great Expectations*, n 60 below, p. 3.

<sup>52</sup> Progressive lending has enhanced the incentive to repay early loans; the discipline effect of collateral depends not on its resale value, but on its value to the debtor; high frequency of payments reduces the free-cash problem.

The accumulation of experience showed that an increasingly wide range of lending products could be successfully employed. Thus, gradually microfinance products worldwide became more flexible involving larger groups, different maturities, individual rather than group lending, flexible savings schemes,<sup>53</sup> especially during the 1990s when the focus moved on to micro-savings. Based on careful analysis of poor people's financial service needs and usage patterns it was demonstrated that the poor were 'too poor not to save'.<sup>54</sup>

The technology boom of the 1990s provided the information systems necessary for managing bigger portfolios and new products, while leading financial institutions and organizations that gather funds for microfinance, began to set standards and improve governance within the industry. Thus, the development of microfinance schemes has been rapid over the recent years. By the end of 2004, 92 million poor people and 62 million of the poorest were being helped.<sup>55</sup>

### 3.2 The Organizational Structure of the MFI Sector

The organizational structure of MFIs and their business models and product and service technologies differ widely and there appears to be no dominant organizational form.<sup>56</sup>

This diversity partly reflects the experimental nature of much of modern microfinance

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<sup>53</sup> de Aghion, B. A. & Morduch, J. (2004). *The Economics of Microfinance*. Cambridge, MA: MIT Press.

<sup>54</sup> Rutherford, S. (2003). Microfinance's Evolving Ideals: How They Were Formed and Why They Are Changing. Paper presented at the 2003 ADBI Annual Conference: *Microfinance in Asia*.

<sup>55</sup> Daley-Harris, S. (2005). Microcredit Summit Campaign Report 2005. Washington, DC: Microcredit Summit Campaign, 1.

<sup>56</sup> Honohan, *Financial Sector Policy*, n 48 above, pp. 16-17.

and their need to adapt to local conditions and in particular issues of geography, security of persons and of money transfers, communications infrastructure, temporal variations of income flows, individuals' spending needs, family and community relationships, local customs, tribal, ethnic and linguistic differences. Some MFIs are today fully-fledged financial institutions holding banking licenses and they differ from mainstream financial institutions only in terms of the clientele they serve. Others are NGOs and mainly lend donor money. A first attempt to classify MFIs would distinguish between: (a) charitable and other not-for-profit 'non-government organizations', all of which make loans, although many among them do not take deposits, (b) savings and credit cooperatives or credit unions, (c) regional banks, often rural, controlled by local authorities, and (d) for-profit intermediaries specializing, perhaps, through an affiliate, in microfinance.

Another dimension of the operation of MFIs that adds to their diversity refers to the type of target group chosen, depending on whether they focus on women, or on poor or very poor clients, or on small businesses. For NGO MFIs this is not merely a business decision: helping the target group to improve their economic performance or social and psychological welfare is often the main goal of the organization. Measuring the degree to which the target group has indeed been reached can be in itself a significant task for such NGOs, especially since neither determining the degree of poverty of a client nor measuring microfinance's impact on poverty reduction are methodologically unproblematic.<sup>57</sup> The methodological issues relating to measuring the impact of microfinance on poverty are discussed in the next paragraph.

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<sup>57</sup> *Ibid.* p. 15.



### 3.3 The Impact of Microfinance Schemes on Poverty Eradication and Growth

The results of studies examining the impact of microfinance schemes on poverty are mixed.<sup>58</sup> In some countries, such as Bangladesh and Indonesia, the results are truly impressive.<sup>59</sup> Elsewhere it is hard to discern any difference.<sup>60</sup> Most of the studies commissioned by MFIs and a few independent studies suggest that microfinance has played a substantial role in improving levels of poverty.<sup>61</sup>

Other studies<sup>62</sup> have shown that, while financial depth explains poverty, across countries the degree of microfinance penetration has no special effect on poverty. This ambiguous outcome is partially due to the methodological difficulties that measuring the impact of microfinance on poverty presents.<sup>63</sup>

First, for the purpose of measuring the impact of microfinance schemes on poverty we must define what qualifies as poverty. It is suggested that poverty should be understood as a situation where individuals' income (or more broadly welfare) level is below a socially acceptable minimum. Similarly, the condition of poverty could be one of

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<sup>58</sup> Weiss and Montgomery, *Great Expectations*, n 60 below.

<sup>59</sup> See Khandker, S. (2003). *Micro-finance and Poverty: Evidence Using Panel Data from Bangladesh*. World Bank Policy Research Paper 2945; Khandker, S. (1998). *Fighting poverty with Microcredit: Experience from Bangladesh*. New York: Oxford University Press, published for the World Bank.

<sup>60</sup> See Weiss, J. & Montgomery, H. (2004). *Great Expectations: Microfinance and Poverty Reduction in Asia and Latin America*. ADB Institute, Discussion Paper No.15, [hereinafter, Weiss and Montgomery, *Great Expectations*].

<sup>61</sup> Morduch, J. & Hayley, B. (2002). *Analysis of the Effects of Microfinance on Poverty Reduction*. NYU Wagner Working Paper No. 1014.

<sup>62</sup> Honohan, *Financial Development, Growth and Poverty*, n 28 above; Honohan, *Financial Sector Policy*, n 48 above.

<sup>63</sup> This part draws on Weiss and Montgomery, *Great Expectations*, n 60 above, p.6 and Kurmanalieva, E., Montgomery, H. & Weiss, J. (2003). *Micro-finance and Poverty Reduction in Asia: What is the Evidence?* ADB Institute, pp. 6-9, [hereinafter, Kutmnalieva et al., *Micro-finance and poverty reduction*].

lack of access by poor households to the assets necessary for a higher standard of income or welfare, whether such assets are human (access to education), natural (access to land), physical (access to infrastructure), social (access to networks of obligations) or financial (access to credit).<sup>64</sup> Second, assessing the true relationship between microfinance services and poverty reduction is not straightforward. It is not simply a case of looking at a group of borrowers, observing their income change after they took out microcredits, and establishing who has risen above the poverty line. Accurate assessment requires a rigorous test of the counterfactual, namely, measuring how the income of individuals or families receiving microcredit compares with what it would be without it. This requires empirical examination of a control group identical in its characteristics with the recipients of microcredit, who are also engaged in the same productive activities but have not received credit, provided that their income can be traced through time to compare with that of the recipients of microcredit. In the same mode, to account for changes over time, assessments should allow for the possibility of reversals with households slipping back below the poverty line, if the productive activities financed by the microloans proved to be unsustainable.

Studies based on rigorous counterfactual analysis find much smaller gains from microfinance than those unadjusted for the aforementioned events, which erroneously attribute all gains to micro credit.<sup>65</sup> In addition, strategies such as group lending may hinder, through group self-exclusion, microfinance schemes from reaching the core poor.<sup>66</sup> Moreover, where the loans have been directed by poor households towards

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<sup>64</sup> World Bank (2000). *World Development Report 2000/01: Attacking Poverty*, p. 34.

<sup>65</sup> Kurmanalieva *et al.*, *Micro-finance and Poverty Reduction*, n 63 above, pp. 8-9.

consumption the situation might have worsened due to the burden of very high interest rates.<sup>67</sup>

For all of the above reasons, the distinction of section 5 between private development finance schemes and loans used to ease consumption presents methodological advantages. For the first class of microcredits economists would concentrate on measuring how much extra income that credit generated. Income increase is a much easier variable to measure than poverty reduction, even if there is no formal system of tax returns that provides reliable income data. Measuring income increase enables MFIs, development banks and other relevant organizations to acquire a clear view of the impact of microcredits to the livelihoods of the poor. As a result, they would be better able to direct their resources to areas that need most private finance and would make the best use of it.

Of course, nothing in the discussion above negates the strong impact that microfinance has had on poverty in certain Asian countries. In addition, the availability of microfinance and the operation of MFIs may have a certain indirect impact on poverty, especially through the development of intangible community assets, such as social capital and providing a boost for institutional reform. More specifically, microfinance has been found to generate, in some cases, social capital by promoting horizontal and vertical networks of workers within a community, establishing new norms of behaviour, and

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<sup>66</sup> Coleman, B. E. (2001). Measuring Impact of Microfinance Programs. 2 *Finance for the Poor* 5-7; Coleman, B. E. (2002). Microfinance in Northeast Thailand: Who Benefits and How Much? Asian Development Bank ERD Working Paper No. 9; Kurmanalieva *et al.*, *Micro-finance and Poverty Reduction in Asia*, n 63 above, pp.8-9.

<sup>67</sup> Dunn, E. and Arbuckle Jr., J. G. (2001). The Impacts of Microcredit: A Case Study from Peru Washington, DC: AIMS, available at [www.usaidmicro.org/pdfs/aims/core-la-peru-2.pdf](http://www.usaidmicro.org/pdfs/aims/core-la-peru-2.pdf); Todd H. (2000). Poverty Reduced through Microfinance: The Impact of ASHI in the Philippines. Washington, DC: AIMS, available at [www.usaidmicro.org/pdfs/aims/ashi-impact\\_of.pdf](http://www.usaidmicro.org/pdfs/aims/ashi-impact_of.pdf), both last accessed on 15.01.2007.

fostering a new level of social trust.<sup>68</sup> The creation of social capital improves the ability of communities to tackle other problems, such as schooling, environmental degradation, and lack of medical care and enables the people to do so on their own terms, rather than on the mandates of distant authorities. In a similar manner, microfinance organizations can be used to deliver education on health risks and sanitation, promote education and insure health, life, agricultural, and livestock risks through micro-insurance products.

Furthermore, the MFI sector may have an indirect impact on growth and development. First, it can foster the development and deepening of the financial sector by bringing access to financial services to the poor, given the ability of MFIs to deliver more tailor made and lower cost products to this segment of the population. Second, microfinance growth can provide a stimulus for institutional improvements (*e.g.*, operation of credit information clearinghouses) effected independently of the prevailing governance structures, which may take a very long time to improve. Thus, microfinance can build support for institutional reform, which is usually opposed by the incumbent elites.<sup>69</sup>

### 3.4 Constraints Facing MFIs

#### *i. Overview*

It has been suggested that in order to deliver on its potential to reduce poverty, microfinance now needs to do three things simultaneously: first, it needs to scale up

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<sup>68</sup> Dowla, A. (2006). In *Credit We Trust: Building Social Capital by Grameen Bank in Bangladesh*. 35 *Journal of Socio-Economics* 102. The term social capital is taken to mean ‘the collective value of “social networks” and the inclinations that arise among their members to do things with and for each other.’ *Id.*

<sup>69</sup> See Barr, M. S. (2005). Microfinance and Financial Development, 26 *Michigan Journal of International Law* 271, pp. 286-294.

rapidly, especially in those regions that are home to large numbers of the world's poor; second, it must realize its potential as a broad platform and social movement; third, microfinance must tap additional philanthropic, quasi- commercial, and most importantly, commercial financing.<sup>70</sup>

However, MFIs face serious constraints in their operation due to lack of adequate external commercial funding, shortage of management skills within the institutions,<sup>71</sup> which reduces the number of projects that may be effectively implemented, and lack of a flexible regulatory framework.

*ii. Constraints on External Funding*

From all of the aforementioned constraints lack of external funding is the most challenging. For this reason, an attempt is made in section 5 to devise a formula that would remove some of the (regulatory) constraints, costs and fears preventing large international banks from lending to MFIs. Thus, this paragraph only explains the factors that limit the availability of external funding to MFIs.

The first obstacle to obtaining external funding relates to MFI organizational structure (*e.g.*, not for profit), operational weaknesses (*e.g.*, lack of management skills), and lack of profitability are often unable to attract the interest of outside investors.

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<sup>70</sup> See Meehan, J. (2004). Tapping the Financial Markets for Microfinance. Grameen Foundation USA, Working Paper Series, available at [www.microfinancenetwork.org/images/GFUSA-CapitalMarketsWhitePaper.pdf](http://www.microfinancenetwork.org/images/GFUSA-CapitalMarketsWhitePaper.pdf), last accessed on 15.01.2007. [Hereinafter, Meehan, *Tapping the Financial Markets*].

<sup>71</sup> Shortage of management skills within MFIs is primarily due to two factors. First, there is an intrinsic lack of entrepreneurial, strategic management and bank management skills in poor countries. Secondly, the low or non-existent profitability of MFIs is unlikely to attract scarce talent in these areas. On the other hand, when management resources are applied on a sufficiently large scale (whether by commercial bankers, NGO activists, or public servants) microfinance operations develop rapidly and become firmly established on a large scale.

Similarly opaque corporate governance structures and the small size of MFIs act as further constraints to obtaining external financing.<sup>72</sup>

Especially, as regards profitability, it is debatable whether this should be an objective pursued by MFIs over and above the tasks of providing affordable financial services to the poor or fighting poverty. In addition, there is controversy as to the actual level of MFI (non-)profitability.<sup>73</sup> Some commentators argue that microfinance is inherently unprofitable, despite the protestations of MFI specialists and many apparently clear cut examples of profitable MFIs, most conspicuously Bank Rakyat Indonesia (BRI).<sup>74</sup> Perhaps no aspect of the microfinance industry has been the subject of more discussion than the degree of subsidy it has typically entailed and how much it relies on it.<sup>75</sup> A large fraction of these institutions benefit from subsidies, whether in the form of technical assistance, an endowment of capital not expected to be remunerated, or a flow of funds for on-lending provided at below market rates. Overall, the MFI sector remains heavily grant and subsidy dependent,<sup>76</sup> even in the most successful microfinance markets such as Bangladesh.<sup>77</sup>

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<sup>72</sup> Meehan, *Tapping the Financial Markets*, n 70 above, pp. 17-22.

<sup>73</sup> This paragraph draws on Honohan, *Financial Sector Policy*, n 48 above, pp. 13-19.

<sup>74</sup> BRI's village banking 'Unit Desa' program has consistently reported profitability despite an absence of subsidies for most of its twenty year life. *Ibid.* p. 18.

<sup>75</sup> Morduch, *The Microfinance Promise*, n 3 above, pp. 1592-1595.

<sup>76</sup> Honohan, *Financial Sector Policy*, n 48 above, p. 14.

<sup>77</sup> Charitonenko, S. & Rahman, S. M. (2002). *Commercialization of Microfinance: Bangladesh*. Manila: Asian Development Bank.

*iii. The Regulation of MFIs*

The Regulation of MFIs is a complex and sensitive task and can become a serious constraint on the development of the MFI sector. Regulations can hinder the emergence of financial institutions more suited to the needs of lower income households or smaller firms. Rigidity in licensing rules, especially (high) minimum capital adequacy requirements (in absolute terms), limited degrees in funding structures, too heavy and bureaucratic regulation and supervision, and very strict accounting requirements can prove insurmountable obstacles for MFIs.<sup>78</sup> Therefore, it is very important to fashion differentiated licensing and supervisory regimes for MFIs depending on their structure and on the services they offer, namely, depending on whether the institution borrows money, takes deposits, or is owned by its members and only caters to those.<sup>79</sup> In developing a new approach for the regulation of MFIs, the objective of enhancing access to financial services must be balanced with the need of sealing the MFI sector from ‘loan sharks’ and unscrupulous marketing practices which can lead the poor to financial catastrophe. Thus, marketing laws and predatory lending restrictions have to feature prominently in MFI regulation. However, this does not mean that MFIs must be licensed and supervised in the same way as commercial banks, though many may seek a banking license.

MFIs may offer services that do not amount to extension of credit, since a large number of them are interested in savings and payments services only, and the supervision of these services may be different than the framework applicable to banks. In addition,

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<sup>78</sup> Claessens, *Access to Financial Services*, n 8 above, p. 16.

<sup>79</sup> van Greuning, H., Gallardo, J.S. & Randhawa, B. K. (1999). *A Framework for Regulating Microfinance Institutions*. Washington: World Bank.

the credit service provided may be different than mainstream loans. For instance, department stores and other non-financial institutions offer the bulk of credit to poor people in developing countries. Moreover, effective supervision of a strict regulatory framework may be hindered by lack of local expertise in many developing countries burdening the operation of MFIs with inefficient regulations and regulators.<sup>80</sup>

Finally, it is doubtful whether MFIs, given the small size of their assets, currently pose any systemic risk.<sup>81</sup> It seems that the total assets of MFIs are very small relative to mainstream finance—even in countries, which have reached high levels of penetration.<sup>82</sup> It is notable that even in conditions of severe economic crisis and consequent instability of the mainstream financial sector, the health of the MFI sector does not seem to be seriously affected. For instance, despite the severe economic crisis and near collapse of the financial sector experience by Indonesia in the late 1990s, loan repayments to BRI ‘Unit Desa’ were not affected.<sup>83</sup>

Accordingly, it is preferable to devise a new regulatory model that is more tailor-made to the needs of MFIs and their size.<sup>84</sup> Such framework must also focus on educating

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<sup>80</sup> Barth, J. R., Caprio, G. Jr. & Levine, R. (2004). Bank Regulation and Supervision: What Works Best? 13 *Journal of Financial Intermediation* 205.

<sup>81</sup> Honohan, *Financial Sector Policy*, n 48 above, p. 10.

<sup>82</sup> *Ibid* p. 7.

<sup>83</sup> Patten, R. H., Rosendgard, J. K. & Johnston, D. E. Jr. (2001). Microfinance Success Amidst Macroeconomic Failure: The Experience of Bank Rakyat Indonesia during the East Asian Crisis. 29 *World Development* 1057.

<sup>84</sup> See Christen, R. P. *et al.* (2003). Microfinance Consensus Guidelines: Guiding Principles on Regulation and Supervision of Microfinance. CGAP Document; Christen, R. P. & Rosenberg, R. (2000). The Rush to Regulate: Legal Frameworks for Microfinance. CGAP Occasional Paper No. 4; Vogel, R. C. *et al.* (2000). Microfinance Regulation and Supervision, Concept Paper 3. Microenterprise Best Practices Working Paper. Hannig, A. & Katimbo-Mugwanya, E. (eds) (2000). How to Regulate and Supervise Microfinance?



people about the risks of financial services,<sup>85</sup> and on granting MFIs preferential access to payment systems, which would bring them closer to the function of mainstream financial institutions.

#### 4. International Capital Adequacy Standards and the Basle Committee

##### 4.1 The Basle I Framework

The Basle Committee on Banking Supervision (initially called Basle Committee on Banking Regulation and Supervisory Practices) was founded in 1974 under the auspices of the Bank of International Settlements (BIS), which furnished a conveniently neutral meeting place for the Committee's membership. The establishment of the Committee, an initiative of the G10 central bank governors to whom the Committee still reports, came in the aftermath of the twin collapse of Franklin National Bank and of Bankhaus Herstatt, because of losses in foreign exchange trading. Both events sent shockwaves to the spine of the then emerging global financial system and made apparent the pressing need to set up a forum that would facilitate international cooperation among banking regulators.<sup>86</sup> The Committee's membership - currently 13 countries are represented<sup>87</sup>- comprises representatives from the central banks of the member countries. Where central banks do

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Key Issues in an International Perspective. Kampala: Bank of Uganda/German Technical Cooperation (FSD) Project.

<sup>85</sup> Claessens, *Access to Financial Services*, n 8 above, p. 19.

<sup>86</sup> For the history of the Basle Committee see Wood, D. (2004). *The Basle Committee and the Governance of the Global Financial System*. Aldershot: Ashgate Publishing. Malloy, M. (2005). Emerging International Regime of Financial Services Regulation. 18 *Transnational Lawyer* 329.

<sup>87</sup> Belgium, Canada, France, Germany, Italy, Japan, Luxemburg, Netherlands, Spain, Sweden, Switzerland, the UK, and the US.

not discharge the duties of banking regulators, an additional representative of the competent national authority participates in the proceedings, without increasing the number of votes held by each member country.

The first challenge that national regulators had to answer concerned the allocation of supervisory responsibility for internationally active banks, namely which (home or host country) supervisory authority was responsible for supervising bank branches and subsidiaries across borders. The result of those discussions was the Basle Concordat of 1975, which has since undergone numerous refinements and amendments. The Concordat was further refined in 1983, following the collapse of Banco Ambrosiano in 1982, to tighten the framework for international banking supervision, and was effectively replaced in 1992 in the aftermath of the BCCI debacle in 1991 with a set of minimum standards on the supervision of international banking groups.<sup>88</sup> These were followed by the publication in 1997 of the Core Principles on Banking Supervision developed by the Committee in cooperation with the International Monetary Fund and the International Bank for Reconstruction and Development.<sup>89</sup>

Further to this work, the Committee endeavoured in the 1980s to devise a common framework of guidelines governing the measurement and enforcement of bank capital adequacy. This referred to the prescribed capital resources that internationally active banks were required to set aside so that to be deemed as operating on a prudent and sound basis. In this respect, the Committee developed a framework of standards that

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<sup>88</sup> Basle Committee on Banking Regulation and Supervisory Practices (1992). Report on Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishment.

<sup>89</sup> Basle Committee on Banking Supervision( 1997, revised in October 2006). Core Principles for Effective Banking Supervision.

would foster effective capital adequacy regulation of banks and facilitate convergence of national regulatory standards in this field. The main focus of the first framework (widely known as Basle I), published in 1988, was on credit (counterparty) risk and much less on other important risks such as currency risk, interest rate risk, and market risk. In this respect, the framework required a minimum 'ratio of certain specified constituents of capital to risk-weighted assets.' The prescribed regulatory capital constituents comprised: Tier 1 (core) capital, which mainly consists of shareholders equity, disclosed reserves, and retained post tax profit and Tier 2 (supplementary) capital, which mainly consists of subordinated debt. The Basle I framework endorsed a risk-weighted approach to the assets denominator of the capital assets ratio.<sup>90</sup> The Basle I methodology for risk-weighting was relatively simple with only five risk weights: 0, 10, 20, 50 and 100 percent of asset value assigned to all types of assets and of counterparties, judged by the origin of the counterparty (OECD, non-OECD countries) and its organizational/legal/economic nature (sovereigns, credit institutions, corporates). It did not allow any separate assessment of counterparties' creditworthiness. For instance, the risk-weighted ratio for all corporates was one hundred percent (100%). In addition, following further consultation, the Basle Committee adopted a target standard capital to assets ratio of eight percent (8%), of which core capital constituted at least four percent (4%).

Due to the institutional weight of participating public organizations, the importance of the countries they represented, and the need to level the playing field in the fast growing global market for financial services, the Basle I Accord was adopted by most world jurisdictions, regardless of whether they participated in the workings of the Committee. In fact, most developed countries, including the US and the EU member

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<sup>90</sup> Malloy, n 86 above, pp. 332-333.

states, extended the application of the Basle I framework to domestic banks that did not maintain a significant international presence.

However, it soon became apparent that the Basle I framework suffered from a number of technical weaknesses relating to its narrow band of credit risk classifications<sup>91</sup> and its inability to adapt to changes in the global financial services industry. It was especially inept at accommodating the emergent new techniques and instruments used to mitigate risk, such as credit derivatives and securitisations. In addition, the narrow band of borrower classification did not allow lenders to distinguish between major, stable and recognized companies versus risky upstarts.<sup>92</sup> Moreover, little attention was given to correlations and the mitigating effect of uncorrelated credits to well diversified loan portfolios.<sup>93</sup> Finally, Basle I did not properly account for banks' operational risk.

#### 4.2 The Basle II Framework and its Impact on Credit Flows to the Developing World

The weaknesses of Basle I led to an extensive round of negotiations on a new accord. Given the many changes in the financial services industries and the growing difficulties experienced by supervisors with the complexity and changing nature of risk in global financial markets, the starting point was to emphasize the role of market discipline in risk management. In June 1999, the BIS issued a proposal that would significantly change the capital adequacy accord through extensive revision and refinement of Basle I and by

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<sup>91</sup> *e.g.*, one obvious distortion was the zero weight given to loans to OECD sovereigns irrespective of the riskiness of the country, which allowed countries such as Korea and Mexico to be treated for capital adequacy requirements the same as more developed countries with lower ratios of public debt.

<sup>92</sup> Claessens, S., Underhill, G. R. D. & Zhang, X. (2003). Basle II Capital Requirements and Developing Countries: A Political Economy Perspective, [hereinafter, Claessens *et al.*, *Basle II Capital Requirements*].

<sup>93</sup> *Ibid.* pp. 19-23.

providing an alternative approach to measuring risk that would bring the capital framework closer to global market risk management practices.<sup>94</sup> Following several Consultative Papers and consultation rounds<sup>95</sup> the revised Accord was published in June 2004<sup>96</sup> and further additions were released in 2005.<sup>97</sup>

The Basle II framework for the assessment of the capital adequacy of international credit institutions and monitoring of their compliance is based on three pillars: Pillar 1 provides *minimum capital requirements*; Pillar 2 describes the process for the *supervisory review* of capital adequacy; and Pillar 3 provides the mechanisms to facilitate and enforce *market discipline* through public disclosure.

Of the three pillars, by far the most extensively discussed in the successive consultation rounds was Pillar 1, which involves significant changes in capital adequacy regulation. More specifically, although Pillar 1 reproduces the basic provisions of Basle I, it also introduces important changes in the way aspects of credit risk are to be calculated and expands the range of risks to include operational risk. Three different options are available to banks to measure the regulatory capital that they have to assign for each asset. The *standardized approach* intended to be used by less sophisticated institutions, though based on Basle I, uses enhanced risk sensitivity measures, as it differentiates

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<sup>94</sup> Bank for International Settlements, 1999. A New Capital Adequacy Framework, available at <http://www.bis.org/publ/bcbs50.pdf>, last accessed on 15.1.2007.

<sup>95</sup> For an account of the consultation process see Barr, M. S. & Miller, G. P. (2006). Global Administrative Law: The View from Basel. 17 *European Journal of International Law* 15, pp.23-27 and 29-31.

<sup>96</sup> See BIS, Press Release (26 June 2004). G10 Central bank governors and heads of supervision endorse the publication of the revised capital framework, available at [www.bis.org/press/p040626.htm](http://www.bis.org/press/p040626.htm), last accessed on 15.1.2007.

<sup>97</sup> See Basle Committee on Banking Supervision (2004, updated November 2005). International Convergence of Capital Measurement and Capital Standards, A Revised Framework, [hereinafter, *Basle II Accord*].

among exposures to different classes of bank clients. 'Risk weightings' for sovereign and corporate exposures may be calculated according to external credit assessments provided by rating agencies or public organizations such as the OECD. The second and third options are based on the new *Internal Ratings Based Approach* (IRB). Under the IRB, international banks are required to establish their own internal methods for assessing the relative risks of their assets in determining the capital requirement for given exposures. In this mode, Option two is a simplified or *foundation* version of the IRB for risk management, making limited use of internal Value at Risk (VaR) models. Option three is an *advanced* IRB approach meant for the largest and most sophisticated financial institutions.

In relation to the application of IRB approaches to risk assessment, a specific framework has been created for the treatment of corporate exposures that present the characteristics of specialized loans (SLs). As SLs qualify corporate credits that rely, for repayment of the loans, upon a stream of income generated by an asset rather than the creditworthiness of the borrower, such as project finance, income-producing real estate, lease financing (or 'object financing'), commodity financing, and high-volatility commercial real estate. These forms of credit financing are subject to a tailor made framework of capital standards.<sup>98</sup>

Another form of lending that is subject to a tailor made framework is loans to SMEs.<sup>99</sup> Responding to fears, mostly expressed by German banks, that SMEs would face worse financing conditions following the adoption of Basle II, a compromise was reached

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<sup>98</sup> *Ibid.* paras 220-228 and 275-284.

<sup>99</sup> Basle II, paras 219-220.

where loans to SMEs up to 1 million Euros may be included in the regulatory retail portfolio when certain conditions are met, receiving favourable capital treatment,<sup>100</sup> or considered a separate class of corporate credits<sup>101</sup> that receive a preferential risk curve.<sup>102</sup> The latter takes into account the fact that a portfolio of many small credits is less risky than a single credit exposure to one large company.

As said earlier, this article sets out a proposal (in section 5) for the creation of a further separate class of corporate exposures comprising loans made to specialized central country funds or similar wholesale finance providers that would on-lend funds to mainstream financial institutions and MFIs to be used as private development finance loans. Given the low default rate of private development finance loans, including group loans, the treatment of such loans should be preferential both under the IRB and the standardized approach.

According to Glaessens *et al.*, Basle II has largely been developed to the exclusion of developing countries' input.<sup>103</sup> Other commentators disagree with this assertion.<sup>104</sup> Yet China and India have decided not to adhere to the Basle II framework, indicating, in part, that developing country authorities do not think that the interests of their financial services industries received adequate attention in the new framework. Furthermore, for a number of reasons the Basle II framework is predicted to create

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<sup>100</sup> *Ibid.* para 231. However, doubts have been expressed as to whether the 1 million threshold is not very low to cover the majority of exposures/credits to SMEs.

<sup>101</sup> 'SME borrowers are defined as corporate exposures where the reported sales for the consolidated group of which the firm is a part is less than €50 million.' Basle II, para 273.

<sup>102</sup> *Ibid.* paras 217 and 273.

<sup>103</sup> Claessens *et al.*, *Basle II Capital Requirements*, n 92 above, pp. 2-3 and 9-11.

<sup>104</sup> Barr and Miller, *The View from Basel*, n 95 above, pp. 39-41 and attendant notes.

several problems to developing countries. First, there are problems with the implementation of Basle II by the less sophisticated financial institutions in emerging market economies. These, due to lack of resources and sophistication, are expected to adhere to the *standardized approach* of Pillar 1, which is by definition more costly and will therefore affect the competitive playing field.<sup>105</sup> Second, as Basle II has significant implications for the cost of capital for developing countries, it could reduce their access to external financing. Namely, developing country corporates and other entities naturally have lower ratings, which attract under Basle II higher capital charges under all approaches.<sup>106</sup>

As regards these fears, it is argued that banks make lending decisions on the basis of their economic capital models, which fully capture, unlike the Basle II framework, the effects of risk diversification that is represented by developing country lending for developed country banks. Thus, the predicted impact of Basle II on developing country credit flows may be unfounded. Namely, to the extent that regulatory capital charges do not exceed those of economic capital, flows to developing country entities will not be affected.<sup>107</sup> There is, however, controversy as to whether banks price their loans on the basis of economic capital models<sup>108</sup> and we may, in fact, have to devise alternative approaches to contain the predicted adverse consequences of Basle II on developing

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<sup>105</sup> See Bailey, R. (2005). *Basel and Development Countries: Understanding the Implications*. LSE, Development Studies Institute, Working Paper 05-71, pp. 34-35 and 38-39.

<sup>106</sup> See Griffith-Jones, S. & Spratt, S. (2002). *The New Basle Capital Accord and Developing Countries, Issues, Implications and Policy Proposals*. Discussion Paper No. 2002/36, World Institute for Development Economics Research; Griffith-Jones, S., Spratt, S. & Segoviano, M. (2003). *Submission to the Basel Committee on Banking Supervision: Consultation Paper 3 and the Developing World*. Institute of Development Studies, University of Sussex.

<sup>107</sup> Bailey, n 105 above, pp. 13-17.

<sup>108</sup> *Ibid.* pp. 14-16 and Griffith-Jones, Spratt & Segoviano, n 106 above, pp. 7-8.



country credit flows. It is suggested, in section 6, that treating private development finance loans as a separate asset class for capital adequacy purposes may have a beneficial effect on developing country credit flows, mitigating the potentially adverse impact of Basle II.

## **5. Utilizing Capital Adequacy Standards to Foster Private Development**

### **Finance**

As explained in section 3, the largest constraint that MFIs face in order to grow in scale and become very significant players in the fight against poverty is lack of commercial funding. Subsidized financing, long an important source of funding, is now insufficient. The World Bank's Consultative Group to Assist the Poorest estimates that less than 5 percent (5%) of total demand for microfinance is being met. According to some estimates the market demand for microfinance services is more than three hundred billion USD.<sup>109</sup> By contrast, market supply today is only in the range of four billion USD.<sup>110</sup> Despite the important and catalytic role played by the international donor community in promoting microfinance, this only allocates an incremental one billion USD per year in new financing, which falls far short of meeting demand. Viewed in this light, it becomes obvious that only unhindered access to commercial lending and the global financial markets may remove funding constraints. However, and despite impressive progress over the recent years, MFIs still face major issues of creditworthiness, which inhibit credit

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<sup>109</sup> See Social Enterprise Associates (2003). White Paper: The Business Case for Investment in Microfinance, available at [http://www.socialenterprise.net/pdfs/buscase\\_microf\\_inv.pdf](http://www.socialenterprise.net/pdfs/buscase_microf_inv.pdf), last accessed on 15.01.2007.

<sup>110</sup> Meehan, *Tapping the Financial Markets*, n 70 above, p.5.

flows to them. This according to Meehan is due to the fact that microfinance - in spite of its track record - has not yet been generally recognized as an asset class with a history of high portfolio quality and low correlation with major economic events in both domestic and international markets.<sup>111</sup>

Arguably, the long-term solution to the above problems is not the mere fashioning of a system of guarantees that covers the obligations of MFIs to global financial markets, which for certain kinds of loans will be entirely unnecessary. Thus, this article suggests that microfinance will have to be divided to two broad classes of loans. Those intended for a productive/development use and those moving into consumption.

The first class should merge with loans and other forms of credit, provided by mainstream financial institutions to the poor with the purpose of acquiring a productive asset. Together those schemes should comprise a new asset class called here: private development finance.<sup>112</sup> This would include all forms of financing to low income people and small enterprises, as defined by local standards and the standards of the World Bank, that have an evident development goal regardless of whether the provider is an MFI or a mainstream financial institution. Naturally, group loans would be considered development finance and financing schemes for individuals and SMEs in low income countries that are intended for investment in some form of a capital asset, or acquisition of a means of production (*e.g.*, plant seeds) should also be included. Loans for health and education purposes, although they have a clear impact on the income of the poor and a

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<sup>111</sup> *Ibid.* pp. 23-27.

<sup>112</sup> This term is used here autonomously from any previous uses and is not directly linked with Development Finance Institutions despite several similarities as to what goals should be pursued through finance provided by these Institutions. *See* Development Finance Forum, CAPITAL PLUS, January 2004. The Challenge of Development in Development Finance Institutions, A Practitioner Perspective.

development bias, should (provisionally) be excluded from this asset class, until their repayment rate is reliably calculated. All other loans provided by MFIs shall comprise a second asset class. In the case of the latter class of microfinance schemes subsidization may continue, as the default rate of such loans could render commercial funding unsustainable.

Given their similarities and very low default rates,<sup>113</sup> private development finance loans merit to be treated as a separate class of corporate exposures for capital adequacy purposes receiving preferential treatment within the Basle II framework. Yet, some MFIs have either a dismal loan repayment record or under-report default rates.<sup>114</sup> Thus, a two fold strategy must be devised so that the risk of lender institutions is measured by reference to repayment rates (cash flows) and the creditworthiness of a counterparty that is remote from the any risk of bankruptcy associated with the MFIs and the credit ratings assigned to MFIs.

Furthermore, it is suggested that private development finance lending is moved up a level (reflecting to a large extent current market practice) and relevant funds are borrowed by central country schemes,<sup>115</sup> or other specialized corporate vehicles operating

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<sup>113</sup> Despite the lack of systematic data on a global scale, there is a convincing body of evidence that microfinance loans with a development objective, such as group loans and loans to microenterprises, included under the present proposal to the suggested class of private development finance loans, have zero or very low default rates. See Fischer, S., 3 November 2003 November 2003. Wall Street Meets Microfinance. WWB/FWA Lenore Albom Lecture Series, p. 2. Fischer, a former deputy managing director of the IMF, was at that time Vice President of Citigroup. Professor Fischer is now the governor of the Bank of Israel. See also *The Finance of Microfinance*. Microrate, Washington, November 2002, available at <http://www.microrate.com/PDF/Finance%20of%20Microfinance.pdf> and MicroCredit Enterprises at <http://www.mcenterprises.org/index.aspx>, last accessed on 17.1.2007.

<sup>114</sup> Chowdhry, B. *et al.* (2005). Pricing Microfinance Loans and Loan Guarantees using Biased Loan Write-off Data. Mimeo, UCLA Anderson School, pp. 1-2.

<sup>115</sup> While private development finance loans must be provided and administered at the local level for reasons of furthering access to finance, of increasing microfinance penetration, and of lowering transaction costs and information asymmetries all of which lead to higher efficiencies, the funding of MFIs is more

as wholesale finance providers.<sup>116</sup> The business objectives of such functionaries would not extend beyond on-lending to MFIs or mainstream financial institutions - for exclusive use in for the provision of development finance loans – the gathering of information regarding such loans, including borrower credit scoring, and the facilitation of access of such institutions to payment systems and other infrastructure services. The same national schemes may be used to facilitate the securitisation of such loans and the sale of resulting bonds to investors in the global capital markets.<sup>117</sup>

Of course, treating private development finance loans as a separate class of corporate exposures would require some modification of the existing criteria of the Basle II Framework (paragraph 264) as regards the time period for which banks are required to have data for relevant loans in order to measure Probability of Default and the other credit risk components of the IRB. However, obtaining ratings for such loans prospectively and endeavouring to build on them an internal rating system should not prove an insurmountable obstacle. There are already a number of specialized entities

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efficiently managed if it is centralized or conducted on a wholesale basis. A good example of a centralized national scheme used for the funding of private institutions operating in unbanked areas (administration of government subsidy funding distributed to MFIs) and the provision of infrastructure services to them is the Mexican development bank BANSEFI (Banco de Ahorro Nacional y Servicios Financieros, *National Savings and Financial Services Bank*). See for an analytical description of the operation of BANSEFI, de la Torre *et al.*, *Innovative Experiences in Access to Finance*, n 8 above, pp. 48-51.

<sup>116</sup> Granting private development finance loans to a centralized country scheme that operates as an independent entity or other specialized corporate vehicle operating as wholesale finance provider would allow these credits to fulfill most of the requirements of para. 219 of Basle II as regards the legal form and economic substance of SLs. However, the independent entity would be created specifically to finance on-lending and not physical assets, as required by paragraph 219.

<sup>117</sup> An example of an innovative wholesale financing transaction in this area was concluded by SHARE, a leading Indian MFI, and ICICI Bank, India's largest commercial bank, in January 2004. See Meehan, *Tapping the Financial Markets*, n 70 above, pp. 13-14.

which are dedicated to the provision of objective and reliable ratings for MFIs and microfinance credits<sup>118</sup> and their databases are available for commercial purposes.

MFIs obtaining funds for lending under the above scheme would be subject to a number of conditions. End-lenders would be obliged to account for the destination of the borrowed funds and to build databases about the profiles of their borrowers and the nature and repayment rates of loans given out of such funds. Although the flow of information would come from the end-lenders, there is no serious reason to worry about its quality. End-lenders would have a strong incentive not to lie about the default rate of their private development finance loans and the destination of funding so obtained; if found cheating they would be expelled from the scheme or denied further loans by the wholesale provider. In addition, the World Bank should have an active involvement in building and co-ordinating centralized country schemes and specialized funding vehicles for development finance and in structuring the rules and incentives for their operation.

As mentioned earlier, it is expected that large international banks will use the more sophisticated *advanced* version of IRB, which will enable them to set aside less regulatory capital for loan and securities portfolio. Thus, the use of wholesale methods to resource private development finance providers coupled with lower capital adequacy requirements means that very large international credit institutions would have the right set of incentives to enter the market for the provision of credit to the poor. Lower capital charges would allow such loans to become a business opportunity for large credit institutions, which would also lower the interest rates charged, as the high monitoring and

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<sup>118</sup> e.g., Microrate ([www.microrate.com](http://www.microrate.com)) and the Microfinance Rating and Assessment Fund, which offers over 150 reports with rating statistics about MFIs and microfinance loans in a very large number of countries. Available at [http://www.ratingfund.org/fund\\_statistics.aspx](http://www.ratingfund.org/fund_statistics.aspx)

transaction costs that such loans typically entail (analytically explained in sections 2 and 3 above) would continue to be borne by the end lenders.

Of course, low ratings are not the only reason that curtails credit flows to the developing world. They do, however, remain a serious consideration. Therefore, the implementation of the present proposal, by removing the issue of low ratings and thus higher regulatory capital reserves for international credit institutions, would, to some extent, boost credit flows to developing countries. By achieving this effect, it would also help to contain some of the undesirable effects of the Basle II on developing countries (discussed in section 4).

Another advantage of the separation of private development finance loans from other forms of microcredit is that it would enable some MFIs and other credit providers to specialize in the provision of such loans enhancing their credit ratings, given the high repayment rate of such credits. Securing higher credit ratings would enable these institutions to attract loans from large domestic banks in the developing world that will use the *standardized approach* under Basel II. As mentioned in the previous section, the *standardized approach* assigns lower regulatory capital charges to higher rated counterparties. MFIs that find commercial funding at advantageous rates either because their credit ratings have been raised, or because they obtain such funding from centralized schemes or wholesale providers that utilize the private development loans facility, would free up local and international resources and donor money. These funds could then be used for aid to the very poor and to subsidize microfinance loans that belong to the second class, as divided above, where the risk of default is much higher and the risk perhaps unsustainable for profit driven organizations.

Furthermore, as local regulators would be very unwilling to act unilaterally fearing regulatory arbitrage, or conversely loss of reputation, only a global initiative setting the framework for uniform capital adequacy rules in this area would be effective. Thus, the development objective of this proposal may only be served by International banking regulation and the active involvement of the Basle Committee. The private development finance qualification/division ensures that the high repayment rate of such loans negates any fears relating to the safeguarding of the objectives of systemic stability and depositor protection. As such the present proposal redefines the normative boundaries of international banking regulation. Therefore, it contributes to the debate about the proper ambit and reach of the global administrative space,<sup>119</sup> since it brings international banking regulation within the framework of the MDGs and of the Monterrey Consensus. Both the MDGs and the Monterrey Consensus constitute a solemn declaration of intent by the global community, represented at the highest level by UN member states, to elevate the quest for development and poverty eradication into ecumenical objectives.

The biggest objection to the above proposal may be ideological. To some commentators the present proposal could seem as heralding the collectivization of global finance. Not quite! The determining criteria of whether large international credit institutions would find it profitable to invest in centralized microfinance schemes or lend highly rated MFIs are those of the market. Lower capital requirements for the asset class of private development loans only provides economic incentives that would make such loans attractive to international credit institutions on the basis of a risk and return analysis.

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<sup>119</sup> See Krisch, N. & Kingsbury, B. (2006). Introduction: Global Governance and Global Administrative Law in the International Legal Order. 17 *European Journal of International Law* 1, p. 1.

**6. Conclusion**

This article has undertaken a comprehensive review of the academic and public policy literature relating to international capital requirements for banks and access to finance and microfinance. Access to finance as major component of FSD is an important addition to the development agenda in the post-Washington consensus era. Several credible studies have shown that financial sector development is of fundamental importance in ensuring economic development and fighting poverty. Furthermore, Microfinance schemes have proved to be a very effective means of furthering access to finance.

However, given the very amorphous nature of microfinance and its evident limitations as regards poverty alleviation, it has been argued that an alternative approach should be pursued. This separates private development finance for the poor (whether provided by mainstream financial institutions or MFIs) and other forms of credit finance targeting temporary alleviation of poverty by financing consumption needs. It is probable that, while the former has increased possibilities to interest, given the right bundle of investment structures and regulatory incentives, large financial institutions increasing external funding of private development finance projects, the latter might have to remain subsidy driven for a very long period.

In this context, it has been suggested that private development finance loans - granted to and administered by centralized country schemes or other specialized corporate vehicles operating as wholesale finance providers - should be treated as a separate class of corporate exposures under the Basel II framework and be assigned lower capital requirements, reflecting their very low default rate. Arguably, the endorsement and implementation of the present proposal would remove a serious obstacle to the



commercial funding of MFIs, allowing them to tap the vast resources of global credit markets. It would also provide strong incentives for international credit institutions to take a direct or indirect stake in the market for the provision of financial services to the poor. Finally, by utilizing this mechanism, international banking regulation would start being used as a development tool, without compromising the pursuit of its core objectives of systemic stability and depositor protection.