Crossfire: 'Should financial inclusion be part of the next set of MDGs?'

HUGH SINCLAIR and MATTHEW S. GAMSER

In this issue's Crossfire*, Hugh Sinclair and Matthew Gamser discuss whether financial inclusion should be part of the next set of Millennium Development Goals.*

Dear Matt,

Ban Ki-moon suggests the Millennium Development Goals (MDGs) 'have been the most successful global anti-poverty push in history'. Meanwhile, David Roodman of the Centre for Global Development summed up the impact of microfinance upon poverty concisely: 'zero' (Walt, 2012). This is a response echoed by academics worldwide, suggesting we may have fallen short of Muhammad Yunus's (2006) optimistic suggestion that poverty will be relegated to museums thanks to millions of small debts. Rather than suggest that financial inclusion is therefore useless in the battle against poverty, I propose it be included as an MDG in the post-2015 target categories for four reasons.

Firstly, microfinance is largely unregulated, in both developing countries and in the developed countries where capital is raised. Bodies such as the Smart Campaign are managed, financed, and operated by microfinance insiders. The sector generally resists any genuine regulation for fear of the impact upon profitability. It is an opaque sector that has suffered a string of crises, scandals, and frauds over the last decade, leading to a backlash against the concept of indebting the poor as a means to reduce poverty. The global financial crisis has not helped the situation. Transparency in the sector is woefully low, with few MFIs even publishing the interest rates they charge, let alone their funders revealing such embarrassing statistics. The profitable IPOs (initial public offerings) of institutions such as Compartamos and SKS left many wondering if profit rather than poverty reduction is the ultimate goal. The Andhra Pradesh scandal and endless cases of exploitative interest rates exceeding 100 per cent further darkened the shadow over the sector. By including financial inclusion in the MDGs it is probable that the increased scrutiny from researchers and the media could reduce such abuses. The involvement of the Inter-Agency and Expert Group, including bodies such as the ILO and UNCF, may ensure certain abuses are less likely.

In short, it is not that financial inclusion deserves to be included in the MDGs *per se*, but rather that becoming a formal MDG may improve the effectiveness of financial inclusion via improved transparency, regulation, and scrutiny.

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MDG 2 (universal primary education) has been relatively successful, although progress has stalled since 2008. Encouraging millions of micro-entrepreneurs to engage in debt-financed labour-intensive activities *may* reduce poverty, child labour, and school desertion. But equally it may have the opposite impact by encouraging some clients to remove children from school in order to work in micro sweatshops. Evidence exists on both sides of the debate; 25 per cent of children enrolled in primary education drop-out before completion (40 per cent in sub-Saharan Africa; United Nations, 2013: 16). No one knows to what extent this is caused by microfinance, but incorporating financial inclusion within the MDGs may pressure institutions to support current and former MDGs. Alas, school desertion disproportionately impacts girls, and even the apparent self-regulatory bodies such as Smart and Truelift refuse to address the rights of children – were financial inclusion an MDG the sector would struggle to sweep this issue under the carpet as it has to date.

Thirdly, inclusion in the MDGs may draw increased attention to credit unions and cooperatives which are both an integral part of financial inclusion, and played a significant role in the development of the financial sectors of many developed countries. The mainstream microfinance community largely ignores such structures, possibly because they are collectively owned and less profitable for external investors. For all the fuss made in 2005 about microfinance, how many in the financial inclusion movement even noticed that 2012 was the UN Year of the Cooperative?

Finally, it is likely that control of preventable diseases such as malaria and HIV will remain focal points of the MDGs. Financial inclusion essentially creates a distribution channel and, if included within the MDGs, institutions may exploit the obvious synergies of so-called 'microfinance-plus' activities, such as educating clients about disease avoidance, distributing malaria nets, and encouraging vaccinations for children, among others.

Now, more than any time in recent history, the possible harmful impacts of debt are painfully clear. Let's limit the extent to which financial inclusion entraps the poor rather than liberates them. Financial inclusion has demonstrated only modest success to date. This is a missed opportunity, and by incorporating it into the MDGs this may leverage an existing base to be more effective in the eradication of poverty.

Kind regards,
Hugh

Dear Hugh,
It may sound odd for a person whose business is development finance to argue that financial inclusion should *not* be one of the new MDGs, but that's what I'm going to argue. Financial inclusion is very important, and my colleagues Asli Demirguc-Kunt, Thorsten Beck, and others have empirically demonstrated that higher financial inclusion levels in countries correlate directly with higher levels of poverty reduction. But for the same reason you cite about the development field often taking a good idea the wrong way, I don't think a financial inclusion numeric goal should be a 2030 MDG.

At best, finance is the oil that helps the economic development machine to work – we shouldn't confuse it with the machine itself! Education, jobs, incomes, infant mortality, decent housing, food security, equal rights/resources for women and minorities – these are the machine. I feel the previous MDGs worked, overall, because there weren't too many of them – we didn't score 100 per cent, but having a few numeric targets was the key. So, in the next set of goals, we need to focus on the few real results that matter, rather than the means to those ends.

The other problem is what indicator to use to measure financial inclusion. For all the reasons you mention, we certainly don't want to use credit as our key datapoint, as we are finally listening to what a few wise hands have been trying to tell us for a long time: that credit is not the most important financial service for the vast majority of the poor. It is other services – savings, insurance, and payments/transfers – that often are far more important in improving lives, and far less risky. So we could, perhaps, measure how many people have or don't have transactional accounts with formal financial institutions, if we were going to pick an indicator. This would probably technically be a better way to go, but I can't see it being very inspirational, can you? Credit is much more 'sexy' and over-exploited, as it's been used to raise resources for various causes; it is also much more dangerous. I can see the same vested interests perturbing any attempt to put financial inclusion in MDGs, pushing to put things in what seems a more simple and attractive form, but one that has serious risks.

I agree with you that we need to continue to improve openness and transparency in financial sectors. We do this through formalizing institutions and building stronger financial markets infrastructure: for example, credit information services, movable assets registries/pledge systems, and electronic payments alternatives. We need to help microfinance to become truly 'finance' and not just credit-push, and on the SME side (where most of the jobs come from) we need to greatly improve responsible credit services from the formal sector. But I don't think a UN-led, MDG-type initiative is the right way to push in these areas. Let's make it clear the important role well-functioning financial markets and services play in promoting the achievement of the MDGs, but let's not try to make the oil into the machine. It's that sort of thinking – that finance really is the centre of the universe – that has dumped us into our present crisis.

After all, how else could we have decided that you could bundle up hundreds of high-risk home mortgages and turn them into a AAA-rated product that pension funds and insurance companies could pour people's retirement savings into?

Best wishes,
Matt

Dear Matt,
That we put the cart before the horse is clear, and it is a relief to hear someone acknowledge that the credit-driven frenzy that fuelled the microfinance bubble may have been unwise. Alas what you propose is 'much of the same', and it is precisely this neo-liberal, free-market, laissez-faire attitude that worsens rather

than improves borrowers' lives, with rampant over-lending, excessive interest rates, and periodic microfinance crises.

'Developed' countries have begrudgingly acknowledged that banks need stringent regulation. Alas it took a crisis, and substantial harm inflicted, to prompt this change of spirit. National regulators, perhaps fearful of political repercussions, have made mild attempts to act more explicitly in the interests of the clients (i.e. voters) rather than the bankers. We turn a blind eye to the interest rates charged to the poor by such vultures as Banco Compartamos in Mexico (Roodman, 2011), but when payday lenders such as Wonga arrive in Europe charging high interest rates, there is uproar (Petroff, 2013). This change of spirit was prompted in part by recognizing the damage reckless credit can inflict upon the broader economy; effective legal systems and client protection bodies; a *relatively* financially literate public; and a willingness for national regulators to work together.

Developing countries often lack these attributes. *Effective* local regulators are scarce. Clients may possess only modest financial literacy (and often insufficient literacy to understand the contracts they sign). They are more broadly vulnerable, particularly when banks target women. And yet in microfinance, banks and investment funds are allowed to run amok in developing countries with minimal oversight and substantial profit potential – a recipe for disaster. This is hardly speculation – look at the microfinance crises of Nicaragua, Andhra Pradesh, Bolivia, Morocco, Bosnia, and so on. You appear to agree that transparency and credit bureaus, among others, are useful, but you stop short of mentioning explicit regulation. Is the MDG framework not an ideal means to regulate microfinance transnationally? Unfortunately it may be the best chance we have. Challenges in selecting the optimal indicator are a red herring.

The microfinance investment chain suffers from asymmetric information and a chronic *principal–agent problem*: investors, donors, and governments entrust their funds to specialized intermediaries and microfinance institutions to act on their behalf, which they invariably fail to do – they act *in their own* best interests. Take your own institution, for example. The IFC invested in the vilified Mexican bank Compartamos, earning an undisclosed return on capital. Compartamos was criticized for its massively profitable IPO, with huge payouts to certain lucky individuals, on the basis of extortionate interest rates, fuelling a suspiciously high return on equity. The IFC also lent to a heavily criticized Nigerian bank that had suffered endless adverse publicity, a rating withdrawal, charging deceptive interest rates to the poor, capturing savings without a banking licence, and various documented cases of fraud. Meanwhile, the IFC is a proud sponsor of the Smart Campaign, apparently promoting fair interest rates, transparent pricing, and client protection. Smart is run by Accion, who also invested in Compartamos, received funding from the IFC, and gain directly from extortionate interest rates charged to the poor. In a sensibly regulated financial sector such conflicts of interest would be prohibited. In microfinance this is acceptable. Perhaps nowhere better is the dichotomy between action and rhetoric more visible.

Alongside Yunus himself, I lament the fact that microfinance has become the loan shark it apparently sought to replace. Banks have not displayed a natural tendency to act in the best interests of the poor, or even their own clients, when profit is at stake. They act in their own best interests – and as the bedrock ideology of the free market, this is assumed to produce the best of all possible worlds. When local regulators attempt to rein in such players they are inevitably criticized as 'anti-free market' by the likes of the IFC. And with claimed global self-regulatory bodies such as Smart so clearly in cahoots with the lenders and investors, what hope is there?

'Much of the same' is not the solution, and an impartial body such as the UN, with few vested interests in microfinance, may be our last chance to salvage an idea that has increasingly gone awry. It could begin by defining extortionate interest rates (either directly, or via return on equity/assets, as espoused by industry experts such as Chuck Waterfield, 2012, or Dan Rozas, 2012); it could establish meaningful client protection principles extending to the children of microfinance clients, and actually enforce these rather than the current façade of mere endorsement; and it could monitor whether institutions are acting in accordance with the range of MDGs that seek to improve the lives of the poor.

Until this happens, expect more of the same impact on poverty reduction: 'zero'. We can do better, but not until the current structure of the microfinance sector is overhauled, and the MDGs are one means to achieve this. Expect resistance to such an idea from precisely those who stand to lose by meaningful regulation.

Yours,
Hugh

Dear Hugh,

I'm not sure where to start because your reply takes us far away from the question at hand … Let me start with the errors of fact: when I last checked (pretty recently), Compartamos was still growing by leaps and bounds. If people in Mexico and its other markets really felt that its services were so bad, I don't see how this could be the case. Compartamos also continues to be profitable, though its loan spreads have decreased as it faces more market competition. Compartamos also has considerably diversified the financial services it offers the poor in its markets, adding insurance services. IFC's investment in Compartamos and any subsequent investments through rights issues and so on, are a matter of public record, as anyone can find at www.ifc.org. Compartamos's doings are much more transparent than the vast majority of microfinance institutions because it went public and because it has formalized, to be under the scrutiny of not one, but several regulators. Again, when I last checked, there was no move from Mexico or its other countries of operation to shut it down or evict its founders – would that I could say the same for what has been going on with the Grameen Bank, which was never properly formalized, and is now a major political football in Bangladesh!

I cannot comment on the unnamed Nigerian bank, because it's unnamed, and IFC has investments in several Nigerian banks. In these, as in all its financial institution investments, IFC promotes socially and environmentally sustainable practices by these institutions through performance standards developed and monitored, in the open, with a wide range of civil society institutions. These standards have, in turn, been taken up by other financiers, whether in formal groupings such as the financial institutions that sign on to the Equator Principles, or other, less public, adoptions. Do IFC investee clients make mistakes? Of course they do – but IFC is trying to help them to be positive forces in their countries and communities, and our primary mission remains alleviating poverty through private sector development. IFC focuses on finding sustainable, profitable institutions to invest in to show that there doesn't need to be a trade-off between sustainability and profitability – and over its more than 50-year history it has grown as an institution while not needing new capital from its 190 or so country owners. In addition, for the past several years IFC has contributed hundreds of millions of dollars per year to the International Development Association (IDA) fund, which the World Bank uses to lend at concessional terms to the world's poorest countries – the only non-sovereign to do so.

Sorry, but I had to be a bit defensive here for my employer … and little of this is relevant to our key question. So what should Compartamos and Nigerian banks tell us about whether there should be a financial inclusion number in the next MDGs? Actually, I think they tell us how careful we have to be in such areas, how dangerous the 'public embrace' can be in the finance field. From my vantage point, it was governments pushing quotas onto microcredit institutions, both formal and informal, that may have been the straw that broke the camel's back in your listed crisis countries such as India and Morocco. In all these cases we saw public and donor funds channelled into more and more institutions, pressuring these groups to push more and more loans out the door to service this growing debt. If we push for MDG quotas, we're going to feed this beast again. We can talk about not focusing on credit, but even if we create different targets (savings accounts? insurance? money transfers?), we still risk an excessively heavy hand using instruments that encourage herd mentality, that confuse promotion with prudent regulation.

For you see, Hugh, despite your implication, I'm not against regulation of the financial sector. Not in the least … but we need smart regulation, regulation that promotes open, competitive markets, and which builds an information infrastructure so that both financiers and their clients can have a clearer picture of markets, products, and options. We have to be very strict about what financial institutions can do with small savers' money (a lesson the West still has not learned), because protecting the poor's savings is paramount. With all due respect to Professor Yunus, credit is not, and should never have been spoken of as a human right; but it really helps to have a safe place to save, much cheaper ways to move money around than currently available in most emerging markets, and financial products that enable the poor to manage major risks – insurance that actually works. And we should encourage microfinance institutions that want to capture public savings to be regulated. But that doesn't mean we should then put quotas onto them. That encourages haste, and in haste more mistakes are made.

I just don't think the fastest, smartest way to get there is to push targets through the MDG system. Targets should be about the things that matter directly – health, shelter, education – not the means to those ends. Pushing for achievements through targets for these basic needs doesn't seem to risk the unintended consequences of pushing for numbers achieving the means to those ends. So by all means we should advocate for the recognition of the importance of financial inclusion in the fight against poverty, and we should make sure that inclusion and credit are understood to be two very different things. And with this knowledge, we should work to build strong financial institutions that can achieve profitability and environmental/social sustainability at the same time, and an overarching financial infrastructure that reduces the costs of serving the public for all financial institutions.

Matt

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