

New Vistas in Financial Services: Lessons from International Experiences

Promoting Financial Inclusion— Lessons from around the World

This article is an excerpt from, 'New Vistas in Financial Services: Lessons from International Experiences,' a publication prepared for the 'International Conference on Banking and Financial Services 2008' organised by the Indian Merchants Chamber (IMC) in association with The Institute of Chartered Accountants of India (ICAI). The conference was held in Mumbai on 17th April, 2008.

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McKinsey & Company, Inc.
Express Towers, 21st Floor, Nariman Point,
Mumbai - 400 021 INDIA

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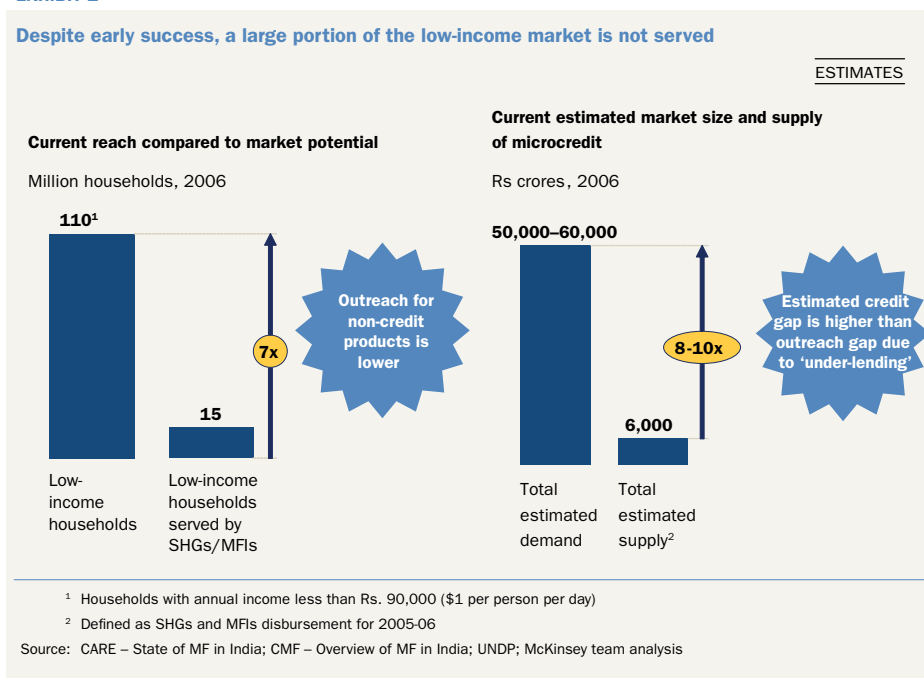
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Jonathan Bays, Alberto Chaia, Tilman Ehrbeck, Valerie Faillace, Rajiv Lochan, and Robert Schiff

While India has witnessed historic progress and growth in the past decade, large segments of society remain excluded from the country's formal financial system, with limited access to financial services, coming at a large cost to them. Low-income Indian households in the informal or subsistence economy often have to borrow from friends, family or usurious moneylenders. Their savings are largely in the form of cash, jewellery, or livestock, which earn little return and are subject to theft or loss. They have little awareness and practically no access to insurance products that could protect their financial resources in unexpected circumstances such as illness, property damage or death of the primary breadwinner.

The country has long recognised the social and economic imperative for broader financial inclusion. Starting with priority lending sector requirements for commercial banks, policy makers, regulators and industry players over the years have taken a number of steps to increase access to financial services to the poorer segments of society. Despite all these efforts, however, India has a long way to go. Of the estimated 110 million low-income households in India, only 15 million currently have access to microcredit (see Exhibit 1). The situation is even starker on other financial products. In health insurance, for example, only an estimated 2–3 per cent of low-income households have access to some form of community-based or micro-health insurance.

Today's dominant Self-Help Group (SHG) model and the traditional Microfinance Institutions (MFIs) modelled after the Grameen Bank have made significant contributions to financial inclusion in India. However, based on our research, we believe these models, with their reliance on community-based relationships and uncollateralised lending, face intrinsic challenges in scalability and cost structures, which often lead to high operating costs and thus contribute to relatively high interest rates.

EXHIBIT 1**Despite early success, a large portion of the low-income market is not served**

To overcome challenges of scale and cost structures in a vast country like India, we believe a broader approach that calls for greater involvement of private sector players, and complete participation and cooperation between the public, private and social sectors is required.

FIVE AREAS OF INNOVATION

Our research on the global microfinance industry has identified key areas where innovation can encourage cross-sector participation and take financial inclusion to scale. To efficiently serve low-income groups and ensure greater financial inclusion players need to innovate on the following five fronts:

1. Overcome information barriers
2. Leverage non-financial distribution channels to reach low-income markets
3. Promote industry standards and efficiency
4. Develop management talent
5. Enact pragmatic regulations with a focus on consumer protection.

Globally, the public, private and social sectors are already testing and implementing innovative solutions in these areas, tailored to local challenges, but with potentially broader applications. Indian players in the microfinance industry can gain insights from these global best practices to develop innovative products, overcome bottlenecks, explore new channels and leverage their competencies. A menu of these interventions follows—ideas that have either demonstrated the ability to significantly improve financial inclusion, or—if still in the pilot stage—offer a creative approach to overcoming one or more of the current barriers to scale.

1. Overcome information barriers

Many commercial players are hesitant to enter the financial inclusion space primarily because of the lack of available information on customer acquisitions and screening practices. The high-touch approach pioneered by the specialised microfinance institutions to compensate for this lack of information is too expensive compared to the low-ticket size of the loan or premium. Many players also lack sufficient knowledge of potential customers' needs to develop well-suited, affordable and risk-free products. And finally, many players are uncertain about the market size for their customer-specific products.

These information roadblocks can and have been removed with the use of innovative products and alternative channels. Our experience indicates five approaches that have either been put into practice or exhibit significant potential.

Develop risk-sharing agreements with local parties. In this scenario, people who have strong community relationships with low-income customers are responsible for credit dissemination and risk assessment. For example, small 'mom and pop' store owners could offer small loans to their customers (through a bank, most likely with the support of its credit-scoring system). On successful repayment of loans, store owners would get a portion of the interest and on defaults assume part of the risk.

Encourage co-investment in new technologies. New technologies like mobile banking are too expensive for a single private or social sector institutions to develop. But, co-investment can reduce risks for players and increase participation. In Kenya, for example, the United Kingdom's Department for International Development (DFID) co-invested with Vodafone in the M-Pesa project. The product allows people to make deposits into an e-money account through airtime sellers. These funds can either be saved or transferred to another M-Pesa customer. Four months after its launch in March 2007, M-Pesa

had 150,000 customers in Kenya. M-Pesa now provides access to payments and savings. Without DFID's participation, the new venture would have been very risky for Vodafone to undertake.

Create innovative products. Recently, products that do not rely on individual consumer information have been developed. One such product is 'indexed insurance'—a payout is triggered when a predetermined metric that cannot be controlled by the policy holder crosses a given threshold. In Malawi, the World Bank worked with the National Smallholder Farmers' Association of Malawi, the Opportunity Bank of Malawi, and the Malawi Rural Finance Company to pilot drought insurance using rainfall as the independent variable. Payouts were triggered when conditions deviated from historical averages of this independent variable. This eases the claims process because proof of the trigger event is simple and eliminates the risk of moral hazard.

Increase consumer financial literacy. Financial literacy is of crucial importance to established and emerging economies. The Organization for Economic Cooperation and Development (OECD) is working with its member countries to improve awareness on retirement planning. Recent events in the sub-prime mortgage market reiterate the importance of ensuring that consumers completely understand their financial situations. In many emerging markets, major financial services firms and other smaller players are driving similar efforts. For example, the Citigroup Foundation has committed US\$200 million over 10 years to develop financial education programmes around the world.

Develop a secondary market. Efficient secondary markets can increase the liquidity of loans, as lenders have access to a broader pool of capital and in effect, borrowers benefit from lower costs. But setting up such efficient secondary markets requires subsidisation, as witnessed in developed economies. In Mexico, a government-supported secondary liquidity and insurance provider was instrumental in allowing small non-banking financial institutions called SOFOLES to provide mortgages to the low-income and informal sector of the economy. As a result, the mortgage market in Mexico saw 30 per cent annual growth from 2001 to 2006.

2. Leverage non-financial distribution channels to reach low-income markets

Today's predominant distribution and service models of Self-Help Groups (SHGs) and microfinance institutions (MFIs) are challenging to take to scale. More recent financial inclusion efforts around the world are looking to combine the skills of traditional commercial banking players with complementary, non-traditional distribution channels to reach low-income families.

Expand correspondent banking. Retail stores are one avenue of correspondent banking. In Brazil, for example, several banks have adopted a correspondent banking model that distributes credit, savings and insurance products through grocery stores, retailers and local centres. The impact has been remarkable. In 2000, before correspondent banking took off, 1,659 out of 5,636 Brazil's municipalities did not offer financial services. By 2004, each municipality had a banking correspondent. This initiative of correspondent banking resulted in the number of current accounts in Brazil increasing from 45 to 54 million between 2002 and 2005. This growth included the poor—in the correspondent banking networks of two of the largest players, 58 per cent and 43 per cent of customers respectively, earn less than around US\$4 a day.

Using local stores that were already serving the poor, Brazilian banks were able to reach new segments of customers with a minimal upfront investment. Similar partnerships in Bolivia have expanded rural access to savings as well as payments and transfers.

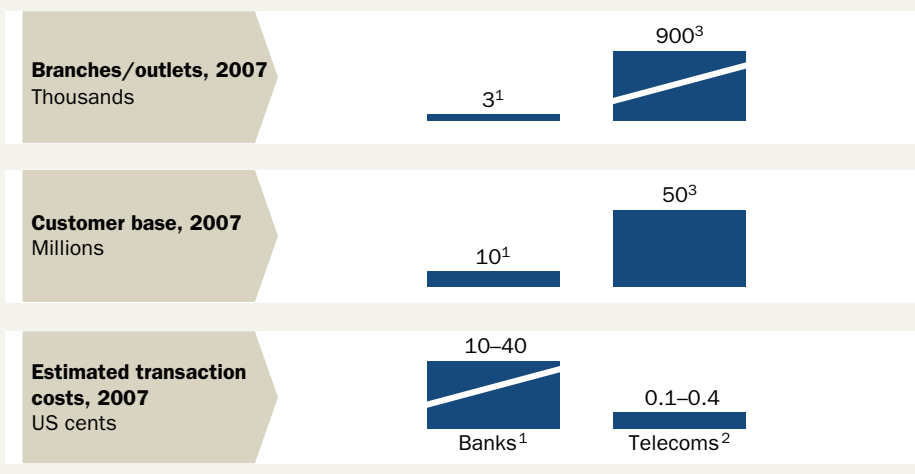
Expand mobile banking. Telecom companies have huge advantages over traditional banks in terms of physical reach, customer base and transaction costs (see Exhibit 2). Like correspondent banking, mobile banking can expand the range of people who act as bank tellers, bringing airtime sellers and clients into the process of coordinating financial transactions. As developing countries dominate mobile sales globally, cell phones are already reaching the unbanked poor. In South Africa and Botswana, one-third of people who do not have a bank account—many of whom are poor—own a mobile phone or have access to one.

In South Africa, 48 per cent of the adults have no access or insufficient access to formal financial services. In 2004, the South African Bank of Athens launched WIZZIT, its own 'virtual bank'. WIZZIT customers use their cell phones, as well as their debit cards, to make purchases at stores, transfer funds to other customers, withdraw funds from any ATM, and make deposits at Absa and Postbank branches. WIZZIT now claims to be the largest branch network in South Africa. This virtual bank targets the low-income group of customers and its fees are up to one-third less than those of South Africa's major retail banks. Its distribution model targets consumers through a network of 'WIZZ kids' who explain the product to consumers and are paid on commission. To sign up, customers only need a national identification number. One study shows that early adopters of WIZZIT have low incomes, but are wealthier and technologically and financially more sophisticated than most poor people in the country. But researchers suggest that awareness-building efforts will help other segments of the population understand that they are also eligible for WIZZIT services.

EXHIBIT 2

Telecom companies have better reach, more customers and lower costs than banks

PHILIPPINES EXAMPLE



¹ Sum of top 10 retail banks in Philippines

² Sum of SMART and Globe for branches and customer base; estimated transaction costs is average range

³ All accredited retailers where cash-in and -out can be done; SMART's airtime resellers

Source: Interviews; literature search; team analysis

Mobile banking concepts could extend beyond mobile phones. ACCION International's Gateway Microfinance Infrastructure Fund recently made an equity investment in a rural internet service provider with the intent to offer microfinance products through the network. The service provider, United Villages, operates internet kiosks at roadsides. The computers store data until a van, equipped with WiFi, comes within range, picks up the data and sends it back to the provider over the Internet. This approach extends internet services deep into hard-to-reach, poor rural areas. This model may also be used to extend microfinance.

Correspondent and mobile banking are two of the most promising innovations in the distribution of financial services in the low-income market because they encourage commercial players to leverage existing networks. Unfortunately, in many countries, regulators do not allow for either of these innovations. However, this does not mean that there is no role for the private and social sectors. Private players and donors may be able to rationalise the benefits of these models with regulators by demonstrating how banks from Brazil, South Africa and other countries have successfully managed to avert the risks associated with allowing non-financial institutions to take deposits.

3. Promote industry standards and efficiency

Currently, financial services for the poor use a vertically integrated operating model. That is, each organisation fulfills all (or most) functions in the value

chain, including product development, account origination and back-office operations. Throughout microfinance's history, providers have lacked an ecosystem of supporting organisations that could offer some of these services more efficiently.

Standardise management information systems. Management information systems (MIS) are of major importance in financial institutions and a source of frustration for many players in this sector. This is particularly true for MFIs. Experts estimate that 60 per cent of MFIs use either paper-based or Excel-based methods to track accounts, while the other 40 per cent use primarily small, customised applications. A well-designed, affordable, externally supported platform that is specifically targeted for MFIs would go a long way towards helping the institutions manage their information.

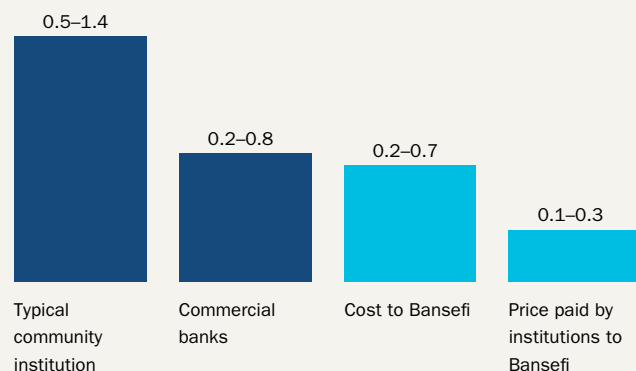
Create shared-services back-office infrastructure. In 2001, Mexican legislation formalised the semi-formal 'cajas'—community-based savings and loan institutions that are primary providers of financial services to the informal sector. The legislation created Bansefi, a development bank, to drive greater efficiency in the sector. The legislation authorised Bansefi to serve as a 'quasi central bank' for the sector. Bansefi offers a common technology platform for transactions and account management to cajas who want to participate. The bank also oversees 'La Red de la Gente', a commercial alliance between Bansefi and local cooperatives, which connects them to the international payments system. Eighty-nine members and 1,217 branches are part of this network that has allowed each member to dramatically reduce operating costs (see Exhibit 3).

EXHIBIT 3

Bansefi's transaction backbone lowers transaction costs for banks

Estimated costs per transaction

US\$, 2007



Source: Bansefi data; CONAPO; CNEV; team analysis

Use technology to increase efficiency of transaction processing. Several MFIs have piloted the use of Personal Digital Assistants (PDAs) to reduce the time spent in manually recording and transferring data from the field to the home office. ADOPEM in the Dominican Republic reported that expenses for paperwork dropped by 60 per cent and for data entry by 50 per cent by using PDAs. Productivity increased by about 35 per cent. Similarly, Fincomun (Mexico), BanGente (Venezuela) and Banco Solidario (Ecuador) have improved workflow efficiency, reduced operational costs and made more accurate information available to loan officers. However, Compartamos (Mexico) failed to benefit with the use of this technology and abandoned its pilots. Compartamos management believes it may have tried to implement the technology before the software was sufficiently developed. Success with PDAs depends on several factors: a business model that relies on such substantial input of client data to realise efficiencies, a well-functioning MIS with high speed access and reliable technical support, relatively stable and proven products and processes that will not change often, and strong support from top management.

4. Develop management talent

MFIs and commercial institutions are struggling to find an adequate supply of trained management talent. The loan officers promoted through the ranks of MFIs lack training in management skills and managers in commercial institutions are unfamiliar with the business models appropriate for serving low-income markets. Furthermore, some of the greatest opportunities for achieving substantial scale are coming from emerging business models that require managers with the entrepreneurial spirit to tackle the challenges of testing an unproven business model.

Launch new sector-specific training institutes. The shortage of management talent could be addressed through private and social sector collaboration and setting up of shared training institutes. The Public Health Foundation of India (PHFI), for example, aims to address India's limited capacity in training, research and policy development in public health. This public-private partnership evolved through consultations with multiple constituencies. It seeks to establish five to seven new Institutes of Public Health as well as strengthen existing training programmes and build a research network.

Sponsor training programmes at existing universities. The petroleum industry in several emerging markets offers another model for talent development. Major oil companies (MOCs) face a talent shortage as their geologists and engineers retire and they expand their recruiting in developing nations like Russia, China and India. MOCs are undertaking various strategies to combat this challenge.

The Institute of Petroleum Studies (IPS) at the University of Port Harcourt has been set up in conjunction with the French Petroleum Institute in Paris to provide training in petroleum engineering and management-related studies to Nigerians. Also, Halliburton has established Technical Excellence Centres (training facilities) in Malaysia with Petronas at the Universiti Teknologi Petronas (UTP).

5. Enact pragmatic regulations with a focus on consumer protection

A supportive regulatory environment is essential to achieving broader financial inclusion. In fact, regulations in many countries prohibit some of the most promising innovations, in particular in distribution. The challenge facing the pragmatic regulator is to craft policies that protect consumers while enabling the growth of a 'financial services for the poor' ecosystem.

Thoughtfully use subsidies. Many companies are unwilling to navigate the relatively uncharted seas of microfinance. One solution is to engage the public and social sectors to share some of the risk, or at least lend a hand. In some cases thoughtful investments in market research will help the private players determine the demand for goods and services. As the example of M-Pesa in Kenya illustrates, governments can use subsidies to encourage research and development in experimental models and to enhance infrastructure. Governments should continue to look for ways to encourage innovations that spur growth while avoiding direct subsidies that might prevent commercial players from developing financially sustainable solutions.

Create regulatory obligation. Different countries have taken different regulatory approaches to engaging the private sector. India's requiring commercial banks and insurers to offer some percentage of their products to consumers in low-income and rural markets is only one example. The United States followed a similar approach when Congress passed the Community Reinvestment Act in 1977. The Act encourages depository institutions to help meet the credit needs of communities in which they operate, including low- and moderate-income neighbourhoods. While critics dislike the market distortion associated with directed lending, many observers would credit this type of regulation with having given commercial players the initial nudge to embrace what can be profitable business opportunities at the base of the economic pyramid.

Provide consumer protection. As the recent sub-prime mortgage market in the United States has shown, even in the most developed countries there is a need for consumer protection, especially for the most vulnerable segments of the population. There are several examples of financial intermediaries targeting the

poor with products that an informed consumer would not use. Regulators need to provide consumers with assurance and facilitate easy comparison of metrics for different financial products. For example, Mexico's recent truth-in-lending regulation requires all retailers offering credit to disclose the total financial cost to the consumer—not only the monthly payments.

Enable alternative distribution channels. Regulations can be an obstacle to taking creative approaches in distribution, but in some countries regulators have been willing to make changes. In Brazil, traditionally only bank branches administered financial services and transactions such as receiving applications for deposit, term deposit and savings accounts, conducting receipts and payments, and receiving credit applications. However, beginning in 1999 a series of resolutions permitted financial institutions to contract companies as banking correspondents that allowed them to provide such services. In Kenya, the government worked with Vodafone to clarify the regulatory situation before Vodafone invested in the M-Pesa pilot. Without this type of collaboration, the regulatory complexities would have spelt doom for the endeavour. In both cases, regulators were able to clarify the law and determine how non-financial businesses could distribute financial services in partnership with traditional players. In Uganda, the government recognised the need for community-based organisations to offer savings products and took a pragmatic approach to allowing regulated MFIs to take deposits (see Exhibit 4).

Allow players to cover the costs of operations. Price restrictions, whether in the form of interest rate caps or limits on fees, often impede the scaling of financial inclusion. Regulators should allow players to cover their costs of funding and operations. The costs associated with lending to the very poor can be high—this cost, combined with characteristically small loan sizes, largely explains the high interest rates required for microcredit to be economically sustainable. A 2004 study by a leading microfinance consortium looked at the penetration of microcredit in 23 countries with interest rate ceilings and seven countries without these restrictions. The study revealed that penetration rates were four to five times higher in the countries without caps. In Indonesia, Bank Rakyat Indonesia reported that the growth of its microcredit programme was severely constrained until the government lifted interest rate caps in the early 1980s.

EXHIBIT 4**Pragmatic approach enabled deposit-taking by regulated MFIS in Uganda****MF Deposit Taking Institutions Act (2003) created 4 types of financial institutions**

Commercial banks	Commercial credit unions	Microfinance deposit-taking institutions (MDIs)	Unregulated microfinance institutions
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MDI Regulatory Requirements

Management must have significant banking experience

MDIs have to be incorporated as limited companies with issued shares

MDIs are required to hold minimum capital of \$285,000 and maintain a capital adequacy ratio of at least 15% of weighted assets at any time

MDIs cannot grant credit of more than 1% of capital to a specific individual or more than 5% to a group

No group or individual can own more than 30% of the MDI during the first 5 years, and then groups or individuals are limited to 20% ownership stakes

Source: Uganda Microfinance Effectiveness review 2004; Grameen site; literature search; McKinsey team analysis

CONCLUSIONS

Early pioneers have made an enormous contribution to economic development by finding innovative ways to empower the poor. They proved that it is possible to offer financial services to the low-income market through sustainable models.

Yet, even the most developed financial inclusion markets reach no more than 30 per cent of the addressable population. A successfully scaled market must provide all members of the economically active population access to credit, savings, insurance and payments products that are relevant and affordable for them. Around the world, innovation is at work.

India has made enormous strides towards greater financial inclusion. At this stage, adopting best practices from around the world that are relevant to India and leveraging the nation's inherent strengths can significantly accelerate the ongoing efforts towards greater financial inclusion—a critical social and economic imperative of the country.

Tilman Ehrbeck is a partner in the New Delhi office, Rajiv Lochan is a partner in the Mumbai office, Alberto Chaia is an associate partner in the Mexico City office, Jonathan Bays and Robert Schiff are consultants in the New York office, and Valerie Faillace is a consultant in the San Francisco office.

Financial Services Practice
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