Financial Services Assessment

ENABLING ENVIRONMENTS FOR MICROFINANCE: A CONCEPT NOTE

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Financial Services Assessment project can be found on the web at http://www.fsassessment.umd.edu/

ABOUT THE PROJECT

The *Financial Services Assessment* project is designed to examine the impact of financial services on the lives of poor people across the developing world. This project is funded by the Bill & Melinda Gates Foundation, which is committed to building a deep base of knowledge in the microfinance field. The IRIS Center at the University of Maryland, College Park, together with its partner Microfinance Opportunities, will assess a diverse range of innovations in financial services. The results of this project will shed light on the design and delivery of appropriate financial products and services for the poor, and the potential to scale up successful innovations to reach larger numbers of low-income households.

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ABSTRACT

This paper examines the key elements of what constitutes an enabling environment for microfinance. The Bill and Melinda Gates Foundation provides microfinance innovation grants designed to avoid or alleviate the potential negative difficulties involved in the risks and uncertainties of the microfinance industry. Here we review exogenous, macro-, and meso-factors that can create beneficial and negative impacts on the financial sector. Analysis of instruments, such as policies and organizations that the public or financial sector creates, are examined, explained and compared. The purpose is to ultimately determine the most beneficial environmental factors for the microfinance innovation grant success.

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Abbreviations

BMGF	Bill and Melinda Gates Foundation
EE	Enabling Environment
ID	Identification
IT	Information Technology
MF	Microloan Foundation
MFI	Microfinance Institution
NGO	Non-governmental Organization
ROSCA	Rotating Savings and Credit Association

Introduction

Grants are sometimes called "seed money." In farming, seeds flourish or fail depending on whether they are planted in fertile soil. Or, more broadly, we might ask if the environment is conducive, having appropriate amounts of moisture, sunlight, nutrients, and the like. In our present context, grants supply "seed" to areas where it is likely to flourish. But they do not supply a conducive environment.

This analogy, with all its imprecision, points out that microfinance must grow in a context not of its own making. The context may include imponderables such as war, famine, or natural disaster as well as trends and cycles that vary in intensity – as do the weather and the state of the economy. And microfinance institutions (MFIs) must also deal with risks arising in their operations, such as possible default, competition, shifts in demand, and variable liquidity.

Now, there are two basic approaches to addressing the complex of risks and uncertainties in microfinance:

- First, programs and products can be designed in ways that avoid or alleviate potential difficulties. The Bill and Melinda Gates Foundation provides microfinance innovation grants that support such designs.
- Second, reforms might be adopted at the level of national or local government, or alternatively at the level of the banking or microfinance sector, to create mechanisms that reduce costs, risks, and uncertainties.

The microfinance innovations are within the control of the grantee organizations. They are the primary subject of the empirical studies being carried out by the IRIS Center and Microfinance Opportunities under the rubric, *Assessing the Impact of Innovation Grants in Financial Services*. Those innovations are not, however, the main focus of this note. Rather, we focus on the second group of elements listed, those usually described as the *enabling environment* (EE).

Describing the enabling environment this way suggests *why* we should seek to understand it. In our farming analogy, the quality of the seed alone cannot explain a flourishing or failed crop, and so one must look to soil, environment, and techniques used by the farmer. Disentangling innovation from context is critical for assessing the impact of the grants. As well, both innovations and the conditions in which they are deployed vary. Thus, examining the latter conditions makes it possible to judge which design is likely to work in which context, and thus to calibrate expectations about the impact of similar innovations in future settings. Incorporating EE analysis into this assessment project should provide yet another benefit. It affords a basis for determining whether, in some contexts, supporting enabling environment reforms would have a higher payoff in terms of improved financial access than supporting retail microfinance innovations.

Just as critical, we must carefully delimit *what* we study when we consider the EE. It is neither the environment as a whole nor the innovation itself, but the instruments such as policies and organizations that the public or the financial sector establishes to create a stable basis for action. (In terms of our farming metaphor, the EE constituted by a society corresponds to the techniques used

by the farmer.) The discussion below will flesh out the meaning and importance of the enabling environment, the components of this environment, and our suggested approach toward analyzing it in areas where innovation grants are being implemented.

The Environment for Microfinance

An impact assessment of the BMGF innovation grants must focus on key variables *within the microfinance provider's purview*. These include the design of the innovation and the provider's management of the roll-out – in other words, steps taken at the level of retail microfinance supply. The latter has been termed the *micro* level of the microfinance sector (Christen et al. 2003). We can broaden this definition to include demand-side issues at the level of the household or microenterprise. Here, we are concerned with clients' uptake and use of the financial services on offer, including their planning and cash management. Action at the micro level is the focus of the quantitative impact studies, supplemented by the financial landscape and related studies – and we do not cover it here.

At the farthest remove from the micro level, the overall environment encompasses variables that influence program outcomes but that are largely beyond the control of the grantee. That environment is vast and complex. It includes everything outside the control of the microfinance provider, such as rainfall, terrain, disease incidence, and civil conflict. These are the givens, or *exogenous* factors, in the operating environment. Most of these factors are impervious to human intervention, at least in the near term, but have a major role in determining economic and financial opportunities. Table 1 below provides examples.

Table 1.

Microfinance Access: Exogenous Factors
○ Geographic setting, including resources and barriers
○ Population density
○ Weather patterns, seasonality and variation
○ Incidence of shocks due to weather events, natural disasters
○ Poverty, education level, health status of population
○ Overall human resources, human capital
○ Political stability, incidence of civil conflict
○ Social structure

These kinds of factors are either known in advance or present clear risks that must be hedged or otherwise taken into account at the micro level. As such, they form part of the grantees' design and implementation challenge. The impact studies measure the success of the grantees in addressing this challenge, and in doing so, take account of variability in exogenous factors by means of statistical controls. We set aside these exogenous factors for purposes of the EE component of the project.

The enabling environment, by contrast, embraces neither the micro-level innovations nor the exogenous factors. Like the innovations, the components of the EE arise *in response* to exogenous factors in the environment and the need to manage the costs and risks of microfinance transactions (i.e. they are *endogenous* from the perspective of the country's political and economic order). Thus, the EE embraces a less comprehensive but still quite large arena. It includes two categories of independent variables situated between the micro level and the exogenous factors. These are the *macro*- and *meso-level* factors. Together, these elements – briefly, institutions and infrastructure (see below for more detail) – *enable* access to microfinance services to a particular extent. These factors make it possible for consumers and providers of

microfinance services to cope with exogenous uncertainties, to manage the risks and costs arising within microfinance transactions, and thus to take steps at the micro level (retail microfinance provider, household, microenterprise) to ensure that the supply of services meets demand.

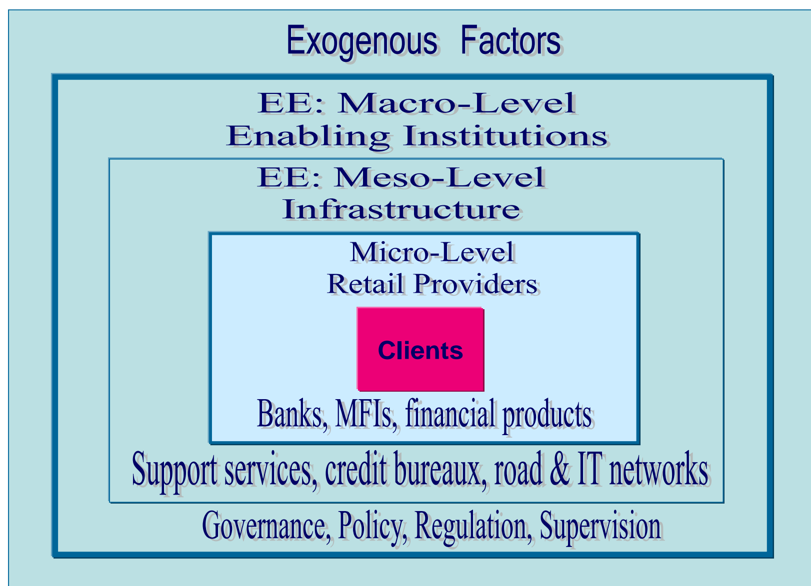
Studies of enabling environments often focus on macro-level, i.e. institutional, factors. A widely-used definition of the business enabling environment describes it as (IFC 2008: 14):

> [A] complex of policy, legal, institutional, and regulatory conditions that govern business activities. It is a sub-set of the investment climate and includes the administration and enforcement mechanisms established to implement government policy, as well as the institutional arrangements that influence the way key actors operate (e.g. government agencies, regulatory authorities, and business membership organisations including businesswomen associations, civil society organizations, trade unions, etc.)

Analyses of microfinance environments tend to expand this focus to include infrastructural (meso) factors that affect microfinance access (Christen et al. 2003), such as roads, information networks, and bank branching beyond the major urban centers.

Actors at the micro level (e.g. MFIs and customers) can, to a degree, adjust to the enabling environment. But in many countries the EE can change in unpredictable ways due to policy reversals, variations in implementation, and political climate. Thus, a microfinance provider might design a product that takes into account weather variations or even the likelihood that its activities could be affected by ongoing civil conflict. But the product's success depends on such factors as interest rate policies, property rights, and access to information on client assets and credit history. These enabling variables must be taken into account if we are to assess the impact of a given innovation in a specific environment. Figure 1 below depicts the layered (onion-like) disposition of levels in the microfinance environment.

Figure 1: Environment for Microfinance



Adapted from CGAP Direct Donor Guidelines (http://www.cgap.org/direct/resources/donor_guidelines.php).

What are the component parts of the macro and meso levels? The macro level is comprised of *institutions* such as rules, organizations, and norms that affect transparency and certainty. Appropriate institutional arrangements enable economic actors to transact on the basis of adequate information and stable expectations. Economically, the touchstone of successful institutions is not formal enactment or approximation to international best practice but rather their impact on transactions. Do they supply sufficient information and certainty for risk-taking and growth? Thus, for example, the efficient financing of enterprises on a wide scale usually depends upon such institutional factors as stable macroeconomic policies, a clear legal basis for valuing firm assets and pledging them as security, and effective mechanisms of enforcement. Also important are the informal institutions such as folkways and traditional authorities that coordinate behavior.

In contrast to the policies and institutions provided at the macro level, meso-level factors largely consist of physical or organizational *infrastructure*. Thus, for example, transport and communications networks, and associations that provide information and other support to the financial sector, help to make financing transactions more efficient and thus cheaper.

The macro-meso distinction is not hard and fast. It is used here (and elsewhere) to organize the discussion of the enabling environment and thus to shed light on relationships among issues. It may be helpful to bear in mind that macro-level factors consist largely of public goods (or the opposite – negative externalities or "public bads"). Establishing or changing institutions requires action at the level of the polity, whether national, regional, or local. By contrast, meso-level factors are in some cases provided publicly, by government (e.g. roads), but often are private goods supplied for a fee by companies (e.g. credit reporting) or hybrid "club" goods furnished to members in good standing of the financial sector or relevant association (e.g. clearing house). Also, meso-level factors may either good or bad (e.g. adverse credit culture).

Table 2 below presents an illustrative listing of factors in the enabling environment. This list reflects global experience over the last two decades and a substantial analytical literature on frameworks for microfinance.[1] We refer to relevant parts of these findings below, without attempting a comprehensive review.

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[1] See, e.g. van Greuning et al. 1999, Meagher 2002, CGAP 2002 and 2003, Christen et al. 2003, Jansson et al. 2004.

[2] Research increasingly shows a link between financial system development and strong governance in the form of the rule of law, administrative accountability, and the like (Tressel and Detragiache 2008).

[3] Christen and Rosenberg (2000), Meagher (2002), Christen et al. (2003).

Table 2. Microfinance Access: Enabling Factors

MACRO LEVEL FACTORS	
Quality of governance	○ Rule of law, transparency & accountability in government ○ Security, public order, crime ○ Capable and accessible courts/tribunals ○ Quality of legislature, executive, bureaucracy ○ Civil and political rights ○ Corruption, political interference ○ Enforcement of civil, criminal, commercial laws
Property rights and enforcement	○ Property laws: real estate, movables, intangibles ○ Property registration, protection, conveyance ○ Family law: marital property, inheritance, divorce, legal autonomy of spouses & children, customary/religious law on personal status
Local governance and informal organization	○ Local government: quality of administration & taxation ○ Local government: treatment of property rights ○ Informal norms, authority structures, dispute-resolution ○ Social capital, networks, associations, resource-pooling.
Economic and commercial laws and policies	○ Monetary policy, interest rates, exchange rates ○ Investment (domestic & foreign) law and regulation ○ Taxes: incidence, levels, stability, application ○ Rules on company formation & registration (including non-profits) ○ Regulations affecting operations: labor, health & safety, competition, consumer protection ○ Commercial laws: contract, corporations, securities, bankruptcy ○ Secured finance law
Financial law and regulation	○ Banking, financial services, and insurance laws ○ Financial services regulation, including licensing & prudential standards ○ Specific provisions for microfinance ○ Supervision: quality, burden, cost ○ Deposit protection/insurance ○ Financial products accessible by law to the poor, e.g. inexpensive, low minimum-balance savings accounts ○ Operating rules including branching and agents ○ Provision for transformation to regulated status (e.g. by NGOs, coops) ○ Usury and money lending laws, interest rate caps ○ Treatment of small/informal microfinance groups & providers
MESO LEVEL FACTORS	
General infrastructure and services	○ Road and transport networks ○ Electricity, water, sanitation services ○ Telecommunications and information technology accessibility ○ Healthcare and education ○ Social safety nets, welfare & relief programs ○ Availability of qualified personnel ○ Systems for identity documentation and record-keeping
Support systems for business and finance	○ Clearing, transfer systems ○ Credit information system/credit bureau ○ Enterprise development support & promotion ○ Infrastructure: marketplaces, information access (e.g. on relative prices) ○ Associations/apexes for microfinance, microenterprise
Financial sector conditions	○ Banking infrastructure – quality and extent ○ Competition in banking and small-scale finance ○ 'Credit culture,' market (or non-market) basis of development finance (including aid donor programs)

The Impact of Enabling Factors

The enabling environment is important both for MFIs and for potential clients among the poor. The latter are often severely affected by enabling factors that enhance or diminish microfinance access. For example, the alternatives available to the poor in the absence of accessible microfinance – such as credit from moneylenders or relying on kin networks – are far more disadvantageous than are the informal alternatives of the relatively wealthy and well-connected (Barr et al. 2007).

Enabling factors such as those listed in Table 2 may, at first glance, appear rather remote from the needs of people at the "bottom of the pyramid." Yet, they can exert major influence on the ability of MFIs to achieve scale and effectively to expand access to poor households and informal entrepreneurs. Meso factors such as road networks and public services have an obvious impact on the livelihoods of the poor. In comparison, the importance of ID cards and credit bureau is less visible if no less important in connecting ordinary people to the financial system. At the macro level, commercial laws may not impinge directly on transactions between MFIs and their clients. They nonetheless strongly influence the MFIs' operations, sources of finance, and hence potential effectiveness in expanding microfinance access.

In some cases, one factor gains importance from the existence of another. For example, the poor may not have access to basic savings accounts due to adverse banking laws or limited banking infrastructure – and this becomes critical where high crime and low social capital make alternatives such as cash-holding and informal rotating funds (ROSCAs) more risky.

Other factors such as the rule of law and macroeconomic policies are still more indirect in their effects. They influence the financial system and the economy as a whole through their effects on the integrity (including enforcement) of contracts and regulatory standards, and the stability of prices and investment expectations.[2] This is perhaps clearest from the perspective of large investors (including non-profits such as BMGF). Adverse conditions are likely to constrain, and may prevent, significant inflows of capital that would otherwise stimulate the microfinance sector and enhance access. The enabling environment appears especially important in the current global economic crisis, in which investment and non-profit funding have contracted and financial services markets in the developing world are incapable of taking up the slack (USAID 2009).

Now, it is widely understood that the overall development of microfinance requires many of the same macro- and meso-level factors that are critical for traditional banking and commercial finance. This is clearest where the aim is to make microfinance commercially sustainable at scale. The institutions and infrastructure of modern financial services aim at maximizing the mobilization and intermediation of funds, enhancing efficiency in the allocation of capital, ensuring appropriate risk management, and protecting depositors. These factors are essential for commercial banking. They also become important for MFIs as soon as their growth leads them to look beyond

[2] Research increasingly shows a link between financial system development and strong governance in the form of the rule of law, administrative accountability, and the like (Tressel and Detragiache 2008).

government or donor support to attract private capital and to mobilize savings.

The inherited enabling environment, however, may unduly constrain microfinance. Perhaps the clearest example of this is banking regulation and supervision. The standard approach tends to impose inappropriate requirements on MFIs when applied without modification, thereby raising costs and curbing innovation. Thus, an NGO microfinance provider may be prevented from accepting even small savings deposits unless it becomes a commercial bank – often an impossibility. The same issues of appropriateness apply to other enabling factors such as financial system infrastructure, telecom systems, and information technology access. The key question here is whether these factors facilitate or constrain linkages between the poor and the financial system.

Thus, the special features of microfinance need to be accommodated within the enabling environment for finance. These features include:

- its attempt to deepen financial markets to serve microenterprises and poor households, physically taking banking services to clients who have few other options to receive financial services;
- its high unit costs of lending;
- the relatively undiversified and sometimes volatile nature of MFI credit portfolios;
- lack of collateral that can be valued and used by financial institutions;
- the fact that most MFIs began as unregulated credit NGOs, with a focus on social goals rather than financial accountability and sustainability, thus creating very different cost structures and funds sources; and
- the market risk posed within the microfinance sector itself when MFIs are not properly managed and monitored – but (usually) with low risk to the financial system as a whole due to the sector's relatively small scale. [3]

Avoiding over-regulation is at least as important as putting well-tailored rules and systems in place. Problems can arise, for example, when there is a mismatch between regulatory norms and lending technologies (e.g. interest rate caps that prevent MFI cost recovery), and when policymakers attempt to use the regulatory framework for objectives other than the core rationale of avoiding excessive risk (e.g. populist bans on money lending or on foreign ownership).

The impacts of enabling factors are not quite as straightforward as some would claim. The same enabling factors can influence microfinance in opposite ways, depending on the level of development in the sector, institution, or product. Microfinance, and indeed its precursors in small-scale banking and credit unions, arose in response to severely limited financial access. Constrained access is in part a result of a poor enabling environment. Microfinance products and programs are therefore designed to succeed in adverse settings. Thus, *a disabling* feature of the institutional environment, such as outdated laws and weak infrastructure for asset-based enterprise credit, can severely limit access to traditional banking, while at the same time creating opportunity for microfinance programs to provide financial access to those not adequately served by the banks.

[3] Christen and Rosenberg (2000), Meagher (2002), Christen et al. (2003).

In sum, what is bad for banks may be good for microfinance institutions – but not always. An adverse environment can *both* create opportunity for microfinance *and* limit its upside potential. Thus, for example, stringent entry requirements for financial institutions, such as high capital and reserve requirements may unduly restrict the development of the banking sector. This opens up competitive opportunities to MFIs. But the same constraint may prevent an MFI from obtaining a license and therefore limit its ability to raise capital and to engage in regulated financial activities.

The diversity of impacts just discussed pertains mainly to the level of individual financial institutions. A condition that favors the overall development of the financial system may be good, bad, or indifferent from the perspective of a particular bank or MFI. This is a question of competitive advantage. But from the perspective of access to finance, the goal should be an enabling environment that supports financial inclusion, that is, development of appropriate financial institutions and instruments to meet demand at all levels of the economy.

The more difficult questions arise in connection with sequencing. It is often the case, for example, that a country must give highest priority to developing or stabilizing the banking sector, while letting microfinance develop with little oversight. In terms of microfinance, this might be harmful if it creates unsustainable institutions and an adverse credit culture. In many cases, however, this freedom to develop has allowed MFIs to experiment in ways that lead to stronger models. Once these models prove their worth and help microfinance scale up, then regulators can (and indeed should) step in. This pattern has played out in many settings, beginning with the launch of microfinance banking in Bolivia.

In other words, the ideal enabling environment for an immature microfinance market may be different from the ideal for a mature market. At a minimum, investments in microfinance-specific policies, regulations, and infrastructure may have low priority in the immature stage, but become more urgent as microfinance matures. In the later stages of market development, consolidation and competition come into the picture. Often, access to services is the main concern for potential microfinance clients, while price may be relatively unimportant. But as access becomes more universal, the price of microfinance services grows in importance, with commercial providers competing among themselves and with government and non-profit providers (CGAP 2006).

Sharpening the Focus

The success of microfinance innovations in alleviating poverty depends on their success in *enhancing access to finance*. This is a multivalent concept. In order for an innovation to make a difference, access to financial services must initially (*ex ante*) be constrained. The provider aims to increase this access (*ex post*) by means of an innovation that addresses an unfilled niche or backlog of unmet demand. At each of these stages, access to finance has a supply side and a demand side (see McGuinness 2008). On the demand side, effective access means the client's being able to use financial services to improve the household's standard of living. The enabling environment plays a major role in defining the level of constraint *ex ante* (where we expect it to be relatively high) and *ex post* (where we expect it to be lower). Table 3 below charts these relationships.

Table 3. Access and Enabling Environment

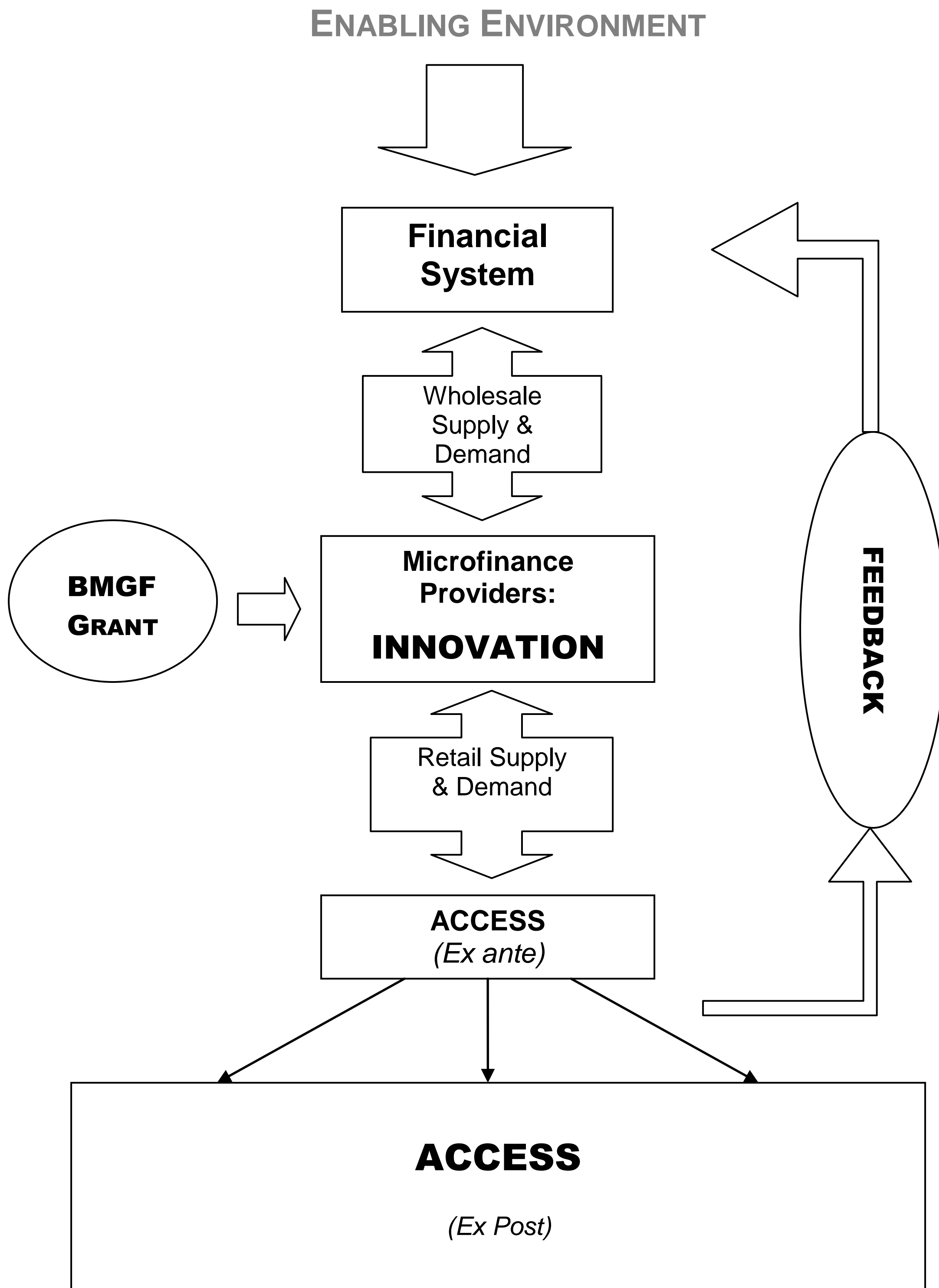
	Supply	**Demand**
Ex ante	EE factors both enable and constrain MF services provider	EE factors both enable and constrain clients accessing MF services
Ex post	EE factors affect scope of expanded supply due to MF innovation	EE factors affect scope of expanded use of MF services by clients/consumers due to innovation

The discussion above suggests that, potentially, a very large number of enabling factors are relevant to financial access and worthy of study. However, in the current context, neither the need nor the resource base exists for a comprehensive study of them. The analysis must focus on those enabling factors *most critical to the innovation's impact*. These are factors that affect the ability of the grantee to succeed in deepening and broadening microfinance provision using the particular innovation, and the ability of clients to make use of the services thus afforded.

A given BMGF-supported microfinance innovation will face a specific enabling environment that shapes its value proposition and likely impact. A specific EE country study must focus on the factors in this environment that theory, experience, and context suggest are the most salient. This yields a finite set of variables, yet a broad enough view to draw a meaningful picture and allow for flexibility. The findings from this analysis help to narrow the range of enabling factors to a smaller number of high-priority issues that can be investigated in more depth during the research. This approach is best suited to producing insights while using resources efficiently. Thus, for example, a microfinance innovation in the insurance field will call for a different EE emphasis than an innovation in credit or savings.

Figure 2 below provides a graphic depiction of the factors and impacts just discussed. Within a general enabling environment, BMGF supports innovations by the grantee microfinance providers. These innovations aim to enhance access to financial services for a target clientele, the poor. The enabling environment influences microfinance services at two main levels. It affects wholesale supply and demand, where MFIs and other providers raise capital, and retail supply and demand, where clients access services from the providers and use them for household or enterprise purposes.

Figure 2. Enabling Environment and Impact on Microfinance Access



If, as expected, the innovation enhances access, then it should have a feedback effect on the financial services supply chain, at both wholesale and retail level. At each level, enabling factors play a role in determining the magnitude of impact, and the EE itself is subject to pressure for change as trends in supply and demand expose bottlenecks in the system. Thus, new credit and savings technologies may prove so successful that regulators take steps to recognize and supervise new types of financial institutions (as in Bolivia) – and the cycle begins again.

Assessing Results

When the enabling environment analysis is combined with the other research in this project, we gain a clearer understanding of the impact of the grant-funded innovations. The empirical impact assessment yields information on microfinance access *ex ante* and *ex post*, along with evidence on the extent to which any change is attributable to the innovation. The impact study also tracks changes in household income and standard of living, identifying those attributable to enhanced microfinance access. The qualitative studies – financial landscape, financial diaries, enabling environment – provide necessary contextual information for understanding whether the impacts in terms of access and income are significant, and how they came to be. As suggested above, the two main causal axes here are (1) the innovation itself, and (2) the enabling environment. The residual third category of exogenous factors is largely taken as given, while any significant changes here would be taken into account in rolling out the innovation and assessing its impact.

The above approach allows us to determine, in the final analysis, to what extent the enabling environment affects the innovation's outcome – for good or ill. Such a determination, in principle, requires answers to several questions:

- Does the EE amplify or dampen the impact of the innovation – and how?
- Has there been a change in the EE during the period of the study that accounts, in whole or in part, for the difference in financial access *ex ante* and *ex post*?
- Is there a difference in the role and effects of the EE in the innovation impact zones as compared to other regions where the innovation has not been implemented?
- What role does the EE play in producing any differences in impact found between the poorest and the better-off? Between formal and informal savers, borrowers, and entrepreneurs?
- How does the impact of the innovation grant differ from the impact of an enabling environment reform – either an actual reform implemented before or during the period studied in this project, or a prospective reform that is feasible and might be supported in future?

Thus, the quantitative impact studies differentiate among possible causes for enhanced (or diminished) microfinance access – including the innovation itself and such other influences as economic shocks, government interventions, or other donor programs.[4] The EE studies feed into this causal analysis of impact, in terms of both direction and magnitude.

But a note of caution is in order. Years of research on enabling environments shows that it is very hard to pin down discrete impacts of EE factors. To provide a valid empirical measure of impact requires econometric analysis of large comparative data-sets, and even then the causal relationships are subject to debate.

[4] The impact studies also look at the nexus of microfinance access and poverty. Here, counterfactuals become relevant, such as self-financing of enterprises as an alternative to credit (Dichter 2007) and channeling grant funds to alternate uses such as employment-creation through investment in medium- and larger-size firms (Karnani 2007).

Our EE research does not include surveys or empirical data analysis. Rather, we use qualitative research and analysis to identify and understand the relevant EE issues, and to qualify the findings in the overall impact study from the EE perspective. While the innovations can be rigorously assessed, using treatment and non-treatment areas, the same does not apply to studies of the enabling environment. Here, our objective must be limited to providing findings that are as careful and informative as possible, even if unavoidably approximate.

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