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Reforms in Weak Institutional Environments

A Framework for Reform

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SEMINAR PAPER

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A FRAMEWORK FOR REFORM

Mark Napier, CEO – FinMark Trust

Introduction

Financial sector reform, aimed at increasing both financial breadth and depth, is fairly widespread across Africa, although not all countries are reforming and some countries are embracing reform more energetically than others. CGAP estimates that, as at end 2007, $4.2bn has been committed by donors to financial sector development in Africa. Zambia, Mozambique, Tanzania and Rwanda are examples of countries where donors have invested substantial sums in comprehensive reform programmes covering large parts of the financial system – central banking, capital markets, microfinance, payments systems, pensions etc. Examples of other approaches to reform include the dramatic recapitalisation of the Nigerian banking industry and the processes that fed into, and now flow from, South Africa's Financial Sector Charter. As an indicator of potential reforms, several FSAPs were carried out in Africa in 2006 and 2007 with more scheduled for 2008.

But the implication in the title to this paper is some reforms are taking place either in the absence of a framework for reform or that the frameworks that do exist are somehow inadequate. A particular concern is that ambitious reform processes are being adopted by (or imposed on) countries whose capacity to carry out the reforms, certainly in accordance with timetables prescribed by donor funding, is limited. Are these sorts of long term reform processes being given undue priority over the short cuts or quick fixes that could achieve good near-term results[1]? Are there other initiatives that governments, perhaps supported by donor agencies, can initiate that would strengthen the chances of success of reforms currently underway?

FinMark Trust's main focus is on access. As such, we see that successful financial sector reform requires not just technical fixes (for example, around regulation, payments systems or the provision of information) but also fundamental changes in behaviour on the part of organisations (ie service providers) and consumers. The reality is therefore that financial sector reform has to be regarded as a long term goal. Technical fixes (which often take far longer than they should) do not necessarily lead to the desired changes in organisational or consumer behaviour. We suggest that the access debate

[1] A question posed in Making Finance Work for Africa (Honohan, Beck – World Bank 2007)

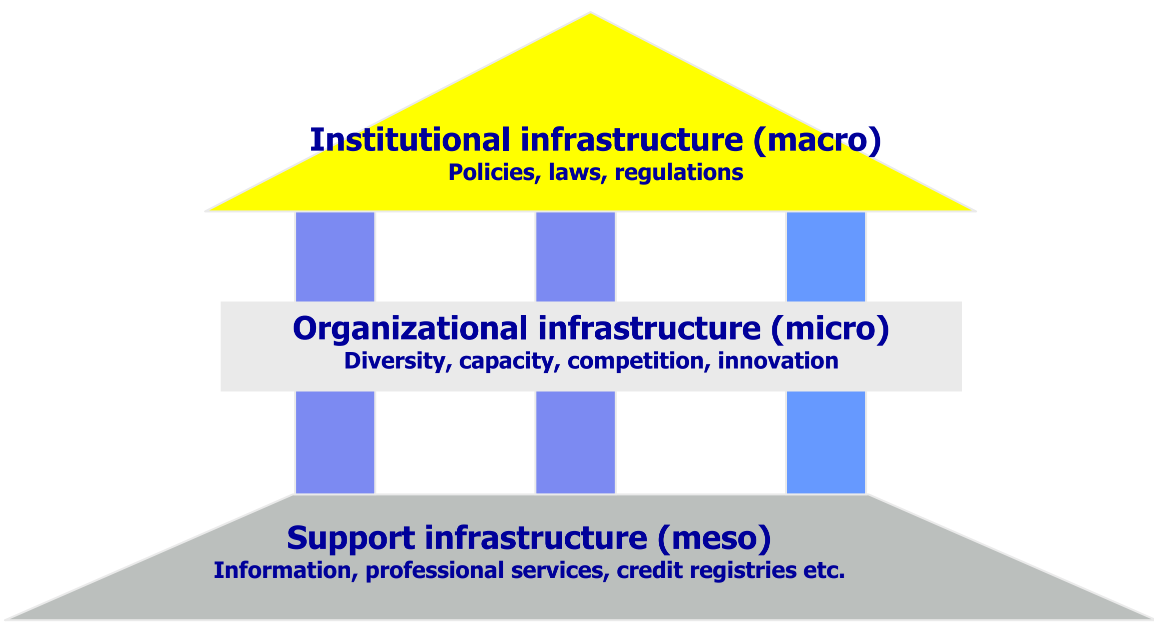
would benefit from greater *political* leadership in certain countries. Of course, technical expertise is needed too but, without strong political, or policy, backing, technically-led reforms will not be as effective, or as quick, as politically-led reforms.

But we also suggest that political *dirigisme* can co-exist with the pro-market approaches to financial sector reform that we are generally seeing across the continent. Better information for policy makers should allow politicians to articulate a vision for financial inclusion and more effectively coordinate market-led activity towards the achievement of that vision.

Financial Inclusion Assessment Tool

Developed jointly by CGAP and FinMark Trust[2] the three tier Financial Inclusion Assessment Tool (FIAT) has become a useful tool for policy makers or regulators to organise their strategies for building greater financial inclusion.

Figure 1 – Financial Inclusion Assessment Tool



The FIAT encourages methodical and in-depth analysis of a market, allowing constraints to be identified and trade-offs managed. It is based on the insight that the solution to market failure will most likely come from *within* the market itself and so a deep understanding of how a market functions (or why it fail to function) is the first step rectifying market failure. As Amartya Sen says[3], "These [problems of market failure]

[2] FinMark Trust's three layers form a "house" where the policies and regulations in the institutional layer, and the service providers in the organisational layer, rest on the "foundations" of the support layer, which is why the "meso" layer is depicted at the bottom. However, CGAP and FinMark Trust see the three layers having essentially the same components

[3] Development as Freedom

have to be dealt with not by suppressing the markets, but by allowing them to function better and with greater fairness".

The FIAT aims to depict a financial system *in its entirety*. This is an essential point. Other approaches to expanding access look at microfinance in isolation from the rest of the financial system: this tends to focus attention on microfinance or other "pro-poor" financial *institutions* rather than address the *systemic* reasons why access is being constrained – ie the regulatory constraints, payments infrastructure problems, lack of information on the needs of poor consumers etc. In short, fixing the deficiencies of the existing system, and allowing the components of the existing system "to function better and with greater fairness" is likely to yield quicker and better results than setting up a parallel, or separate, system "for the poor".

By grouping the constraints to market development into the three tiers of the FIAT, it is possible to identify where effort should be deployed to achieve greatest impact. This is important in resource-constrained markets where it may not be possible to enact reforms on a broad front. FinMark Trust has used the FIAT approach recently for a supply-side study of inclusion in Zambia which has concluded that, because the macroeconomic and regulatory environment is already broadly conducive to financial inclusion, and the informational environment is also improving, it is the organisational layer that provides the greatest set of constraints to access[4] and to which policy attention should be directed.

Examples of some of the kind of analysis that the FIAT approach might yield include the following:

FIAT layer	*Focus of analysis*	*Possible outcomes*
Institutional (macro)	▪ Analysis of policies, laws, regulations etc ▪ Understanding the trade-offs between efficiency, stability, consumer protection and market development (ie access) ▪ Balancing international standards with country specific conditions	▪ Understanding impact on access of credit market legislation ▪ Tiered banking legislation ▪ Review of AML/CFT or Basel 2 for their impact on access ▪ Review of competitiveness of financial sector
Organisational (micro)	▪ What is the organisational landscape of supply? ▪ What products/services are available to the market (especially poor consumers) – and at what prices? ▪ What are the practical constraints faced by banks and insurers?	▪ Support to emerging players ▪ Technology innovation ▪ Mass market pricing strategies ▪ Financial needs' analysis of consumers ▪ Better disclosure by banks ▪ Innovation or research funding ▪ Payments systems reform
Support (meso)	▪ Is there access to information for better market function? ▪ What support institutions and services are	▪ Credit registries ▪ Price comparators ▪ Research/data

[4] It is hoped that this study will be approved by the Bank of Zambia and published shortly

	needed?	▪ Skills and training ▪ Standards and support professions

It could be argued that the structure of the FIAT does not adequately consider financial markets from the perspective of the consumer, who, after all, should be the end beneficiary of financial sector reform. The FIAT instead "targets" policymakers and regulators and the providers of financial and other services. Certainly, analysis of financial markets cannot be said to be complete without understanding the status of (i) consumer financial literacy and (ii) the accessibility of both financial literacy training and of recourse mechanisms. "Financially capable" consumers are an essential part of well-functioning financial markets, constituting an important feedback loop for service providers, through the financial decisions (and complaints) they make.

Lack of understanding is part of the reason why people "self-exclude" and the analysis shows that demand-side barriers, including lack of understanding, are a much greater contributor to overall exclusion than access, or supply side, factors (such as physical distance or product pricing). Completed FinScope surveys[5] show that 2 out of every 3 unbanked people[6] give as the reasons for not banking the fact that they "do not have a job", "do not have money", or "do not have a regular income". These perceptions of the (limited) value of a bank account may be based on misunderstandings or poor information and is a reflection of the overwhelming power imbalance between poor consumers and large financial institutions that too often keeps these two constituencies separate. Hence it follows that strategies to improve financial literacy and recourse should be an essential part of an overall policy to combat financial exclusion: policies focussing on supply side factors alone will only improve access levels to a certain extent.

Technical and political

The FIAT framework, supplemented by analysis on consumer literacy and recourse, thus can be seen as an effective "organising principle" in support of financial sector reform. It will be readily apparent that the analytical work involved is a rich seam for technical experts. The question really is: how does this in-depth analysis lead to actual change? Put another way, does this analysis merely create the illusion of activity when nothing much is changing "on the ground"?

Clearly, there has to be an effective mechanism to translate an enhanced understanding of financial markets into policy change, or innovation support. Those mechanisms do not always exist[7] and sometimes, where they do, vested interests get in the way of evidence-based policy formation. Nevertheless, if used properly, this information will be valuable

[5] from South Africa, Namibia, Botswana, Kenya (FinAccess), Tanzania, Uganda and Zambia
[6] and in fact a higher proportion in the middle income countries of southern Africa
[7] this points to the need for an effective academic environment and/or independent policy centres or think tanks that can help to "sift through" the information and propose courses of action. This is an obvious area for donor support.

as baseline data and can be repeated over time to monitor the effectiveness of policy change.

Many of the outputs from FIAT analysis will be technical in nature and will typically be the result of research or implementation projects of which the following commonly seen project types are only a sample:

- Central bank support
- Credit registries
- Land registry reform
- Capital market reform
- Demand side surveys
- Capacity building
- Infrastructure (eg around payments systems)
- PPP support
- Consumer financial literacy
- Innovation funds
- Guarantee schemes
- Micro equity/SME funds
- Business Development Services
- Fiscal reforms

Some of these technical "fixes" are clearly very important (information-based interventions such as credit registries and demand side surveys have proven catalytic impact) and will contribute to the development of robust financial markets over the long term. But, even though they are only technical in nature, they can take years to implement. Often this is because the projects, *once reduced to this technical level*, lack political weight and the connection between an individual technical project and the wider vision for financial inclusion is often lost. Further, in the absence of a coordinated government policy on access, these projects become vulnerable to in-fighting between government departments.

We argue that FIAT analysis can bring much-needed political energy to bear on the access debate by:

1. painting, for the politicians, a vision of how much more inclusive financial markets could be
2. informing a dialogue between government and the industry
3. making the case for a policy on financial access that would streamline the efforts of the various government departments with a mandate to promote access
4. generating the indicators by which progress can be measured

Simply put, the starting point for an improvement in access levels is a dialogue between government and industry where government communicates its desire for greater financial inclusion (ie its vision) and sets out what it expects the industry to do to deliver this, and what it, as government, intends to do to contribute – for example, by way of a legislative programme, reform of state-owned financial enterprises, tax incentives, and so on. Where government capacity is weak, it is often the case that private sector financial services providers are much better resourced to argue their side of the negotiation, and perhaps even to argue why the *status quo* should not be changed at all. Better information, ideally independently produced, will allow governments to be credible in their negotiations with industry and should also provide for a better quality negotiated outcome as targets can be set that the parties can agree are realistic. It is an obvious comment but it is clearly essential that government officials should know their brief when negotiating with industry.

This is the basis for the "access charter"[8] type of negotiation that we, at FinMark Trust, have argued would benefit many African countries. At its core, an access charter is a contract entered into by key financial sector stakeholders under which the parties commit to work together to transform the state of access to financial services for the poor. It would not be statutorily imposed but would be acted upon as if it has the force of law. The charter would acknowledge the poor state of access today (expressed as a percentage of the adult population with a bank account, insurance product etc.) and would set targets for an improvement in access within an agreed timescale. The charter approach is, theoretically, a "quick fix" because it should take less time to introduce than formal legislation, has political weight behind it and, because it is the outcome of a negotiation, has the willing participation of industry.

This would be an example of moral suasion but moral suasion in the absence either of strong political leadership or credible information will not work. Having a consistent long term policy that stands scrutiny over several years because it is grounded in good information will be viewed very positively by market constituencies.

It might also be argued that moral suasion in the absence of the threat of coercive legislation might not work either. Coercion in its more extreme forms, such as directed lending, has (we believe rightly) been disavowed as a credible tool for driving greater financial inclusion. But, given stubbornly low access levels, some "softer" forms of coercion (or the threat thereof) should surely be considered as part of a policy framework for access. These might include Community Reinvestment Act-type legislation, the requirement for better disclosure to allow consumers to compare prices, levies for consumer financial literacy or collaborative market research and so on. Such measures, apart from possibly yielding a direct benefit, would also be a useful way to signal political will.

FIAT-style analysis allows the indicators to be created that will enable progress towards greater financial inclusion to be monitored. Without such indicators, it will be difficult to determine whether the more *laissez-faire* charter approach is proving effective in bringing about improved access or whether a more coercive approach is required. Provided they are collected from the demand and supply side, indicators can be used to measure both the quantum of access (eg percentage of people with a bank account,

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[8] See http://www.finmark.org.za/documents/FACharter_Africa.pdf for a fuller description of the concept of access charters

percentage of people excluded etc.) and the quality of people's access (eg time taken to travel to a bank, attitudes towards service providers, such as trust).

Finally, indicators allow for comparisons to be made between countries. An unfavourable comparison with a country considered to be a peer is likely to engender political pressure for quicker results. The World Bank's Doing Business indicators have had this effect in the business climate environment; the World Bank's new Getting Finance indicator exercise (currently in pilot) is intended to have a similar effect. FinScope surveys, now in 12 countries across Africa, can be used for this purpose too.

Conclusion

We have argued in this paper that the FIAT framework is a sound basis for enacting the kinds of technical reforms that dominate financial sector reform processes but they can also build the much-needed political energy to ensure that technical reforms are driven with urgency and that the wider vision behind the reforms is not lost sight of.

Political impetus, therefore, is the "quick fix", being able to start processes of change as well as unblock log jams when they occur. Financial inclusion is, after all, a highly political issue, conferring on those who are financially included a basic freedom - the "freedom to transact"[9]. If fewer than 20% of African adults have an account with a formal or semi-formal financial intermediary[10], an outrageously low figure, this surely is the cue for politicians, and not just officials, to assume greater responsibility for the financial access agenda in their countries so that the business of delivering greater access is prevented from becoming an arid and remote technical exercise and instead becomes something that people will actually vote for in elections.

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[9] Amartya Sen, Development as Freedom
[10] Making Finance Work for Africa