

## **The contribution of the financial sector to reduce poverty**

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For quite a while now, the financial sector has continued to gain ground in the development-policy debate. The United Nations in particular emphasised the link between poverty reduction and the existence of a fully operational financial sector in its Millennium Declaration in the year 2000, where it highlighted the importance the financial sector has on peace and prosperity. The Monterrey and Johannesburg Conferences (both of which were held in 2002) also pointed out the need to strengthen the financial sector owing to its ramifications for sustainable economic and social development.

### **How a functioning financial sector is expected to perform**

What does it take to make a financial sector work properly and why is it so very important for developing countries to have one? In an economy based on the division of labour, having options for money and credit creation is of fundamental importance. Savings deposits should be collected via suitable financial institutions and transformed into loans, and particularly loans for investment purposes. Besides lot-size transformation (small deposits/larger loans) at different terms for the money being deposited and the money being loaned, the institutions also see to maturity transformation and steer and diversify risks (risk transformation). Another key element concerns payments transactions at the regional, national and

international level. However, a functioning and viable financial sector is expected to offer the services described here to more or less all population strata as market players. So much for the general idea. But what is it really like in developing and threshold countries?

### **Financial-sector structure - the Mexican example**

A financial sector that provides access to financial services to all population groups and companies, i.e. to small-income earners, small and micro companies too, is virtually unheard of in these countries. I would like to look into this issue in more depth, citing the threshold country of Mexico as an example.

After two hefty economic crises – the last (so-called “Tequila Crisis”) dating back to the '90s – and subsequent privatisation of the banking sector, the country’s largest banks are now owned by international companies (e.g. the US American Citi Group, the Spanish Banco Bilbao Vizcaya Argentaria (BBVA). As a group, these banks pursue very similar business models which involve concentrating activities on the capital cities and large urban conurbations. The financial services they offer are geared to very specific customer segments, namely to larger-scale companies, many of which have international business dealings, to insurance companies and pension funds as well as to population groups in the high-income bracket. A glance at the operating results generated by these banks proves that this strategy of selective market segmentation is very profitable indeed.

Small and medium-sized companies in structurally weaker regions and the population in rural areas are not served by this group of banks, nor by the commercially oriented national financial institutions, which all consider this segment to be too risky, too fragmented and thus too costly and simply not profitable enough. The upshot is that in Mexico there are cities

with 200,000 inhabitants but not one branch office of these banks.

### **Imbalance in supply and demand**

And yet, these rural, structurally neglected regions still have a significant demand for financial services. Let me quote a few figures to underscore the potential here: Mexico has more than 100 million inhabitants but, according to estimates by the Mexican Ministry of Finance and the Mexican Central Bank, only 25 million at the most are served by the commercial, international and national banks. Of the remaining 75 million inhabitants, some 30 to 35 million qualify as “bankable”, i.e. they have money they could or would like to save or they are eligible for credit by virtue of their employment situation. This group of bankables includes those people who receive remittances, i.e. money from family members working away from home, be it further afield within Mexico itself or abroad. In Mexico, the total of international remittances transmitted via official channels already exceeds 10 billion dollars a year. The IDB (Inter-American Development Bank) estimates that remittances that go through informal channels (e.g. couriers) total the same amount again.

The ongoing offer in terms of efficient financial-service providers is not sufficient to harness this potential in Mexico. The regions outside the urban centres are the domain of the savings banks, known as “cajas” for short, whose focus is on population groups from the lower end of the income bracket as well as on micro enterprises, especially craftspeople and farmers. They are generally set up as cooperative banks, which means their services are limited to their members. At present, there are around 650 cajas. All in all, they have around 3.5 million members. In the past, the cajas were a feature of the informal sector, which means they were neither regulated nor supervised. Over the course of time, this repeatedly resulted in

cases of fraud and embezzlement, money laundering or pyramid systems, which has generated considerable mistrust.

In principle, efforts designed to establish these *cajas* as a kind of self-help group are a welcome move. The fact that the *cajas* often lacked the know-how needed to effect even simple banking operations, along with the absence of external support in key fields such as accounting, liquidity management and risk steering, allowed the deficits plaguing these institutions to manifest themselves strongly time and again. On top of this, the *cajas* were used in the run-up to elections especially to extend state-subsidised loans. However, since the state organs failed to demand repayment of these loans later on, the *cajas* and their members gradually got the impression that loans don't have to be paid back.

What I have just outlined by way of example in Mexico applies to many other developing and threshold countries where the demand for financial services clearly exceeds current offers by existing financial institutions. The British scientists Steven Peachey and Alan Roe have set out in their study "Access to Finance" that "in the advanced industrial economies [...] the [...] rates of access are typically above 80%", while in a developing country like Kenya, "which has one of the better financial systems in Africa" only 10% of the population have access to financial services. In many developing and threshold countries broad segments of the population do not have any chance to take active part in the economic life by gaining access to remittances, to secure and interest-bearing deposits or loans, thus being able to get away from poverty thanks to own economic activities and the mobilisation of own forces and resources.

This is particularly, although not exclusively, true of regions outside urban conurbations. It would, however, be wrong to blame the commercial banks not to provide services to these

neglected customer segments. They follow their own business models, they follow their know-how and they follow the yield requirements of the international capital markets. It cannot be expected that they suddenly change their business model and build up a local infrastructure (IT, branch offices) and local know-how, i.e. invest in staff with knowledge of the local area and retail banking operations on site and vest them with the necessary competence to decide.

Since these commercial banks are not available for this kind of “top-down” approach, the gap has to be closed in a different way, i.e. from the bottom up. The objective is ultimately to satisfy demand by generating local and regional structures focusing on SMEs and all population segments in the financial sector.

### **Generating local structures in the financial sector**

A look back in time at economic history shows that parallels exist between this situation and the one in Europe in the mid 19<sup>th</sup> (nineteenth) century. Even before industrialisation, administrations and socially committed civil societies realised that the average man and small craft enterprises also needed institutions capable of catering for their financial needs. They needed a safe haven to deposit their savings which were their only safeguard against life’s ups and downs. They also needed credit to run their “mini business” and thus to be able to feed themselves and their families and to afford an education for their children. This is why, in addition to the cooperative banks, savings banks came to be established in Europe. In fact, the first German Sparkasse was set up more than 200 years ago. Then as now, the savings banks were committed to serving the needs of large population groups and medium-sized business enterprise. In spite of their now different structures and legal status, savings banks still dominate the market in these segments today in Germany, Spain and Austria. As in the past,

the savings banks concentrate on broad segments of the population, attach importance to close customer relations and thanks to their decentralised set-up are able to ensure fast-track decisions through risk assessments based on their good knowledge of the area and their customers.

By establishing local and regional structures, savings and cooperative banks have done a great deal to promote Europe's economic development. Therefore, it is only natural to impart these experiences and the know-how gained in the course of the years to such countries as Mexico.

### **Need for know-how transfers**

The European savings banks, which are strong in the market, follow different paths to promote a targeted transfer of know-how capable of building up local structures in the financial sector of threshold and developing countries. On the one hand, there is the World Savings Banks Institute (WSBI) which currently has over 6,000 member savings banks or similar institutes in more than 90 countries. The WSBI considers the generation of a platform where its members can exchange experience and best practices as one of its main tasks. This can take place through conferences, workshops or through individual consultancy inputs tailored to the needs of the specific institution.

A key contribution, particularly in the field of technical assistance and know-how transfer, is made by the Sparkassenstiftung für internationale Kooperation (Savings Banks Foundation for International Cooperation). Since it was established in 1992, the Sparkassenstiftung has promoted more than 75 projects in over 45 countries where it has not only helped raise the professional capacity of its partner institutes in developing, transformation and threshold

countries, but has also fostered and promoted the development of financial structures.

The fact that this know-how has been in greater demand in developing countries since the 1990s, plus the fact that developed nations are now offering these services so extensively, can be ascribed to a fundamental shift in paradigm in development policy. To quote the sectoral policy paper on Financial Systems Development elaborated by the German Federal Ministry for Economic Cooperation and Development (the BMZ, for short) in cooperation with the Sparkassenstiftung, the focus of interest shifted from “promoting certain target groups through direct lending via individual institutions to reforming the institutional set-up to strengthen the stability and capacity of the financial system as a whole.”

### **Developing efficient financial systems**

What does the development of an efficient financial system really entail and how does this translate into hands-on implementation in a developing or threshold nation? Again, let me refer to the example of Mexico here to explain what inputs the experts from the Sparkassenstiftung have made in this context.

Financial-sector development can be approached at three levels, namely at:

- the macro level
- the meso level
- and the micro level

I would like to take a brief look at each of these levels.

## Macro level

In terms of a stable, macro-economic environment, a financial sector mainly needs adequate laws and regulations to give it the legal security it requires. Key legislation in Germany includes, above all, the German Banking Act, the Bundesbank Act or the law on financial service regulation. These laws stipulate, for example, which rights and duties a financial institute has, which qualifications are required to run a bank and which powers are invested in the bank supervisory authority. Key components of a stable, macro-economic environment also include, for example, free competition amongst the market players or the existence of a transparent system of taxation.

As already outlined, the savings-bank sector in Mexico was not included in general banking legislation. However, in spite of the mainly negative experience with the *cajas*, the Mexican government, with President Fox as the driving force, still saw sufficient potential in them to order their development into banks for the population at large as well as for small and medium-sized companies. To this end, Mexico's parliament adopted a savings-bank law whose core elements are based on the legal regulations in force in Germany, primarily the savings banks acts in the federal German states and the laws governing cooperative banks. Experts from the Sparkassenstiftung and specialists from the German Sparkassen-Finanzgruppe supported this process with consultancy services. Particular focus was placed on the specific rating duties that apply to lending operations, on the obligation to establish a deposit-insurance fund, including details of how this fund is to be managed, and on each *caja's* obligation to be audited by the association of which it is a member. This so-called delegated auditing by the associations is also based on the German model for savings and cooperative banks. It supplements and reinforces the audits by the bank supervisory authority.

## **Meso level**

At the meso level, the focus is on the structure above the respective institutions.

Auditors, rating agencies, networks and associations, credit bureaus, transfer and payment systems or information technology are key support services for a competitive financial sector and essential for the long-term viability of retail financial institutions.

At this level in Mexico, the Sparkassenstiftung's contribution primarily concentrated on helping develop a concept aligned with the Mexican situation that would facilitate the design and generation of umbrella associations for the cajas. This intervention was spearheaded by activities designed to upgrade auditors in the auditing units and to provide ongoing support for the establishment of an association in line with the new standards, along with training for association staff members to empower them to work as advisers in the individual cajas.

## **Micro level**

The micro level is all about strengthening and further upgrading the individual financial institutions which could be banks, non-governmental organisations (NGOs), cooperatives or other financial institutions with a certain special status.

In the case of the Mexican cajas, one of the Sparkassenstiftung's ongoing tasks involves using a set procedure and achieving specific target objectives in all areas of banking activity, so as to upgrade the cajas' status such that they qualify for official recognition as formal financial institutions by the Mexican banking supervisory authority.

## **Transforming the formal financial sector**

This process of transformation from informal to formal-sector financial institutions is an important and logical next move which heralds an improvement in the quality of each individual institution; a stamp of quality on the part of the bank supervisory authorities, as it were. For the customer, this translates into more trust and security. Ultimately, the aim has to be to strengthen the financial sector as a whole via this transformation process and thus to make financial policy more transparent. In many countries, and with the public good in mind, a lot of NGOs are now active in the field of microfinance. Microfinance encompasses all financial services of importance to poorer population groups. These NGOs belong to the informal sector and are, as a rule, dependent on financial support by international donors. More often than not, however, these NGOs cease to be viable once external funding is capped. For this reason, it is certainly in the interest of development policy to enhance the professional status of these NGOs as early on as possible, and so render them sufficiently profitable to become sustainable institutions even without subsidisation. Once they have attained this status, they are only a small step away from the formal financial sector – a step that they should definitely dare to take.

The fact that profitability and poverty reduction are not a contradiction in terms has been proven by a number of microfinance institutions that have moved on from their NGO status to become a fully-fledged bank. A good example here can be found in the Philippines. CARD, the Center for Agricultural and Rural Development, evolved from a women's initiative into a Rural Bank and now boasts almost 140,000 female customers. This institution increasingly gives thousands of small craftswomen a basis and perspective in their lives. Meanwhile this project has become such a success

that we are able to export it from the Philippines to Vietnam in cooperation with major partners.

Summarising I would like to underline that access to finance is an elementary precondition to reduce poverty. According to our experience it is possible to develop local structures for financial services in developing and threshold countries – with the know-how of the established and local oriented Sparkassen – which are economically able to give broad population segments and small enterprises access to financial services without government subsidies, particularly by intensively co-operating on a national level, and thus significantly contributing to the reduction of poverty.

I would like to close here, but before I go may I just thank you for your kind attention.