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## ON INSTITUTIONAL TRANSFORMATION

The literature on the institutional determinants of economic prosperity has yet to yield solid policy prescriptions. The good news is that everything that we know about economic growth suggests large-scale institutional transformation is hardly ever a prerequisite for getting growth going.

Dani Rodrik

Source: Dani Rodrik. 2007. *One Economics Many Recipes*. Princeton: Princeton University Press. p.190.

## From Exclusion to Inclusion

### Challenges to Developing Enabling Policy and Regulatory Frameworks for Microinsurance



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#### BACKGROUND

As emerging markets worldwide move on to a higher growth trajectory, there is a growing consensus that increased participation of the economically weak segments of population in the process of economic growth is important to sustain and accelerate the growth momentum. Promoting financial inclusion by way of providing access to financial services delivery mechanisms at an affordable cost to the excluded segments of the population is now seen in many countries as a condition sine qua non for poverty reduction and social harmony in the financial landscape. The development of microinsurance is a central element not only for the promotion of inclusive financial systems<sup>1</sup> but also for equitable mitigation of risks.

Today, governments in many countries are exhibiting an interest to extend the reach of insurance services to those segments of the population that have remained uninsured or under-insured. One noticeable development is the developmental role assumed by insurance supervisors in emerging insurance markets such as Brazil, People's Republic of China, India, Pakistan, Peru, Philippines, South Africa, and Sri Lanka to expand access to insurance to the masses. This new role is in addition to their classical role of protecting policyholders through prudential regulations.

From a policy perspective, it is important that the demarcation line between social security programs and market-led approaches is clear, and subsidies do not inhibit market initiatives.

of insurers, innovations in product design, and tax sops. The overriding objective is, of course, protecting the customers against a risk of an insurer to meet its obligations. As a result, an increasing number and variety of insurers, among those large multinationals including insurers and reinsurers, but also small mutual insurance providers, have been recognizing the huge potential demand for microinsurance.

By recognizing the specific characteristics of microinsurance and marrying it with the tried-and-tested practices of regulating insurance activity, they are developing enabling regulatory frameworks that support the orderly development of the insurance market across a broad spectrum of the population. This facilitatory role is expected to improve market efficiencies and allow inclusion of low-income households hitherto unable to access or afford insurance. It is reflected in the form of recognition of alternate distribution channels, incentive structures, payment mechanisms, different forms

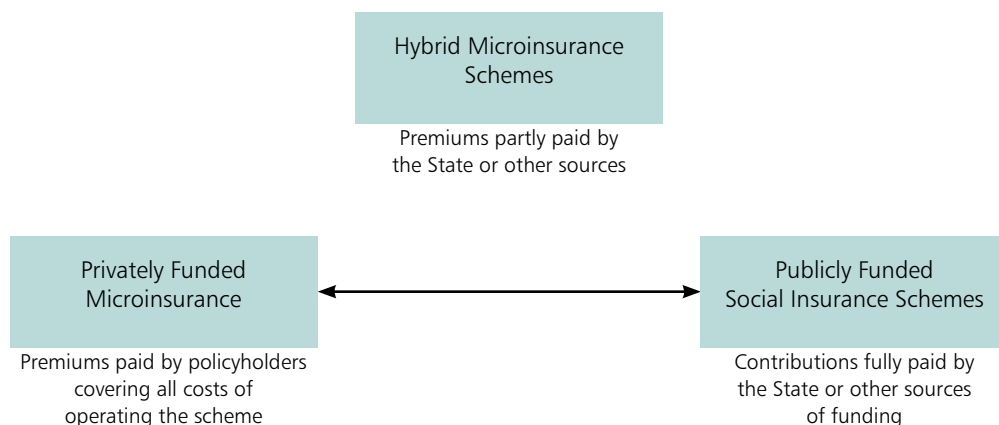
### THE NEED FOR DEFINING MICROFINANCE

The definition of microinsurance continues to be a subject of debate and discussion. The funding of microinsurance runs along a continuum where premiums may be fully paid by the policyholders (privately funded) or they may be partially or fully paid by the State (hybrid schemes and publicly funded) or other components of society, such as formal sector employers (cross subsidies through the contributions paid to statutory social security schemes). The roles of all the entities in the continuum should be viewed as complementary while achieving the highest possible level of protection and coverage.

Many insurance supervisors for good reasons are wary about promoting microinsurance. A major concern stems from the fact that as prudential supervisors they should not be perceived to be erring by being responsible for promoting institutions and risk-coping mechanisms which run a systemic risk. From a policy perspective, it is important that the demarcation line between social security programs and market-led approaches is clear, and subsidies do not inhibit market initiatives.

To establish a sound insurance market, public confidence in the institutions concerned is of prime importance. Confidence can only be strengthened and maintained if institutions deliver reliable and quality services and consumers' interests are protected. In this respect, the institutions responsible for supervising insurance schemes must be in a position to promote the long-term stability of service providers through monitoring of their

FIGURE 1: THE PREMIUM CONTRIBUTIONS CONTINUUM



financial soundness and their treatment of customers. These aspects are particularly relevant for microinsurance since, on the one hand, many microinsurance schemes operate beyond regulatory purview or are regulated and/or supervised by an authority which is not the insurance supervisor of the concerned jurisdiction. At the same time, customer protection for low-income households is particularly critical since less-educated consumers are more vulnerable to fraudulent schemes and mis-selling.

A definition is helpful in identifying the entities that need to be regulated and in providing a rationale to the supervisor to justify any differentiation between the insurers regulated by the insurance laws, the ones regulated by other laws, or the entirely unregulated ones. To minimize the risk of failure and regulatory arbitrage for all market participants, the governmental body responsible for the supervision of different insurance providers should be clearly defined in the respective laws.

The International Association of Insurance Supervisors (IAIS)<sup>2</sup> and the Consultative Group to Assist the Poor (CGAP) Working Group on Microinsurance<sup>3</sup> in their joint paper Issues in regulation and supervision of microinsurance have defined microinsurance, which has been broadly accepted by the supervisory community (Box 1).

## CATEGORIES OF MICROINSURANCE PROVIDERS

In the context of microinsurance, one can distinguish between three categories of providers according to the specific rules and regulations (insurance and others) that apply to them (Figure 2). Entities in the first category are regulated under the insurance law, and are supervised by the insurance supervisor.

The second category is regulated under any other law (other than insurance law). These entities are regulated and/or licensed by authorities and are not always based on insurance regulatory principles and sometimes supervised on the basis of a different set of rules.<sup>4</sup> As a result, supervision may be rather weak compared to supervision by an insurance supervisor.

The third category are the informal providers, which could be individual persons or groups of persons (associations without registration and formal backing), who pool their risks under no legal setting at all. They are not subject to any type

### BOX 1

## Definition of Microfinance

International Association of Insurance Supervisors (IAIS) and the Consultative Group to Assist the Poor CGAP Working Group on Microinsurance have defined microinsurance. This definition was widely accepted among the insurance supervisors.

“Microinsurance is insurance that is accessed by low-income population, provided by a variety of different entities, but run in accordance with generally accepted insurance practices (which should include the Insurance Core Principles).” Importantly this means that the risk insured under a microinsurance policy is managed based on insurance principles and funded by premiums. The microinsurance activity itself should therefore fall within the purview of the relevant domestic insurance regulator/supervisor or any other competent body under the national laws of any jurisdiction.

*Explanatory note: Microinsurance therefore does not include government social welfare as this is not funded by premiums relating to the risk, and benefits are not paid out of a pool of funds that is managed based on insurance and risk principles. For the same reason, it does not include emergency assistance provided by governments in, for example, natural disasters, floods/fires in low-income townships, etc. However, as risk manager of last resort, the State may determine that there is a need to sponsor access to microinsurance for the most underprivileged through redistributive practices. There are cases where the State plays a stronger role in fully funding schemes, but these would only be considered microinsurance if they are run according to insurance principles.”*

Source: IAIS and CGAP Working Group on Microinsurance. 2007. *Issues in Regulation and Supervision of Microinsurance*.

of supervision and are unregistered. These insurers fill a gap and play a useful role in providing protection to low-income households. They have the advantages of cost-efficient delivery mechanisms, have little initial cost, and can freely innovate since they are not constrained by insurance regulations. This is particularly true for informal insurers. However, when schemes grow, appropriate regulation and supervision may be required.

While the supervisor may seem justified for not encouraging insurance entities with weak ownership and capital to be licensed, it is sometimes difficult to explain denying small organizations—often locally based and oriented toward the low-

income market—a license because of stringent requirements that they can never fulfill (e.g., ownership structure, legal form, and minimum capital), which are actually inappropriate for the types of services that they are providing. As a result, they are left with no option but to operate in quasi-legal “grey” areas, outside the insurance laws and escape prudential or market conduct supervision. To avoid attracting the attention of supervisors and risking closure of their operations, they often give their products names other than insurance. In many jurisdictions, for example, health care facilities operate parallel schemes offering free or discounted access to health care in exchange for regular payments (premiums). The customers subscribing to such schemes are not holders of an insurance policy and in case the hospital decides not to fulfill its promises, there is little recourse.

The IAIS Insurance Core Principles and Methodology<sup>5</sup> (2003) does not contain an explicit explanation on permissible activities, as the Basel Core Principles Methodology<sup>6</sup> does. However, the IAIS Supervisory Standard on Licensing (1998) contains a comparable provision<sup>7</sup> that indicates that there may be “insurance business which may not be licensed” since the sums insured do not exceed certain amounts, or that losses are compensated by payments in kind, and that the activities are pursued following the idea of solidarity. This may be helpful in

designing alternative structures for regulating and supervising informal insurance. The question of responsibility for supervision should be clearly answered. It will also be useful to develop principles which assist in identifying the entities that need to be regulated and in providing the rationale to the supervisor to justify any differentiation between the insurers regulated by the insurance laws, the ones regulated by other laws, or the entirely unregulated ones.

Insurance supervisors remain wary about microinsurance providers who “operate underground.” Although not licensed or supervised, informal providers may need to be registered so that supervisors are aware of their existence and can take remedial actions if deemed necessary. Interventions may include enforcing a licensing procedure in case the scope and scale of activities of a microinsurance provider exceed certain limits. Insurance activity which is not well regulated and supervised is rarely priced on actuarial principles and schemes or institutions found lacking in terms of providing for sufficient technical provisions and reserves. This also has negative ripple effects on the clients as:

- greater risk means higher premiums as the unregulated insurer tries to cover unanticipated risks;
- uncertainty increases the likelihood of discontinuation of membership; and

**FIGURE 2: OVERVIEW OF INSURANCE PROVIDERS ACCORDING TO THEIR LEGAL STATUS**

CATEGORY 1	CATEGORY 2	CATEGORY 3
Organizations regulated and licensed under the insurance laws (insurers)	Organizations regulated and/or licensed under any other law (formal entities under laws other than the insurance law)	Informal schemes (unregistered and under no legal setting)
<ul style="list-style-type: none"> <li>• Commercial insurers (joint stock companies)</li> <li>• Cooperative or mutual insurers (member-based)</li> </ul> <p><i>Some jurisdictions exempt certain insurers from being supervised even though they do insurance business.</i></p>	<ul style="list-style-type: none"> <li>• Funeral societies or associations</li> <li>• Cooperatives under the cooperatives authority</li> <li>• Mutuels under the mutual authority or under other laws</li> <li>• Health insurance schemes or health providers under health authorities</li> <li>• Insurance offered through post offices under the postal authority</li> <li>• Nongovernment Organizations (NGOs)</li> </ul>	<ul style="list-style-type: none"> <li>• Funeral parlors or unregistered death benefit associations</li> <li>• Informal groups and community associations</li> </ul>

- irregular contributions threaten the sustainability of the scheme or institution. It also threatens the safety of the scheme's funds and impedes its orderly development, which further denies it the opportunity to remain competitive in the long run.

The agents or other delivery channels of the informal insurers remain unlicensed and hence, not supervised. As a result, clients have no consumer protection and have to rely solely on trust. Funeral societies may be the most common form of micro-insurance scheme outside of the insurance law. Although they may be registered under the societies act (or some equivalent legislation) and may be considered formal, they are not licensed as insurers.

Some jurisdictions have recently responded by setting capital requirements according to business level/and/or risk acceptance level thereby facilitating microinsurers migrating to a licensed insurers' status. However, one needs to wait for a while to assess the outcome of such interventions. In some situations, regulatory forbearance toward insurance schemes outside of the insurance law may be more desirable than creating a new regulatory framework, at least until sizable schemes are enough to justify regulating them under the insurance law.

## DEVELOPING REGULATORY FRAMEWORKS FOR MICROINSURANCE

The worldwide integration of economies and financial markets is increasing, and a sound and vibrant insurance and reinsurance industry is needed to sustain global economic growth. The growth of microinsurance can only contribute to this development if the rules underpinning its regulation and supervision strike the right balance. Investors and consumers have to be protected, but operators must enjoy the freedom to innovate and experiment.

There is no uniform view on what the appropriate policy objectives for the regulation of the insurance sector should be. The following are, however, generally accepted as the most relevant objectives for insurance regulation.<sup>8</sup>

- Safeguarding the solvency of firms involved in the provision of insurance policies (which can also be described as essential for ensuring the stability of the sector);
- Protecting consumers or policy holders;

- Increasing the competitiveness of the market and its efficiency (including the adoption of new technologies and innovation);
- Developing the market, including formalizing financial services to low-income clients; and
- Supporting other strategic (non-insurance) objectives such as compliance with international standards or law enforcement (e.g., Anti-Money Laundering/ Combating the Financing of Terrorism controls).

Traditionally, the focus has mostly been on regulating solvency and consumer protection and, to some extent, market efficiency. More recently, however, the focus has expanded to also include market conduct and market development objectives. In addition, many emerging market jurisdictions have a dual focus, which also includes pursuing the development objective such as financial inclusion and making insurance available and accessible to the informal sector. These twin objectives are particularly challenging and needs to be managed, aligned, and prioritized within limited resources.

To fulfill this objective, some supervisors have started with attempts to contribute to the creation of regulatory frameworks, including their supervisory systems, which will enable large parts of the population to access insurance services. It is being increasingly recognized that an enabling policy environment is essential for the development of microinsurance institutions. Emerging evidence (*see Box 2 on page 6*) reveals that supervisors can directly influence the development of microinsurance by aligning regulatory and supervisory practices to the specific characteristics of their jurisdictions. Such interventions include:

Some supervisors have started with attempts to contribute to the creation of regulatory frameworks, including their supervisory systems, which will enable large parts of the population to access insurance services.

## BOX 2

## Emerging Evidence of Regulatory Adaptations

- In India, the Insurance Regulatory and Development Authority (IRDA), with its microinsurance regulations, has relaxed agent regulations, promoted linkages between regulated insurers and nongovernment organizations (NGOs), introduced product features, and allowed composite insurance services (however, with different risk carriers behind the service).
- In Brazil, the insurance supervisor has developed microinsurance products for car and life insurance and promoted sector dialogue on microinsurance, both of which motivated the industry to become interested in the low-income market. The parallel tax relief for life insurance has also added to expansion in microinsurance provision.
- In the Philippines, the Insurance Commission has adapted its regulations of Mutual Benefit Associations (MBA), which are recognized under the insurance law, by creating a new form (or tier) of "Microinsurance (MI) MBAs" with specific rules. Such rules include simple products, stipulated requirements to comply with performance standards, and defined eligibility criteria for microinsurance products based on the benchmark of the minimum daily wage for nonagricultural laborers. Compared to traditional MBAs, MI-MBAs are subject to lower entry requirements such as a lower guarantee fund.
- In Peru, the supervisor has issued a microinsurance regulation for the insurance industry and its agents such as microfinance institutions, trade unions, and others. The new rule includes, for example, a definition for microinsurance, requirements for simple products, for group and individual insurance, for claims handling, and for simplified reporting to the supervisor.
- In Senegal and Mali, a regulation on micro health insurance has been adopted. From 2004 to 2006, in a participatory process, eight UEMOA (Union Économique Et Monétaire Ouest Africaine) West-African jurisdictions were engaged to draw legislation on mutual social health organizations. The draft regulation is currently under review at UEMOA. This work aims at taking into consideration the specificity of those institutions (that are private, nonprofit, based on solidarity, covering a social risk). The rules, in particular prudential, were drafted with the aim of protecting the individual consumers and of not putting too much burden on still new and fragile institutions.

Source: Adapted from Chatterjee, Arup, *The Role of Regulation, Supervision and Policy in Expanding Access to Insurance*. Presentation at the Regional Workshop on Access to Insurance for the Poor organized by The World Bank (Rio de Janeiro, Brazil, May 2007).

- adjusting rules, regulations, and supervisory practices to microinsurance;
- requiring disclosure from regulated risk carriers regarding involvement in microinsurance;
- providing market analysis on market needs, to motivate insurers to go down-market;
- regulating new distribution channels who are familiar and enjoy the trust of the low-income households;
- incentivizing or even mandating unregulated risk carriers to become licensed;
- creating grievance redressal channels and resolution systems appropriate for low-income policyholders;
- increasing policy makers' awareness of microinsurance and facilitating dialogue (especially on tax issues or social security schemes) in case these services have features which are counterproductive to private-led microinsurance;
- ensuring that products and procedures are tailored to the needs of low-income households; and
- promoting consumer awareness and understanding of insurance.

The development of the microinsurance market presents a number of inherent challenges for the supervisor. Unlicensed insurance schemes can do harm, especially for low-income households. Therefore, supervisors may define a threshold beyond which informal schemes have to have an insurance license. The criteria used in drawing the line between regulated and unregulated entities shall depend on the country situation—number of customers, premium volumes, or even the supervisor's capacity. Supervisors are also challenged to strike a balance between extending insurance to the low-income segments and protecting the investments and confidence of these households. The capacity of the supervisor is a critical element here, especially since supervisors may have priorities that are more pressing. To prevent regulatory arbitrage, it would be useful if one agency is responsible for supervising insurance activities, instead of having multiple ministries or government departments involved. It can also help to develop an activity-based approach, rules, and regulations which are valid for any type of supervised insurance provider.

In terms of the overall approach to microinsurance regulation, two main strategic lines can be distinguished: the activity-based versus the institutional approach of regulating microinsurance,

as summarized in Figure 3. A combination of both approaches is also possible.

## MICROINSURANCE AND IAIS INSURANCE CORE PRINCIPLES

Insurance is a capital-intensive industry requiring large start-up costs and financial commitments, modern technology, and a well-educated workforce. It also depends on a policy, institutional, and legal framework for financial sector supervision in place; a well-developed and effective financial market infrastructure; and the existence of efficient financial markets. The lack of any or a combination of essential conditions could affect the quality and efficiency of insurance supervision.

This is particularly true in developed economies. However, in emerging market jurisdictions, this situation may not be always prevalent.

The IAIS Insurance Core Principles (ICPs) (*see Box 3 on page 8*) cover the essential aspects of insurance regulation and prudential supervision. However, when applying these principles to insurance services for low-income segments, it is necessary to recognize the specifics of microinsurance and the risks posed. The starting point for creating inclusive insurance markets is for insurance supervisors to develop an enabling framework to actively support the expansion of access to insurance through microinsurance, on efficient lines keeping in mind the need for

**FIGURE 3: FUNCTIONAL VERSUS INSTITUTIONAL REGULATION OF MICROINSURANCE**

APPROACH	FUNCTIONAL REGULATION	INSTITUTIONAL REGULATION
	Microinsurance as an activity line, also called <b>activity-based approach</b>	Microinsurance as an institutional type, also called <b>institutional approach</b>
Description	All institutional types of microinsurers (those under the insurance law but also institutions under other laws) have to follow two sets of rules: <ul style="list-style-type: none"> <li>• The same rules and regulations as far as certain aspects of microinsurance provision are concerned.</li> <li>• In terms of their particular institutional type, they follow the rules defined for it.</li> </ul>	A risk carrier can obtain a license as a microinsurer which is separately regulated, such as <ul style="list-style-type: none"> <li>• MBAs in the Philippines under the Insurance Law, and</li> <li>• upcoming health microinsurers in West Africa with a separate regulation and supervisory body.</li> </ul> <p>A specialized microinsurer can also be regulated as joint-stock company, e.g., requiring lower minimum capital than large conventional insurers. Examples under this model are only known from microfinance.</p>
Which rules and regulations can be specifically defined?	Microinsurance defined as an activity line can have the following specific requirements that are valid regardless the institutional type: <ul style="list-style-type: none"> <li>• reporting,</li> <li>• underwriting,</li> <li>• transparency,</li> <li>• resolution of disputes,</li> <li>• agents or other delivery channels, and</li> <li>• claims handling.</li> </ul> <p>This list provides some examples and must be tailored to each jurisdiction.</p>	For a new institutional type of microinsurer, specific regulations can be developed, e.g., for <ul style="list-style-type: none"> <li>• governance,</li> <li>• minimum capital,</li> <li>• on and off-site supervision,</li> <li>• investments, and</li> <li>• agents or other delivery channels.</li> </ul> <p>This can be either lower or higher.</p>
Advantages	All insurers deal with their microinsurance portfolios in the same way. Regulatory arbitrage is minimised.	A specialized type of microinsurer, e.g., with lower entry requirements and limited operations allowed can be created.

Source: Wiedmaier-Pfister. 2007. *Regulation and Supervision of Microinsurance* (Internal Presentation). Eschborn: GTZ.

## BOX 3

## Insurance Core Principles

<p><b>Conditions for effective insurance supervision</b></p> <p>ICP 1 Conditions for effective insurance supervision</p>	<p><b>Prudential requirements</b></p> <p>ICP 18 Risk assessment and management  ICP 19 Insurance activity  ICP 20 Liabilities  ICP 21 Investments  ICP 22 Derivatives and similar commitments  ICP 23 Capital adequacy and solvency</p>
<p><b>The supervisory system</b></p> <p>ICP 2 Supervisory objectives  ICP 3 Supervisory authority  ICP 4 Supervisory process  ICP 5 Supervisory cooperation and information sharing</p>	<p><b>Markets and consumers</b></p> <p>ICP 24 Intermediaries  ICP 25 Consumer protection  ICP 26 Information, disclosure and transparency toward the market  ICP 27 Fraud</p>
<p><b>The supervised entity</b></p> <p>ICP 6 Licensing  ICP 7 Suitability of persons  ICP 8 Changes in control and portfolio transfers  ICP 9 Corporate governance  ICP 10 Internal control</p>	<p><b>Anti-money–laundering activities, combating the financing of terrorism</b></p> <p>ICP 28 Anti-money–laundering activities, combating the financing of terrorism (AML/CFT)</p>
<p><b>Ongoing supervision</b></p> <p>ICP 11 Market analysis  ICP 12 Reporting to supervisors and off-site monitoring  ICP 13 On-site inspection  ICP 14 Preventive and corrective measures  ICP 15 Enforcement or sanctions  ICP 16 Winding-up and exit from the market  ICP 17 Group-wide supervision</p>	<p><b>Markets and consumers</b></p> <p>ICP 24 Intermediaries  ICP 25 Consumer protection  ICP 26 Information, disclosure, and transparency toward the market  ICP 27 Fraud</p>
<p>Source: IAIS. 2003. <i>Insurance Core Principles and Methodology</i>. Basel: IAIS.</p>	

providing an adequate framework for policyholders' protection and financial stability.

Insofar as microinsurers are concerned, there might be different conditions in place to serve the needs of low-income households compared to insurers who primarily target the higher income segments of the population. The supervisor therefore needs to take the specifics of microinsurance as explained in previous sections into account while setting up regulatory and supervisory requirements.

### PRUDENTIAL ISSUES

There is no dispute over the fact that capital requirements, including a sound and appropriate solvency regime as is preva-

lent in case for insurers regulated by the insurance law, should be an essential part for the successful supervision and provision of microinsurance. Prudential regulation focuses on institutions, with the aim of protecting their solvency or viability by setting capital adequacy requirements, and systems for managing various risks and setting limits on risk accumulation for managing exposures of an insurer's balance sheet. Prudential rules are also there to protect the structures themselves as well. Prudential supervision is also concerned with preventing a problem in one institution from spreading more widely in the financial system.

The legal form, the manner of conduct of business, and the risk portfolio of the insurer may help specify the criteria for

determining the minimum amount and forms of capital that are suitable and that can be allowed. This might vary between individual insurers. Some justify the creation of a special institutional form for microinsurance with lower capital requirements—i.e., capital commensurate to the risk in their books, coupled with caveats which restrict the scope of operations to a limited market segment—in response to the lower risk profile that microinsurance is exposed to may be one of the feasible solutions. The correlation between the risk profile and capital which may ultimately justify lower capital requirements or other relaxed rules needs to be carefully determined to ensure that introduction of such regulations does not become counterproductive by permitting a scope of regulatory arbitrage. There might also be an inherent risk of insolvency or nonfulfillment of legal obligations, either because of weak risk assessment or even its absence (health, environment, etc.), and limited possibilities of risk sharing (reinsurance).

The application to microinsurance business of a prudential solvency regime could be achieved through implementing adapted treatments, consistent with the overall solvency regime, whereby the application lies within the power of the supervisory authority. For example:

- very small undertakings typically have less complex risk profiles;
- the costs of interpreting, applying, and checking compliance with regulation may be disproportionately high given the immaterial nature of the risk; and
- such undertakings may provide products or services that are very specific to national markets (or even specific affinity groups), and it would not be in the interests of policyholders to cause the withdrawal of such business by imposing an excessive regulatory burden.

Both past and potential future events can impact the asset and the liability sides of the insurer's balance sheet, and the insurer's cash flow.<sup>9</sup> The identification and management of risks in the microinsurance environment are just as important as in the traditional insurance environment. It might be costly to expect a specialized microinsurer to have comprehensive risk assessment and management policies/systems in place. Insurance providers should concentrate on the significant risks they face. Risk management could serve as a controlling instrument to assess strength and weaknesses of the insurer. Therefore, there

is need for guidelines specifying the minimum internal controls, operating limits, and other practices to ensure that investments risk exposures are maintained within levels consistent with prudential standards and risk tolerance, as defined by internal limits. It is also important to require that the hidden costs and the amount of “grants and external financial aid” in the balance sheet appear clearly so that financial reports and situation remain sound.

#### **GOVERNANCE ISSUES (FIT AND PROPER, TRANSPARENCY, AND DISCLOSURE)**

Fit and proper requirements are specific requirements concerning the personal or professional qualification of shareholders, members of the board of directors, and other managers. Those key functionaries should be defined by regulation. Depending on his/her position and the legal form of the microinsurer, these qualities could relate to a proper degree of integrity in attitude; personal behavior and business conduct; soundness of judgment; degree of knowledge, experience, and professional qualifications; and financial soundness. The extent to which reasonable adaptations can be made for microinsurance, particularly in case of smaller insurers

The correlation between the risk profile and capital which may ultimately justify lower capital requirements or other relaxed rules needs to be carefully determined to ensure that introduction of such regulations does not become counterproductive by permitting a scope of regulatory arbitrage. There might also be an inherent risk of insolvency or nonfulfillment of legal obligations.

The insurance industry is susceptible to fraud both by the customers and the channel partners. There is a need to have a clear understanding of the areas where fraud can arise and where these are likely to differ significantly from traditional insurance.

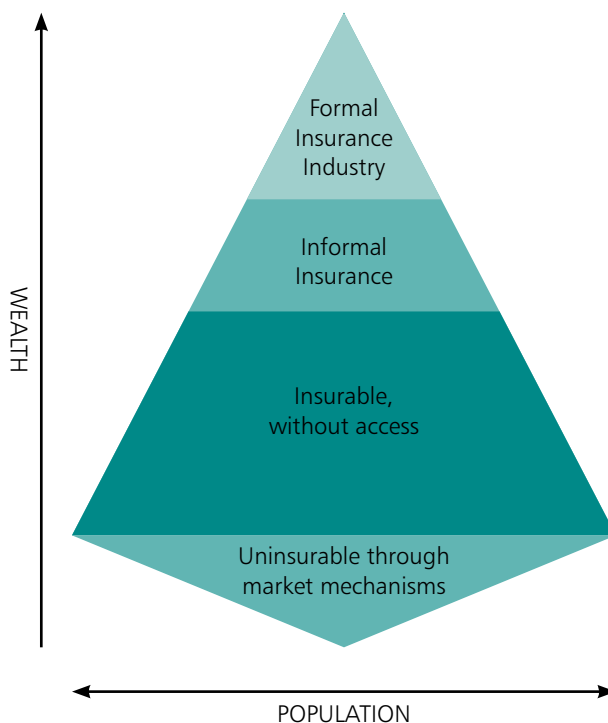
#### MARKET CONDUCT ISSUES

Efficient and effective procedures and processes should be in place for lodging complaints and resolution of disputes between insurers/insurance intermediaries and their customers, keeping in mind that low-income households are likely to require alternative channels for communication and redress of complaints compared to mainstream insurance customers. The insurance industry is susceptible to fraud both by the customers and the channel partners. There is a need to have a clear understanding of the areas where fraud can arise and where these are likely to differ significantly from traditional insurance. A collective

which might require a different management profile and knowledge, needs to be examined.

Even though the complexity or simplicity of a microinsurance product will vary from those provided by traditional insurance, the level of professional expertise that will be required in relation to the product should be similar to those applicable to the large insurers only in certain spheres. Guidelines should identify circumstances where actuarial certification and assistance may not be required or be more flexibly used. In the same manner, insurers having microinsurance operations should preferably report separately on their microinsurance products to help build a credible database for improved supervision besides compilation of comprehensive, accurate information on microinsurance for further analysis and use by policy makers and donors.

FIGURE 4: WHO IS INSURED BY WHOM?



Source: Michael McCord, presentation at IAIS tri-annual Meeting, May 2006, Ottawa.

effort to prevent fraud by all players could promote microinsurance.

There have been instances where fraudsters who pose as authorized insurers/intermediaries issued fake policies. Low-income households are more prone to fall into these traps in comparison to traditional insurance customers who are normally expected to have an overview of the market and have better coping mechanisms in place. Issues of trust in microinsurance could also be potentially addressed through an appropriate intermediation structure. To reduce the risk of fraudulent activities, the supervisor should ensure that the intermediaries' actions are supervised, including inspection of office and records, and complaints against the microinsurance intermediaries are disposed with speed and promptitude. However, such a regulatory provision can be costly and difficult to implement.

Finally, technology may be the way of reducing costs so that services can be provided cheaply, besides limiting fraud and

## BOX 4

# Issues in the Regulation and Supervision of Microinsurance

### Should insurance supervisors assume responsibility for promoting microinsurance?

In some jurisdictions, policy makers and supervisors have already developed innovative approaches to promote microinsurance. In others, microinsurance has developed on its own without any supervisory or other government intervention. However, there is an emerging view that a clear policy direction from the government is important for the supervisor to implement the development mandate.

### What about the issues of policyholder protection versus access?

Which particular regulations related to market conduct could protect microinsurance policyholders, who by definition are unaware of the details of insurance products and thus may have limited options to address inappropriate actions by an insurer? Which regulatory approaches have proven effective in balancing protection with broad accessibility? Eliminating a low-income family's access to microinsurance in order to protect them is not appropriate. Likewise, compelling disinterested insurers to offer products in this market may also lead to undesirable outcomes. Thus, the two extremes of protection and accessibility are not good solutions for this market. The answer is somewhere in the middle with some appropriate protections coupled with some promotion of insurers offering products to this market.

### Can a tiered approach to microinsurance regulation work?

To include microinsurance activities by those without an insurance license, a tiered approach for microinsurance regulation might be appropriate. Second- and even third-tier insurers (as opposed to the first tier) have lower cost levels and simpler institutional designs, which allows them to serve the low-income market where premiums are substantially lower than in the formal market. This is associated with less regulation, simpler products, and often innovative collection and distribution systems. However, one should bear in mind that creating a new institutional type requires significant time and investments in capacity and systems of the supervisor and the new providers.

### Is there capacity within the supervisor's office to supervise adequately the microinsurance activities that it deems important to regulate?

Creating rules to govern microinsurance without the ability—in terms of both people and knowledge—to enforce those rules will undermine the authority of the supervisor. Therefore, supervisors should consider carefully the options to change the regulatory framework, keeping in mind that a gradual approach to microinsurance regulation can start with allowing new delivery channels and creating effective consumer recourse mechanisms. Supervisors can also approach international development agencies for technical support.

Source: Chatterjee, A., and Wiedmaier-Pfister. 2006. *Discussion Paper for Insurance Supervisors*. Basel: IAIS.

misrepresentation. To reduce transaction costs, public policy must facilitate the use of technology and the creation of low-cost organizational structures to reach the poor. Regulators should set clear guidelines for technology use, security of customer data, and standards for messaging (in the case of mobiles). This should be complemented by a robust mechanism for consumer protection that is well communicated to consumers.

## CONCLUSION

Worldwide, approximately 4 billion people live in relative poverty and have incomes below \$3,000 in local purchasing power. Yet together they have substantial purchasing power. The so-called base of the economic pyramid constitutes a \$5 trillion global consumer market.<sup>10</sup> This is the segment which does not have access to insurance and is insurable through market mechanisms.

While creating policies and regulations for microinsurance, regulators need to analyze the key issues in regulating and supervising microinsurance (Box 4) and its potential impact. Conventional insurance regulators need to understand why microinsurance is relevant and how it works, in order to develop an appropriate framework that supports microinsurance without diluting the essential prudential aspects. Their concern should lie in ensuring that regulations are consistent with international insurance norms and that the growing microinsurance industry should not jeopardize conventional insurance. In particular, regulators need clarity about the implications on capital, investments, risks, incentives and disincentives, potential conflicts, and how they should be managed and applied proportionately. In addition, one needs to appreciate the significance of developing transparency and disclosure in the still-evolving legal and accounting framework.

An efficient and well-founded insurance regulation is one of the features of good governance and gives great strength and certainty to society and the economy. On the other hand, bad or cumbersome regulation not only creates barriers to efficient markets, thereby discouraging competition and innovation, but also alienates citizens from government and can contribute to unfair income and wealth distribution. In this context, insurance regulation should be seen as one of a range of instruments available to policy makers. It can be used instead of, or alongside, other instruments, such as information campaigns.

In today's complex world, regulators must continuously pay close attention to the developments of the marketplace and its evolving composition. This will aid not only in better understanding of the risks and practical concerns faced by insurance providers, but also in thoughtfully considering these issues while setting regulatory modernization agendas. An appropriate regulatory regime serves as an effective tool in developing a feeling of trust among individual policyholders besides raising awareness and the credibility of the microinsurance model. For the foreseeable future, supervisory authorities will continue to face the dual challenges of understanding the industry and striking a balance between providing effective supervision and facilitating the industry's legitimate aspirations for further growth and development.

With its potential to significantly change the insurance industry, the joint responsibility of microinsurance operators, intermediaries, experts, and regulators is needed to ensure the orderly and progressive development of this sector. Fostering greater international cooperation will also help in leveraging, not only in terms of exchange and sharing of information to further accelerate the development of microinsurance globally, but also in terms of creating synergies for the future development of international standards on microinsurance. ■

## ENDNOTES

1. In inclusive financial systems, a greater number of persons, particularly low-income persons, have access to appropriate financial services.
2. Established in 1994, the IAIS represents insurance regulators and supervisors of some 190 jurisdictions. IAIS develops international insurance regulatory standards and strives toward creating a harmonized approach to insurance supervision all over the world with the active involvement of both IAIS member-jurisdictions, as well as by way of regional cooperation with nonmember jurisdictions. Over the years, the standards developed by the IAIS have gained wide international acceptance in the international financial community, and the World Bank and the International Monetary Fund make use of IAIS standards to enhance the development of a sound financial system globally. For more information, visit [www.iaisweb.org](http://www.iaisweb.org).
3. Operating since 2002, the CGAP Working Group on Microinsurance, chaired by the International Labour Organization (ILO) includes representatives from donors and international development agencies and other insurance and financial systems development experts. It supports the development of microinsurance through research, tools, coordination, and awareness creation. A key issue is to identify and support the development of regulatory and supervisory frameworks, as well as policies conducive to protect policyholders, and develop insurance markets for the low-income segments.
4. In West Africa, health microinsurers are not regulated under the CIMA Code that applies to the field of insurance. In South Africa, small insurers established under the Friendly Societies Act (under a certain threshold) are exempt from the Long Term Insurance Act.
5. IAIS 2003. *Insurance Core Principles (ICPs) and Methodology*. Basel: IAIS. The ICPs set out principles that are fundamental to effective insurance supervision and identifies essential aspects which need to be in place to enable an insurance supervisor to have authority and control in effective discharge of its functions. These principles also provide a framework for the IAIS to develop more detailed international standards. It identifies subject areas that should be addressed in legislation or regulation in each jurisdiction and this forms the basis on which standards are developed.
6. See essential criterion 4 to Principle 2 (Permissible activities) and footnote 11. Essential criterion 4 states that "the taking of deposits from the public is generally reserved for institutions that are licensed and subject to supervision as banks." Footnote 11 states that the word "generally" allows for the presence of nonbanking financial institutions which may be regulated differently from banks but do take deposits and provide lending services, given these institutions collectively do not hold a significant proportion of deposits in a financial system. These institutions should be subject to a form of regulation commensurate to the type and size of their transactions.
7. See Section III (paragraphs 15–17) in IAIS. 1998. *Supervisory Standards on Licensing*. Basel: IAIS.
8. Prudential Supervision of Insurance Undertakings, the report on the Conference of Insurance Supervisory Services of the Member States of the European Union (2002). Available: [http://ec.europa.eu/internal\\_market/insurance/docs/solvency/solvency2-conference-report\\_en.pdf](http://ec.europa.eu/internal_market/insurance/docs/solvency/solvency2-conference-report_en.pdf).
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# Microfinance Partnerships: Capacity Building



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In an earlier issue of this newsletter,<sup>1</sup> it was highlighted that while continuity remains, Asia's microfinance industry is in the midst of unprecedented expansion and transformation. A major example of this is the proliferation of microfinance institutions (MFIs) that have moved from simply being providers of microcredit, to offering an array of financial products and services, including insurance, remittances, savings, and payments services. In countries across Asia, MFIs have formed links with banks and other organizations to expand credit outreach, and with economic and social service providers to help manage their credit risks and extend the social and economic impact of their services. While microfinance has been linked to the provision of services—such as health and education—for many years, MFIs are increasingly finding innovative ways of facilitating the expansion of access to a range of products, including telecommunication services, solar energy and biogas, water and improved sanitation, often on a commercially sound basis (*see box on page 14*).

A great deal of these changes are driven by the increased commercialization of the industry, which results in tremendous challenges, including increased competition, inadequate capital supply, the need for innovation in service quality, product design, acquiring and adapting to new technologies, changing or

restrictive regulatory environments, and the desire to maintain social impacts while striving for financial sustainability. Adapting to and overcoming both the changes and challenges holds great potential for the industry. However, this will require much hard work in terms of exploring, building, and maintaining a vital vehicle for success—partnerships.

Partnerships are contributing greatly to the expansion and transformation of the microfinance industry. Microfinance partnerships are providing new ways for MFIs to better enable poor households to protect income and assets, increase productivity and business opportunities, insulate against risks and shocks, and improve health and education outcomes. Innovative partnership approaches are opening up new streams of funding for MFIs, which translates into expanded outreach and new levels of financial sustainability. In addition, commercial banks and private sector companies are increasingly focusing on microfinance as a potential new market and revenue stream.

The increasing commercialization of the Asian microfinance sector means that the ability of institutions to identify, build, and manage their relationships with external parties, and to form mutually complementary strategic partnerships, will become increasingly important to their survival. This extends not only to those institutions directly providing financial services, but also to those that support the industry through financing, capacity building or support services.

An incremental growth in the number of microfinance partnerships is not in itself the only answer to the challenges facing the Asian microfinance sector, just as microfinance itself is not the sole solution to reducing poverty or delivering the full range of developmental services. Partnerships are not appropriate in all circumstances. They can carry significant risks, require a range of management skills which may not be present in all the partners, and can take far more time and resources to establish and maintain than may first appear. However, in appropriate circumstances, and when implemented well, partnerships have

## Microfinance and Energy: Innovation in Partnerships

It is estimated that 1 billion people in developing countries in the Asia and Pacific region do not have access to modern energy services for basic cooking, heating, and lighting. This lack of access compromises both quality of life and health, and places significant limitations on the productive capacity of microentrepreneurs.

"Energy lending"—the use of microfinance to expand access to modern, alternative energy systems—is increasingly providing energy to many clients in Asia. While some key challenges have yet to be resolved, the scope for innovation through partnerships is wide. Currently, microfinance institutions (MFIs) are partnering with energy suppliers or manufacturers to provide alternate, cleaner sources of energy in Bangladesh, India, Indonesia, Lao People's Democratic Republic, Nepal, Philippines, and Sri Lanka. These have employed a variety of models—from partner-agent arrangements to fully integrated energy loans sales-service ventures. Some key examples are the flagship SEWA-SELCO partnership in India and SEEDS, which partners with various solar companies in Sri Lanka.

By making microfinance loans available to pay for modern energy services, MFIs aim to overcome the problem of unfulfilled demand for safe, clean, cheap, and income-generating sources of energy by expanding access to loans for many people living in rural areas. The productive use of energy sources for things such as lighting for businesses, irrigation, refrigeration, telecommunications, education, agricultural and retail/street vending has significant implications for poverty alleviation and improving health outcomes. Objectives

for energy suppliers include expanding markets based on the rural outreach by MFIs, the possibility of innovative product development, and cofinancing opportunities.

However, the introduction of energy products also adds a layer of regulatory requirements to microfinance operations, including issues such as technology specifications and standards. Finding partners for energy lending is often difficult due to the MFI's lack of technical knowledge on alternative energy systems, the energy suppliers' perceptions and attitudes toward the microfinance industry; the challenges of developing appropriate technologies and a poor understanding on both sides of the market and the clients' financial and energy needs. MFIs must also demonstrate that the cost of energy systems can be recovered through end-user payments, and consequently attract private sector investments in energy enterprises. MFIs implementing renewable energy loan programs may be able to leverage government funds that are increasingly being allocated for renewable energy applications, while the World Bank; United Nations agencies, such as the Global Environment Facility; and other international financial institutions provide large-scale funding. However, attracting private sector partners in the form of energy companies and energy retailers is essential in increasing outreach, portfolio diversity, and economic impact of energy lending. Organizations such as the Foundation for Development Cooperation, Global Village Energy Partnership, Green Microfinance, and Sustainable Energy Solutions are playing the role of partnership facilitators in brokering and providing technical assistance to develop partnerships.

shown substantial potential to develop innovative solutions to previously intractable problems.

### THE GROWTH OF PARTNERSHIPS

The growing importance of partnerships in microfinance is not an isolated trend. From airlines to software developers, pharmaceutical companies to footwear companies, strategic partnerships are increasingly recognized as a means to overcome resource constraints and increase profits. It is estimated that over 20% of revenue generated by the top 2,000 US and European businesses in 2007 was the result of "strategic alliances," with this expected to increase in 2008.<sup>2</sup> In 2006, interviews by Pricewaterhouse Coopers of 339 of the fastest-growing companies in the US found that alliances, including joint ventures and contractual partnerships, were considered by more than half as central to reaching their business objectives.<sup>3</sup> More importantly, two thirds expected these to be more important in the future.

Along with lessons and experience from formal business to business private sector partnerships, there is much that can be learned from the experience across many sectors in terms of building successful partnership arrangements between formal and informal private sector institutions, and between these institutions and government. As an approach to sustainable development and poverty reduction, the concept of "multi-stakeholder partnerships" has rapidly gained influence in sectors as diverse as the extractive industries, water and sanitation, information and communication technologies, conservation and the environment.<sup>4</sup>

In the microfinance industry, one of the key challenges for creating and maintaining mutually beneficial partnerships in microfinance—in many cases with nontraditional partners—is that the process may require a different set of skills than currently exist in MFIs, traditional banks, or private sector companies.

This skill set includes negotiation, management, technical know-how, training and education, customer knowledge, and product development. However, necessity being the mother of invention, the challenge of identifying complementary skills sets between organizations has been addressed within a number of successful partnerships. The objectives and nature of these partnerships are as diverse as the range of partners, which include banks, MFIs, nongovernment organizations (NGOs), community associations, government agencies, and other entities in both financial and nonfinancial sectors. Some examples from across the region include:

- In countries across Asia, MFIs have formed links with banks and other sources of funds to expand credit outreach, or with economic and social services providers to help manage their credit risks and extend the social and economic impact of their services.<sup>5</sup>
- In India, Indonesia, Sri Lanka, and Viet Nam, commercial and state banks are forming partnerships with a range of nontraditional partners, including post offices, retail outlets and other nonfinancial partners, self-help groups, and community institutions to greatly expand their outreach in rural areas.
- In Bangladesh, India, Indonesia, and the Philippines, telecommunications companies are forming partnerships with rural banks and MFIs to expand access to microfinance services while reducing overhead and costs to clients.
- In India, 30 million people have access to microinsurance, with the entry of multinational insurers partnering with MFIs across the region providing the greatest contribution.
- In Bangladesh, Indonesia, and the Philippines, access to remittances services has been greatly increased due to partnerships with money transfer companies—often making the link between money transfers, insurance, savings, and therefore better products for recipient households.
- In Bangladesh, India, Philippines, and Sri Lanka, partnerships are being formed between microfinance providers, energy suppliers, and energy retailers to expand access to energy, resulting in health benefits and increasing the productivity of small and medium enterprises.
- Water and sanitation projects in Bangladesh and in Southeast Asia are using microfinance to increase access to clean water and improved sanitation.

## **PARTNERSHIPS IN AN EVOLVING MICROFINANCE INDUSTRY**

A central part of the evolution of the microfinance industry is the change in perception of microfinance from a discreet development initiative to an integral part of the financial sector.<sup>6</sup> This has implications for MFIs in the way that “partnerships” are understood and what is implied by the term. The word “partnership” is used widely and often, and indeed is used interchangeably with terms such as strategic alliance, collaboration, linkage, and a number of other terms describing the relationship between two or more parties. Particularly in the development sector, the term “partnership” is often used to describe less formal contractual relationships, and often indicates a relationship whereby the transfer of funds or knowledge flow one-way from development agencies to MFIs. It is necessary, therefore, to differentiate between “development partnerships” whereby gains and benefits are often not shared but flow from an agency to an MFI, and “strategic alliances or partnerships” whereby both the MFI and partner institutions obtain financial or economic advantages from the relationship.<sup>7</sup>

Regardless of the nature of the partnership, it is imperative that all parties have a clear understanding of the relationship into which they are entering. As discussed later, presumptions on

It is necessary, therefore, to differentiate between “development partnerships” whereby gains and benefits are often not shared but flow from an agency to an MFI, and “strategic alliances or partnerships” whereby both the MFI and partner institutions obtain financial or economic advantages from the relationship.

For MFIs, the primary reasons for entering into partnerships are usually to extend the outreach of services and to broaden the range of financial and nonfinancial services. From a strategic perspective, MFIs need to grow in an increasingly competitive market, often with the difficult aim of achieving sustainability while not compromising their original social mission.

in the nature of the relationship between the parties and their rationale for working together.

the part of MFIs and nontraditional partners flowing from differing interpretations of the nature of their “partnership” may result in difficulties and miscommunications later on in the relationship. For example, while called partnerships, commercial relationships between money transfer agencies and MFIs are often, to be more precise, contractual supplier or commercial agent relationships.<sup>8</sup>

Taking all of this into consideration, an idealized partnership in microfinance might simply be described as: “an alliance between two or more diverse parties (for example banks, other businesses, public agencies, MFIs, NGOs, or community groups) in which partners commit resources to achieve a specific purpose that addresses key challenges that have not successfully been addressed by any one organization acting alone. Partners combine their resources and competencies in a complementary and synergistic way, based on what they do best. They pool resources and share both risks and benefits in a way which is mutually beneficial to each of the partners and their clients.”<sup>9</sup> That is, the partnership is not necessarily defined by what is achieved in terms of profit or impact, but

## PARTNERSHIP OBJECTIVES AND DRIVERS

Incentives for entering microfinance partnerships are often a complex mix of commercial, compliance, and philanthropic objectives. These can include drivers, such as improving profitability, expanding outreach, diversifying products and sources of income, responding to client demand, improving public image, complying with regulations, positioning in new markets, reducing or sharing risks and costs, accessing technical and financial resources, influencing sector policy, enhancing accountability and transparency, or increasing social and developmental impact. Transparency regarding these objectives should be a prerequisite to creating fully-informed partnerships.

For MFIs, the primary reasons for entering into partnerships are usually to extend the outreach of services and to broaden the range of financial and nonfinancial services. From a strategic perspective, MFIs need to grow in an increasingly competitive market, often with the difficult aim of achieving sustainability while not compromising their original social mission. As a core of large, commercially-operated MFIs in countries such as Bangladesh and the Philippines continue to contribute the greatest growth to microfinance in the region through an increasing array of partnerships, survival for most small MFIs is dependent on the capacity to become larger, more competitive, and sustainable. Partnerships enable smaller MFIs to overcome resource and capacity constraints, while driving innovation in the sector among larger, flagship institutions. On the other hand, private sector companies are essentially profit-driven and see downscaling into microfinance as a way of expanding their client base and increasing revenue, even where business drivers might be philanthropic or based on regulatory compliance, such as for lending and insurance in India. Such companies are looking to enter into partnerships with MFIs that limit the exposure to risk and provide attractive complementariness.

Despite new relationships with the business sector, the important developmental role of MFIs in providing financial services to the poor need not be lost when a business partnership approach (e.g. through “strategic alliance” building) is taken. The complex array of motivations, objectives, and values that drive organizations and inform partnership creation do not necessarily need to fall along the lines of sustainability versus social mission. Although value alignment is an important consideration between potential partners, organizations need not have



common, shared value systems to forge a viable partnership. For instance, a commercial bank seeking to maximize profits can have an effective partnership with a socially-oriented but professional NGO MFI. The values that underpin the objectives of each partner may not necessarily prevent the identification of mutual objectives or the creation of a shared partnership vision.

While expanding the use of MFIs as delivery mechanisms for a wider range of products and services must be on a commercial basis, sustainable, business to business partnerships in microfinance are, and will continue to be, demand driven. Of course, more traditional development partnerships with the microfinance sector, such as Freedom from Hunger's *Microfinance with Education* programmes in India and the Philippines, are crucial to achieving many of the industry's social objectives in the region. Many potentially valuable partnerships in microfinance do not, nor necessarily should they, fit the private sector model, and in many cases the market cannot be relied upon to exclusively drive their formation.

Whatever the objectives or drivers for entering into a microfinance partnership are, rapid scaling up of partnership approaches is unlikely to occur without active leadership by organizations and individuals in positions to facilitate the process, based on a sound understanding of the dynamics of partnership formation.

### FACILITATING INNOVATIVE PARTNERSHIPS

As a result of these countervailing forces of the need for scale, innovation, and a competitive advantage, commitment is needed to build the organizations' capacity—especially of small MFIs—to actively broker and enter into partnerships on an equitable basis. Organizations, such as technical assistance providers, NGOs, and microfinance networks, have a vital role in facilitating the establishment of microfinance partnerships in terms of the capacity building for MFIs, facilitating negotiations between MFIs and private sector partnerships, or using their convening power to bring together a range of diverse stakeholders. For example, in the Philippines, the Microenterprise Access to Banking Services (MABS) program has played a central role as the broker between rural banks, Globe Telecom, and the *Bangko Sentral ng Pilipinas* (Central Bank), to utilize mobile telephones in expanding outreach to low-income clients. MABS program provided technical assistance, training, and banking compliance expertise to broaden their service outreach, while reducing the cost to clients and financial providers. As a national network, the Credit and Development Forum in Bangladesh has, for many years, acted as a broker between the formal banking sector and MFIs.

Whatever the objectives or drivers for entering into a microfinance partnership are, rapid scaling up of partnership approaches is unlikely to occur without active leadership by organizations and individuals in positions to facilitate the process, based on a sound understanding of the dynamics of partnership formation.

Many partnerships develop in an ad hoc manner, often beginning with a sponsoring partner that then brings in others on the basis of their existing knowledge and networks. However, a more systematic approach can help to ensure greater clarity in the partnership's objectives, greater surety that the right players are brought to the table, and more agreement between partners on their roles and responsibilities.

External, independent facilitation can also be helpful to speed up the partnership process, increase the chances of success, and contribute to the building of necessary capacity. Many partnerships develop in an ad hoc manner, often beginning with a sponsoring partner that then brings in others on the basis of their existing knowledge and networks. However, a more systematic approach can help to ensure greater clarity in the partnership's objectives, greater surety that the right players are brought to the table, and more agreement between partners on their roles and responsibilities.

#### **BANKING WITH THE POOR MULTI-STAKEHOLDER MODEL**

To assist MFIs undertake the analysis and considerations necessary for entering into partnerships, the Banking with the Poor (BWTP) Network, funded by the Citi Foundation, has developed the *Capacity Building for Partnerships in Microfinance Trainer's Manual* and established a workshop model for undertaking capacity building for entering into partnerships.<sup>10</sup> This model evolved over a series of symposium and workshops in Bangladesh, India, Indonesia, and Sri Lanka. The BWTP Network is a multi-stakeholder, Asia-focused network

consisting of members from MFIs; commercial, government, and central banks; microfinance networks; NGOs, and technical assistance organizations working in microfinance. BWTP understands that networks have a vital role to play, along with other capacity building and technical assistance organizations in convening a wide range of organizations working in microfinance, from both within and without its membership, to facilitate the growth of partnerships in the region.

Key to the success of the partnership workshops has been the buy-in and commitment of senior and top executives from NGOs and private banks, government officials, and a variety of microfinance practitioners drawn from both management and the field, all of whom spent 3 days together discussing many of the key issues. While this approach might challenge various perceptions of "status" among participants, it has proven an effective means of stimulating dialogue on partnerships not just across nontraditional partners, but also up and down management chains. While the original objective of the workshops was to improve the capacity of small- and medium-sized MFIs, experience has shown that they can also facilitate a transfer of knowledge between and among a much broader range of institutions. The early lesson of the workshops is that the power of familiarity and shared experience cannot be underestimated—bringing organizations from different levels of the financial sector or from across sectors together can play a vital role in providing some of the early building blocks of partnerships, most importantly effective communication.

These gatherings highlighted that although the number of partnerships and alliances are growing across the region, there is still a limited understanding between MFIs and the private sector with respect to the direction and potential of the microfinance industry. At the same time, there is clearly a growing interest in building greater capacity for entering into partnerships. Early on, workshops centered on partnerships for sourcing capital to enable expansion in lending and the diversifications of financial services, particularly provision of microinsurance and money transfer services. However, sharing partnership experiences, case studies, and examples from across the region resulted in an expansion in the scope of the kinds of partnerships discussed. Exposure of participants, and most importantly decision makers, to innovation in other national microfinance industries has now become a central part of the workshops.

A cornerstone to the BWTP approach has been to bring together a range of stakeholders around a shared capacity-building activity that enables:

- The development of a greater understanding between private banks, other private sector organizations, and NGO MFIs, which challenges underlying assumptions about microfinance, partnerships, and one another;
- A bridging of the gap in the difference of opinions between private banks, NGO MFIs, and other organizations regarding the role and potential of partnerships in microfinance; and
- Exposure of decision makers to the potential of diversified partnership potential and modalities within a mature and fast-evolving microfinance industry.

The model developed by BWTP Network and the Foundation for Development Cooperation take participants through four modules based on a typical business partnership cycle, through the distinct phases of an MFI.

### THE PARTNERSHIP CYCLE—AN OVERVIEW

The concept of a “partnership cycle” is not new, especially within the private sector.<sup>11</sup> Yet it is an essential tool that is often overlooked by organizations new to partnerships. Since the failure rates for partnerships is incredibly high, there is a need to ensure that all possible risks are mitigated by a thorough and systematic approach. This is crucial to ensuring MFIs are well prepared for entering into relationships with new, often nontraditional parties. Within the BWTP model, all workshop participants undertake a process which examines the three stages of the partnership cycle—namely exploration, building, and maintenance. The approach involves facilitating debate on how considerations within the various stages of the cycle (such activities as defining outcomes, resource mapping, negotiating and implementing agreements) act upon and are interpreted by different organizations. This includes from the perspective of the financial and nonfinancial sectors, among varied legal forms of financial institution, to organizations of different sizes, missions, and objectives and within specific regulatory and legal environments.

However, before working through the partnership cycle, workshop participants are asked to investigate some of the following core questions using a range of participatory tasks:

- What does the word partnership mean?
- What is the role of microfinance in Asia?
- How does the poor use their money and what is their capacity to utilize a range of microfinance services?
- What are “formal” and “informal” organizations and what are their roles, missions, and objectives?
- What are the limitations and advantages of different legal and institutional forms and how does the regulatory environment affect these?
- What are the drivers and incentives leading these different institutions into partnerships?
- Does microfinance have the capacity to innovate and grow?

The dialogue around these questions has, time and again, highlighted the fact that assumptions are a major inhibitor to constructive partnership exploration. Potential partners often have preconceived ideas about each other, their roles, mission, and capacities. Therefore, key to the facilitation of the workshop is to ensure that these assumptions are challenged. In each country so far, these questions have garnered a wide range of answers and helped draw out some common misconceptions that exist between potential partner institutions. Encouraging understanding, if not necessarily agreement, between the various stakeholders provides a framework for undertaking some of the issues to be considered by MFIs in the partnership cycle outlined below.

Since the failure rates for partnerships is incredibly high, there is a need to ensure that all possible risks are mitigated by a thorough and systematic approach. This is crucial to ensuring MFIs are well prepared for entering into relationships with new, often nontraditional parties.

Understanding both the capacities and limitations of an MFI will bring into sharper focus what may be needed from a potential partner, as well as provide a clear understanding of what the organization can bring to the table during negotiation.

and visions prior to negotiating with other partners. This stage requires MFIs to complete detailed internal assessments, resulting in an examination of its mission, operations, and capacity—areas which may not usually be a focus of close scrutiny. These are prerequisite steps that fully prepare an organization to negotiate confidently and from a strong, fully informed position. To be adequately prepared for approaching potential partners, MFIs need to be realistic about assessing their own needs and the needs of their clients. An internal assessment undertaken by an MFI should not only reveal the limitations of the organization, but also produce an exhaustive list of its knowledge and capabilities. Understanding both the capacities and limitations of an MFI will bring into sharper focus what may be needed from a potential partner, as well as provide a

### Partnership Exploration

More often than not, nontraditional partnerships, especially across sectors, involve the application of knowledge and skills within new markets, with a new set of clients, and within unfamiliar contexts and circumstances. This is a challenge for both MFIs and their partners, and can be a driver of innovation. Partnerships are attractive to the traditional private sector and they build a dependence on MFIs for understanding market conditions and the unique challenges of providing services to microfinance clients. Therefore, clarity on the part of an MFI in what they can bring to the table will separate them from the competition.

Partnership exploration is an organization-centric stage of the process whereby individual organisations assess their own needs, objectives,

clear understanding of what the organization can bring to the table during negotiation.

### Partnership Negotiation

In terms of identifying an appropriate partner, MFIs need to consider what kinds of skills and resources can reasonably be expected from a partner, what kinds of institutions might be able to provide these skills and resources, and what formal financial and other private sector institutions may be looking for in an MFI. This may be readily apparent, such as in finance or access to clientele; however, this process may also uncover less obvious benefits, both tangible and intangible, that may be attractive to potential partners. Organizations should not necessarily try to predict what may or not be attractive to potential partners, and should place all that is practicable on the table when instigating or negotiating partnerships. An understanding by both potential parties of complementary skill sets or resources provides a firm grounding for recognition of the complementarities that can result from this. Partnerships by their very nature are a two-way process and not unidirectional from the larger to the smaller partner. Although contributions may not necessarily be equal, partnerships are essentially about maintaining an agreed balance between parties.

A partnership will not move forward unless parties are able to reach consensus around how their fundamental interests will be attained and which party will take responsibility for which action. To establish the groundwork for an ongoing partnership, it is necessary to avoid one partner dictating the objectives of the partnership and the terms under which they are to be achieved. Therefore, it is essential that partners adopt a negotiation style that accommodates the inherently different cultures and aims of respective parties. For example, the informal, social-orientated negotiation style of an NGO may prove a stark contrast to the hard-nosed, profit-orientated negotiation style of a large commercial bank. This provides challenges for both potential partners in terms of finding a common language and understanding. Trust built around an understanding of these differences provides a basis for consensual “win-win” styles of negotiation whereby an understanding of objectives, expectations, and complementarities are transparently identified. While this will take time and effort, a lack of mutual trust and consensus will not bode well for the future of the relationship. Adversarial negotiations between partners perceived to be unequal in size or



level of formality will often lead to “win-lose” negotiations that will set a precedent for the partnership. Partnership agreements between nontraditional partners have an even greater need for clarity in terms of relationship structure, decision making, conflict resolution, lines of communication, and capacity-building responsibilities. A clearly defined partnership agreement will mitigate the emergence of an unequal relationship, or at least provide recourse in the event of perceived contravention of agreed roles.

When existing skills sets or resources are not present, entering into a partnership generally involves capacity transfer on a range of fronts, including the transfer of management and skills, of technology and know-how, information systems, monitoring and evaluation, customer services, and staff training. Building the capacity of partners is an ongoing process that should be a theme throughout the entire partnership and should be considered at the negotiation stage. This may consist of the MFI building its own capacity through training from microfinance networks, NGOs, or development partners; MFIs transferring their skills in microfinance to inexperienced major partners; or a transfer from senior partners to MFIs to enable them to fulfil their partnership obligations. A strong argument can be made that subsidies in microfinance are, in many cases, better

directed at supporting MFIs with capacity building grants to better enable them to enter into partnerships.

### Partnerships Maintenance

The monitoring and maintenance of the partnership is critical to its ongoing health and vitality, and key to this is management. To avoid conflict and misunderstanding, lines of communication should be agreed upon at the outset of the partnership, both between partners and across all associated management roles.

A major cause of failure within partnerships is managerial, often due to the fact that the structural and cultural elements associated with nontraditional partners are often very different. Therefore maintaining a partnership will draw strongly on the transparency and understanding achieved during the negotiation stage.

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Learning lessons from these mistakes and implementing change build a stronger partnership, and assist in things such as creating a better understanding of clients, informing product development, tightening management information systems and identifying gaps in capacity. A partnership needs to remain dynamic to survive.

Measuring and reporting on impacts and effectiveness are an essential part of maintaining the integrity of the partnership. This includes ensuring that core objectives are being fulfilled, complementarities are being upheld, and timetables/schedules are being maintained. Partnerships are about balance, and this balance often needs to be realigned during the course of the relationship to ensure that dominant partners do not emerge and operate against the spirit of the original negotiation. Partnerships do not always run smoothly, and a failure in the capacity of one partner can lead to shaky

foundations. However, this does not necessarily mean things will end badly: ways can be found to build the capacities of inefficient or overwhelmed partners.

The effective monitoring of partnerships will minimize their cost and maximize their effectiveness. It must be assumed that mistakes and misunderstandings will happen, and the agreement will require readjustment and realignment over the course of the relationship. Learning lessons from these mistakes and implementing change build a stronger partnership, and assist in things such as creating a better understanding of clients, informing product development, tightening management information systems and identifying gaps in capacity. A partnership needs to remain dynamic to survive: assumptions based on negotiated agreements regarding roles, responsibilities, and outcomes should be constantly re-examined.

#### SOME LESSONS FROM BANGLADESH

The BWTP Network “Capacity Building for Partnerships in Microfinance” workshop held in Dhaka, Bangladesh provides a practical example of the “partnership cycle” facilita-



tion approach. The workshop was held in February 2008 in conjunction with a BWTP Network member, the Credit and Development Forum. The workshop session was attended by senior executives from NGOs and private banks, high-ranking government officials, and microfinance practitioners. To their credit, all participants took time from busy schedules to spend 3 days together discussing how to improve the range and nature of microfinance partnerships in the country. While the first day was spent in heated debate about some of the core issues, particularly partnership definitions and the roles and drivers of different institutions within the microfinance industry, a broad consensus was reached which enabled a robust, participatory investigation of the partnership cycle.

While linkages between commercial and state-owned banks and MFIs have a relatively long history in Bangladesh, the workshop highlighted that there is still often limited understanding between MFIs and banks, and even less opportunity for direct exploration of the potential and opportunities for collaboration. As a result, one of the primary outcomes of the event was a commitment by the commercial and state banks present to have an open door to NGO/MFIs in the future should they want to talk about future funding partnerships. Several participants from both banks and MFIs expressed a strong interest in the establishment of a “partnerships working group,” a multi-stakeholder group that would meet on a regular basis to share information and progress across the financial industry to identify new opportunities and possible avenues for innovation. The BWTP Network will work with Credit and Development Forum of Bangladesh on the establishment of such a group to open up the lines of communication and dialogue.

## CONCLUSION

“Some people say small is beautiful, some people say small is small” is the way a Dhaka workshop participant described the choices facing MFIs in the evolving microfinance industry. Indeed, the drive to extend outreach and expand the range of financial services, while maintaining the social mission or relationship with their clientele, is a constant tension. An indication of how individual microfinance providers have chosen to resolve this challenge is often demonstrated by the types of partnerships into which they enter. Regardless of the types of partnership decisions made by MFIs and to achieve successful partnerships, a commitment is needed to build the capacity of

organizations, especially of small MFIs, to actively broker and enter into partnerships on an equitable basis. While the efforts of organizations working to facilitate the growth and increase the capacity of the Asian microfinance industry are important and ongoing, more work is needed to ensure that the successes, and failures of partnerships within the microfinance sector are shared widely and in a language that can be easily understood by all stakeholders. ■

## ENDNOTES

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6. A recommended resource for case studies on partnerships and linkages between, MFIs, rural banks, and other financial sector institutions is the Rural Finance Learning Centre, which contains the results of a Ford Foundation-sponsored series of studies carried out by the Food and Agricultural Organisation of the United Nations. Available at: [www.ruralfinance.org/servlet/CDSServlet?status=ND0zODg1MSY2PWVuJmZPSomMzc9a29z](http://www.ruralfinance.org/servlet/CDSServlet?status=ND0zODg1MSY2PWVuJmZPSomMzc9a29z).
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