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Financial sector development and the poor in developing countries: revisiting the access to finance channel

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Abstract. *With the help of thorough literature survey, the present study proposes that formal financial services by commercial banks in the developing countries are primarily suitable for the non-poor population and hence acts as a medium-direct channel of financial development to affect the poor whereas the semi-formal financial services by microfinance institutions specifically target the poor in developing countries and thus act as a direct channel. The paper also documents the divergent outcomes of lending through MFIs on the poor in rural areas and explains the coexistence of formal/semi-formal and informal financial markets. The paper further suggests that the future research in the area of finance-poor nexus may focus on providing comparative empirical evidence with respect to the effect of formal, semi-formal and informal finance on the poor in developing countries including the South Asian region. The result of such comparative studies would be of interest to all the key stakeholders in the development finance arena.*

Keywords: financial sector; South Asia; poverty; inequality; bank credit; microcredit; economic growth.

JEL Classification: G21, O16, O18, O53.

1. Introduction

The relationship between financial sector developments (FSD) and the poor in developing countries has received much attention from academics, practitioners, and policymakers in recent times. The existing two key channels of FSD which affect income inequality and poverty levels are economic growth (the indirect channel) and the access to finance channel (the direct one). However, the poor people's access to formal financial services offered by banks in developing countries is very limited forcing them to use informal sources of finance which are expensive as well as risky. Information asymmetry and high fixed costs of borrowing act as the key barriers to poor people's access to formal finance (Stiglitz, 1999). Also, financial institutions evaluate prospective clients on their entrepreneurship and lend those who have highest chances of successful repayment (Agenor, 2004) and thus primarily benefit the better-off. During the last four decades, microfinance institutions (MFIs) have emerged as a credible answer to the small financial needs of the poor by providing them access to a range of financial services such as microsavings, microcredit, micro-insurance, payment facility, etc. often to very low-income groups or households, who otherwise remain excluded by formal financial institutions (Kurmanalieva et al., 2003). MFIs use innovative ways of providing financial services to the poor who usually face significant constraints in obtaining credit from traditional banks (Besley and Coate, 1995). Microfinance has been widely recognized as an effective tool for alleviating poverty (Barr, 2005; Hudon, 2009) by governments, non-governmental organizations (NGOs), banking community, national and international donor organizations, etc. Across developing countries, microfinance has gained much of the attention of policymakers and the sector too has witnessed tremendous growth.

One of the key objectives behind launching the microfinance programme across developing countries was to mitigate the imperfections in the credit market and safeguard the interests of poor borrowers who are charged usurious interest rates by the moneylenders (Meyer, 2002). However, theory suggests that the informal sector's market structure and the formal/semi-formal sector's repayment schedule play a key role in describing the response of expansion in formal credit on the interest rates in informal sector (Hoff and Stiglitz, 1993, 1997). MFIs fix a very frequent and tightly structured repayment schedule for its poor borrowers. As a result, the borrowers find it difficult to invest the borrowed money into projects that have long gestation period as the repayment begins long before the return on investment is realized. The tight repayment schedule forces them to borrow from informal lenders to make the repayment of microloans on time and to invest some part of it in addition to the loan obtained from MFIs.

Among the developing countries, the South Asian region assumes great importance as the region is experiencing an overall high economic growth since 2003 and a whole lot of efforts are being put in the financial sector in order to make finance work for the poor. Although growth in South Asia slowed to 6.5 percent in 2017, it is expected to accelerate to 6.9 percent in 2018. However, an underdeveloped financial sector appears as the major challenge to the growth story in the region. While 46% of adults in the region have a bank account, the regional variation is significant with 83% of adults in Sri Lanka having a bank account, whereas less than 15% adults with a bank account in Afghanistan and Pakistan.

Thus, the region today is known for its high growth rates accompanied by high poverty levels. It remains home to about 1.6 billion people of which about one-third are poor living for less than USD 2 per day.

The failure of the financial sector in South Asia to include the low-income households led to the emergence of Cooperative Credit Societies Act in 1904. However, certain controls limited the ability of cooperative societies to serve the purpose and the cooperative movement failed miserably in the region which resulted in bank nationalisation in the 1970s and the emergence of microfinance sector in Bangladesh. The objective of all the three initiatives – the Cooperative Credit Societies Act, the bank nationalisation, and the launch of microfinance was to provide access to formal financial services to the low-income households or the poor in the region. Despite the fact that majority of low income households in South Asian countries reside in rural areas, the banks have a reasonably strong presence only in urban areas limiting the access to formal financial services by the rural poor. Even the strong presence of bank branches in rural areas has not been able to provide easy access to formal financial services to the poor in countries such as India and Sri Lanka.

Following the impressive growth of microfinance in Bangladesh, other countries in the region also joined the rally and developed the microfinance sector. Since then, the microfinance sector in South Asia has experienced exceptional growth and today has about 75 million active borrowers and 24.32 billion USD of gross loan portfolio (MIX market database). About 54 percent of the global active borrowers of microfinance are from South Asia region. However, owing to the tremendous demand for microfinance in the region (approx. 50 percent of the global demand), the outreach is estimated at less than 10 percent of the total demand, including less than 3% in Pakistan and 2% in Afghanistan. In India alone, more than 300 million potential clients still lack access to financial services.

With the help of thorough literature review, this paper proposes that the formal financial services by the commercial banks, which are considered to have a direct effect on the poor in developing countries, are predominantly availed by the non-poor and urban households and hence their benefits accrue primarily to the non-poor households. Thus, formal credit by banks is a medium-direct channel to affect the poor. On the other hand, the semi-formal financial services, i.e., microfinance, by MFIs provide dedicated financial services specifically targeting the poor and thus act as a direct channel of financial sector development to affect the poor. The paper also documents that while MFIs core objective is to reach out to the poor and the underserved population, their failure in doing so for various reasons results in the existence of informal moneylenders who not only lend their own savings to the poor at exorbitant interest rates but also borrow from formal sources for further lending to the poor. The paper concludes that the future studies with respect to the effect of financial sector development on the poor need to assess the effect of each channel of FSD separately and provide a comparative evidence for the same especially for the South Asian region which is characterized as having a diverse financial sector accompanied with high poverty levels. The result of such comparative studies would be of interest to all the key stakeholders in the development finance arena and would help them take more informed decisions.

2. Review of literature

2.1. Financial sector development, economic growth, and the poor: Theory and evidence

The theory with respect to the emergence of the link between finance and economic growth can be traced back in 1934 when Schumpeter suggested that finance has the potential to boost growth in an economy (supply led hypothesis) followed by Goldsmith (1969), Greenwood and Jovanovic (1990), and McKinnon (1973) who also suggested that finance is the prerequisite for growth. However, Robinson (1952) proposed the demand led hypothesis and argued that enterprises play a leading role and finance merely follows. The empirical studies testing the link between finance and growth have mostly favoured the supply-led hypothesis (Arestis and Demetriades, 1997; Beck et al., 2000; Bordo and Rousseau, 2012; Demetriades and James, 2011; King and Levine, 1993; Rousseau and Watchel, 1998, 2011). However, a few of the recent works that doubt the potential contribution of finance in economic growth argue that finance may impede growth (Arcand et al., 2012; Kneer, 2013).

Extending the finance-growth link, researchers have also attempted to examine the indirect link between financial development and the poor through economic growth. The theory in this respect suggests that finance benefits the poor when it facilitates economic growth which in turn increases the income and consumption levels of the poor. Such an indirect effect of financial development on the poor is observed when the growth proportionately benefits the poor along with the non-poor population. The various channels through which the beneficial effects of growth are passed on to the poor include creation of more jobs, reduction in wage differentials between skilled and unskilled workers at a certain phase of development which benefits the poor (Galor and Tsiddon, 1996), increased tax revenues which results in higher social spending which benefits poor and also allows them to invest in human capital (Perotti, 1993), and increased capital accumulation that facilitates availability of more funds for investment for the poor (Aghion and Bolton, 1997). A few recent cross-country and country level studies have also pointed out that FSD positively affects the poor by bringing structural changes in the economy which increases employment opportunities (affects labour market) and reduces poverty and inequality (Ayyagari et al., 2013; Beck et al., 2010; Gine and Townsend, 2004; Pagano and Pica, 2012).

The two conflicting theories in this regard are the Kuznets's inverted-U hypothesis postulated by Kuznets (1955/1963) and the "trickle down" theory. While the former suggests that as economy grows, income inequality increases at the early stage of development and reduces at a later stage of industrialization; the latter suggests that growth reduces inequality through creation of jobs and other economic opportunities for the poor people (Todaro, 1997). Despite conflicting theories, several researches have reached to a consensus that higher rates of economic growth result in rapid poverty/inequality reduction over a longer period of time (Datt and Ravallion, 1992; Dollar and Kraay, 2002; Dollar et al., 2016; Klasen, 2004; Kraay, 2006; Loayza and Raddatz, 2010; Ravallion and Chen, 2007).

Thus, a robust amount of evidence is available that supports the poverty reducing role of economic growth. This also suggests that if the supply led hypothesis of finance-growth nexus is believed to be true, it may be concluded that financial development reduces poverty and inequality indirectly through its positive contribution to the economic growth.

2.2. Access to formal finance and the poor: Theory and evidence

Theory with respect to access to finance and the poor suggests that well-functioning financial sector benefits the poor directly by providing access to formal financial services to the poor who lack resources to fund themselves or collateral to obtain a bank loan because of information asymmetries (Banerjee and Newman, 1993; Galor and Zeira, 1993). Poor benefit from access to finance by investing the borrowed funds into profitable small-business opportunities and human capital formation such as education for their children (Levine, 2008). Financial development also helps poor to make use of saved and borrowed money in times of sudden economic crisis (Rosenzweig and Wolpin, 1993). A large number of empirical studies using different samples and methodologies support the view that access to finance benefit the poor (Akhter and Daly, 2009; Ang, 2010; Beck et al., 2007; Burgess and Pande, 2005; Honohan, 2004; Jalilian and Kirkpatrick, 2005; Odhiambo, 2009).

Greenwood and Jovanovic (1990) found evidence for the existence of a financial Kuznet's curve which suggests that as financial sector develops, inequality increases in the early stages of financial development and reduces at a later stage. The same theory was later confirmed by Clarke, Xu and Zou (2006) and Jalilian and Kirkpatrick (2005) while analyzing the relationship between financial development and income inequality. Contradicting the beneficial effect of financial development on the poor in short or long-run, Rajan and Zingales (2003) claimed that financial development increases inequality. Akhter and Daly (2009) and Jeanneney and Kpodar (2011) suggest that excessive financial development results in financial instability which negatively affects the poor. Another view suspects the ability of developed financial sector to benefit the poor and argues that the rich and those with political influence largely benefit (Haber, 2005). A study conducted by Mehta and Bhattacharya (2017a) suggests that FSD in India has been pro-urban in nature benefitting the urban population more than their rural counterparts and resulting in declining rural-urban consumption ratio. However, another study by Mehta and Bhattacharya (2017b) suggests that within rural India, bank credit and microcredit have been beneficial for the poor resulting in reduced poverty ratio across states.

Economic theory suggests that the key reason behind the reluctance of banks in serving the rural poor is information asymmetry. The lenders have least information about the repayment capacity of the borrowers in rural areas (Chowdhury, 2010). In order to cover the risk of any likely default, they charge high interest rates from the rural clients (Akerlof, 1970). In such case, good quality borrowers are not willing to take up loan on such high interest rates and find out other sources of obtaining credit and the lender ends up with lending to the poor quality borrowers who are likely to default. The lenders are also not able to track the use of the borrowed funds or the actual return earned by the borrower out of the invested money. Moreover, the transaction costs of serving the rural poor, who need small loans and transact frequently, are quite high. All these issues together have resulted in the failure of formal financial institutions in rural areas and the exclusion of the poor from these markets. Despite banks and cooperative societies having a wide network of branches, their performance in terms of reaching out to the poorest and serving their needs remain very low (Imai et al., 2010). Another argument says that profitability or financial sustainability of the banks is not the only issue to be considered while banking the poor. The bigger challenge remains the suitability of the standard consumer financial services to the needs of the poor. Thus, whether the direct access to finance provided by financial institutions reaches and affects the poor is still an open question.

As per CGAP Donor brief by Pearce (2003), 60-80 percent of the population in developing countries lives in rural areas with a wide dispersion. There exists a huge gap in the availability of physical, institutional, and IT-related infrastructures with very low levels of wages and education. Agriculture, which is mostly dependent on monsoon, is the main occupation and the incidence of income diversification is very low for small poor farmers. For the same reasons, formal financial institutions perceive rural areas as more costly and risky compared to their urban counterparts and tend to focus on financing the urban clients. Banks have also been found collecting savings from the rural areas and lending the same either to the large urban clients or investing in government bonds and treasury bills. Also, formal financial institutions in rural areas, sometimes lend based on social criteria instead of economic criteria. The borrowers' creditworthiness in such cases is avoided which eventually increases the NPAs of the banks in the event of non-payment of the borrowed funds.

As per the Global Financial Inclusion (Global Findex) database – 2014, on the demand side, the poor state of availing banking services by the households in developing countries may be estimated by the fact that only 54 percent of the total households and 43 percent of the poorest 20 percent households – the poorest income quintile – own a bank account with the unbanked living predominantly in rural areas. On the supply side, the number of bank branches per 1 lakh adults in low and middle income countries is as low as 8.6 compared to 21.2 in the high income countries in 2015.

2.3. Access to semi-formal finance and the poor: Theory and evidence

Like non-poor population, poor people do need and use a variety of financial services such as deposits, credit, insurance, etc. to invest in business opportunities or to meet sudden large expenditure or to fight economic shocks. The failure of commercial banks in providing access to mainstream financial services to the poor attracted the interest of policymakers in the potential role of financial products and services dedicated to poverty alleviation in developing countries. During the 1970s, the way to develop access to credit dedicated to the underserved through microcredit was lead by few pioneers such as the Badan Kredit Desa village banks, the Bank Dagang Bali in Indonesia, and Grameen Bank in Bangladesh. MFIs emerged with innovative lending models which included features that distinguish the MFI lending from traditional bank lending such as group lending with self-monitoring, progressive lending and provision of small loans with repayment in small instalments. Such features were suitable for the low-income clients, involved high recovery rate and helped MFIs overcome the problem of adverse selection, moral hazard and strategic default being faced by the traditional banks. Poor with entrepreneurial skills were provided loans to invest in profitable business opportunities, acquire and accumulate assets, enhance income and welfare outcomes. However, a lending model which was based solely on credit soon invited criticism with respect to the financial sustainability and outreach of MFIs in 1980s. This resulted in the discovery of the saving potential of the poor and the extension of microcredit to microfinance comprising savings, credit, insurance, and other financial products suitable for the poor. This led to a significant improvement in the financial markets of many developing countries in terms of market determination of interest rates, increased investment efficiency, increased banking competition, and availability of wide range of financial products which proved to be the foundation of strong growth of microfinance institutions across developing countries.

Microfinance institutions, during the last four decades, have emerged as the pioneers in providing financial services to the poor in developing countries. They provide micro loans to the poor which are easy to repay and instead of asking for collateral, they divide the risk of lending by group guarantee. The loan size of the borrowing group is increased on the basis of the repayment record of the previous loan. The potential clients are reached out by the MFI representatives allowing the lender to know more about the borrower and their family, their job, living conditions etc. (Roodman and Qureshi, 2006). This also helps build mutual trust, speed transactions and enforce compliance.

Microfinance, today, involves provision of financial services such as credit, saving, deposit, insurance and repayment services to the poor who do not have access to conventional formal financial services because of their inability to offer collateral (Ledgerwood, 1998; Littlefield et al., 2003; Robinson, 2001). The model has proved that serving the poor is profitable as well as sustainable. In countries such as Indonesia and Bolivia, the portfolio quality as well as the stability of MFIs is found to be better than that of commercial banks in turbulent times. As per the Microfinance Information eXchange (MIX) database, the global microfinance sector has recorded a double-digit growth with a portfolio of USD 87 billion and 111 million clients in 2014, and an estimated growth of 10% in outstanding portfolio and 15.8% in borrowers in 2015. The microfinance institutions in South Asia, the pioneer of the microfinance movement in world, are serving 72.6 million borrowers and 35.21 million depositors in the region. The average debt per borrower amounts to USD 2762.2 and the average deposits amount to USD 1922.7 in the region.

Theory suggests that microfinance has the potential to correct the market failures resulting from market imperfections, asymmetric information, and the high fixed costs involved in small-scale lending (Green et al., 2006). Access to microcredit empowers poor economically and socially, lifting them out of poverty (Yunus, 2007). It enables the households to diversify their income, acquire productive assets, better education and health standards, smoothen consumption, and fight economic shocks and fluctuations (Abou-Ali et al., 2010; Banerjee et al., 2015; Karlan and Zinman, 2010; Littlefield et al., 2003; Roodman and Morduch, 2014). However, few recent evidence document the impact of microfinance being divergent between positive, no impact and even negative impact (Angelucci et al., 2013; Ganle et al., 2015; Van Rooyen et al., 2012). The impact of microfinance is dependent on context and factors such as population density, attitudes to debt, group-cohesion, enterprise development, financial literacy, financial service providers and others (Armendariz and Morduch, 2005).

2.4. Informal finance and the poor: Theory and evidence

Rural financial markets in developing countries are characterized by the existence of both formal and informal finance on account of weak legal enforcements and low income levels or lack of collaterals (Germidis et al., 1991; Nissanke and Aryeetey, 1998). While banks enjoy superiority in savings mobilization, informal moneylenders are better at gaining superior information about poor borrowers. Since banks have very less information about the behaviour of the poor borrowers as well as the usage of the borrowed funds by them, they require them to provide collateral for obtaining loans failing which the poor borrowers resort to informal moneylenders. Poor borrowers are, thus, found to be borrowing either from formal financial institutions or from private moneylenders or both (Banerjee and Duflo, 2007; Das-Gupta and Nayar, 1989). In the event of insufficient loan amount being lent by the formal institutions, the poor turn to private moneylenders for borrowing some additional amount which makes it possible for them to invest in productive assets. The co-existence of formal and informal lenders may either be in the form of substitutes or complements to each other. In case of substitutes or horizontal integration, formal financial institutions and informal moneylenders compete with each other in the rural financial markets and the borrowers first try to obtain credit from the formal ones first which offers credit at comparatively low rate of interest. Any unmet demand from the formal institution as a result of credit rationing or some other reason is then met by the informal sources. In this way, they are able to borrow from both the sources (Bell, 1990; Bell et al., 1997; Jain, 1999). Whereas in case of complements or vertical integration, the informal lenders borrow from formal sources and re-lent it to the poor. Thus, poor only borrow from the informal sources (Bose, 1998; Hoff and Stiglitz, 1997).

Any change in the formal financial sector would not only affect the availability of credit in the informal market but would also have an effect on the interest rates and would thus affect the poor based on the structure of informal credit market whether it is monopoly, monopolistic competition, or perfect competition (Bose, 1998; Floro and Ray, 1997). Also, local moneylenders have very limited availability of funds for lending as compared to banks and they seek access to funds from banks in order to be able to meet the credit demand of the local population (Conning and Udry, 2007). Moneylenders use two sources for re-lending to the poor; one is their own savings and other is the government-subsidized funds (Bhaduri, 1987; Onchan, 1992; Siamwalla et al., 1990). Availability of formal credit at subsidized interest rates induces entry of new moneylenders in the informal market which reduces the market for each moneylender. A reduced market increases the marginal cost of lending for each player resulting in higher interest rates being charged by them. This negatively affects the poor borrowers. Increased entry of moneylenders in the market may provide increased options of borrowing to the poor, in the event of default, and may also adversely affect their incentives to repay. This may require moneylenders to spend more and put in more efforts on enforcement in order to ensure timely repayment. This raises the cost of lending to an additional borrower and hence with an increase in cost the interest rates for the poor borrowers may rise.

Thus, the development of formal financial sector in a region may result in an expansion of lending through informal sources when the relationship between formal and informal lenders in the region is complementary. Informal lenders, in such a case, have greater access to funds from formal sources which they re-lent to the poor at high interest rates. One of the initiatives taken by the government in less developed countries to address the problem of high interest rates being charged by the moneylenders to the rural poor is 'cheap credit policy' under which credit at subsidized interest rates is provided to the agricultural sector by formal financial intermediaries. However, despite such policies, informal moneylenders do dominate the rural financial markets with the interest rates remaining relatively unaffected (Basu, 1994; Bell, 1990; Hoff and Stiglitz, 1990; Siamwalla et al., 1990).

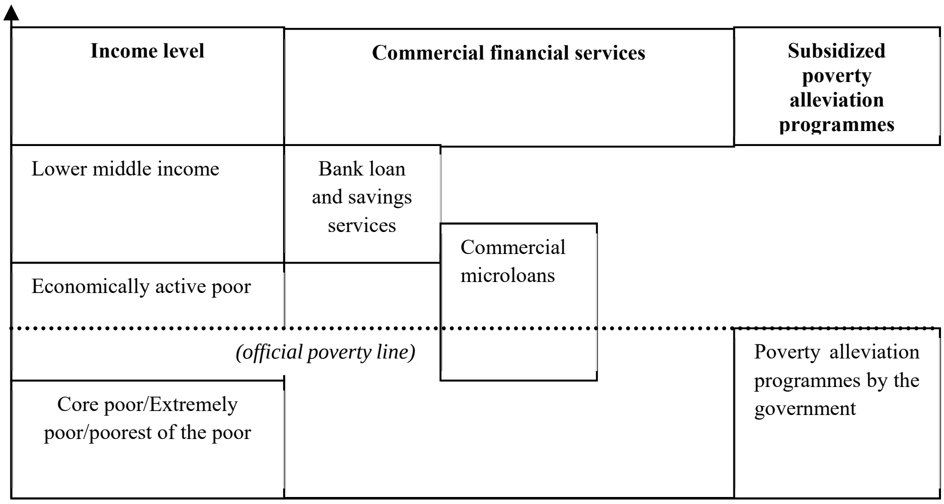
3. The poverty alleviation toolbox

Robinson (2001) in his work "The microfinance revolution – sustainable finance for the poor" has developed a poverty alleviation toolbox for the financial institutions to lend to the poor profitably. There is a huge demand for microfinance services among the poor and such demand can be served profitably and on a large scale. The author proposes that standard financial services offered by commercial banks are suitable for non-poor who belong to the lower-middle income and above category. He further argues that lower-income people who lack access to formal financial services may be divided into extremely poor and economically active poor group (Figure 1). The extremely poor group include individuals who do not have sufficient resources to meet their basic consumption needs or household needs. This also includes individuals who cannot work because of age or other health concerns. Because such individuals have food and shelter as their urgent needs to satisfy, they require tools distinct from financial services (such as employment opportunities) to come out of poverty.

Such individuals, in the absence of appropriate economic opportunities, when provided credit, are unable to make efficient use of it resulting in defaults in making payment of principal as well as interest amount. Thus, neither borrower nor the lender is going to benefit out of such a deal. Moreover, this may also result in extremely poor individual falling in the poverty trap even badly and reduced capacity of the lending institution. Such a fraction may be helped by government by developing policies that promote self-employment, create employment opportunities, or provide skill training and enabling them to make proper use of the financial services.

On the other hand, the economically active poor include microenterprises, marginal farmers, low-income individuals, and poor households. Such individuals are working (self-employed or otherwise), own some property, and are capable of working. They too are unable to satisfy their basic household needs because of fluctuating income due to informal or seasonal employment. This group is the target group of microfinance institutions. Therefore microfinance acts as a complement and not a substitute to the welfare programmes launched by government for employment generation for the extremely poor. The coordination between commercial banks, microfinance institutions, and welfare programmes to alleviate poverty is shown in Figure 1 below. The individuals belonging to extremely poor and economically active poor group are below the poverty line.

Figure 1. *Poverty alleviation toolbox*



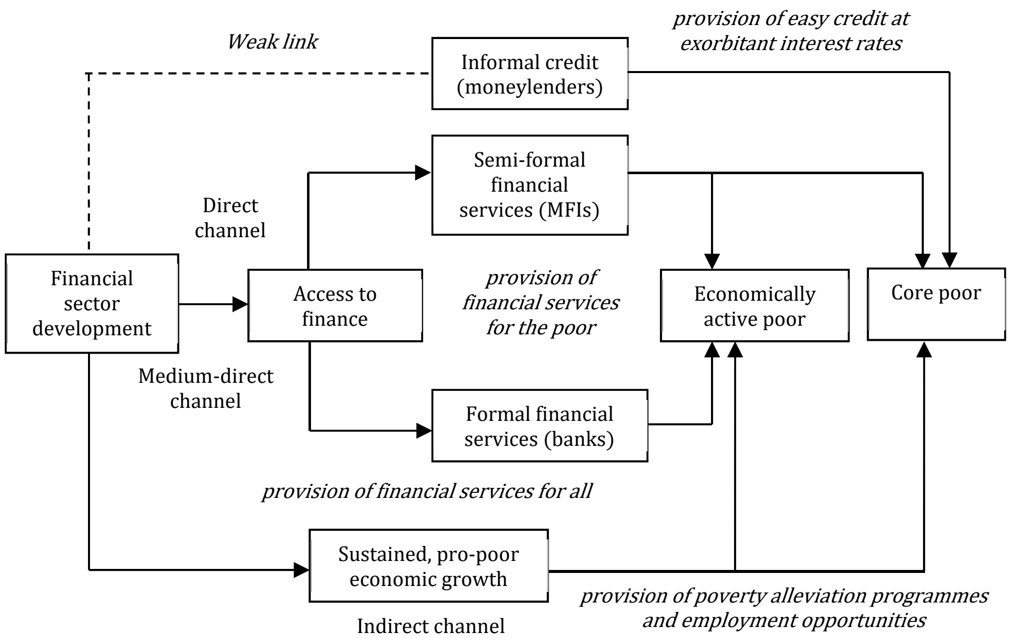
The basic difference between economically active poor and higher income individuals is their socio-economic and commercial characteristics as well as the volume of their commercial transactions. The customers of microfinance do not consider cost of loan as important as the service, speed, and agility. They need the documentation process of loan to be simple and disbursement of loan to be timely. In terms of savings, an attractive rate of interest is less important whereas unrestricted access to savings account with least requirements is more important an issue.

4. Channels of FSD and the poor

Our discussion so far concludes that the financial markets in developing countries including the South Asian region comprise three key segments: formal markets (banks and financial institutions); semi-formal market (microfinance institutions and cooperatives) and informal market (moneylenders, employers, friends and relatives). The basic function of financial institutions is mobilization and allocation of funds between households, individuals, and firms. However, the difference in the three categories of markets lies in their characteristics. In the formal market, financial institutions mobilize savings and lend to those who need financial resources and who are capable of making the repayment. Borrowing involves a certain transaction cost and interest rates are determined by market forces. The semi-formal financial markets mostly serve to the financial needs of the poor households. They are characterized by high interest rates with frequent and tightly scheduled repayment schedule. Informal markets, on the other hand, are more popular among the poor across developing countries because of their ability to reach out to the poor in a better way. They are characterized by very low transaction cost with high interest rates. Such a market exists because poor find it easier to borrow from them without much formality.

The literature review with respect to the link between financial development and the poor in developing countries so far suggests that the access to finance channel mostly considers the economy wide measure of financial sector development, i.e., credit by commercial banks. The literature also suggests that commercial banks do not adopt a targeted approach for the poor nor do their products and services suit the needs of the poor. Lending to the poor is also detrimental to the financial sustainability of the formal financial institutions. On the other hand, microfinance institutions were created with the sole objective of providing access to financial services dedicated to the poor suiting their needs. Thus, a comparison between the two institutions, i.e., commercial banks and microfinance institutions, in terms of their lending model and target client suggests that access to financial services provided by commercial banks acts as a medium-direct channel to affect the poor whereas access to financial services provided by MFIs acts as a direct channel. Financial sector development, thus, affects the poor through three channels: indirect, medium-direct, and direct (Figure 2). Indirect link flows through its impact on economic growth (when the growth is pro-poor). The impact is medium direct when banks provide access to full range of formal financial services primarily to the lower-middle income and above group (non-poor) which provides employment opportunities to all including poor and thus helps everyone enhance their income levels. Financial services have direct impact on inequality and poverty when the microfinance services are provided directly into the hands of poor by microfinance institutions and thus enable them to enhance their income and consumption levels. Lending by informal market agents such as moneylenders, friends and relatives to the poor may also be considered as a weak link of FSD since the informal lenders to borrow from formal financial institutions to lend it further to the poor at higher interest rates. However, such markets are not regulated by the government.

Figure 2. *Channels of financial sector development and the poor*



5. Conclusion

This paper examines the literature that establishes relationship between financial sector development and the poor in developing countries. The existing literature highlights two key channels of FSD that affect the poor: one is indirect – which flows through economic growth and another is direct: access to finance channel. The present study doubts the potential role of traditional commercial banks in enhancing access to formal financial services to the poor. Moreover, a lending model that is meant to serve the poor is neither financially sustainable for the commercial banks nor the financial products and services offered by them are suitable for the poor. Also, commercial banks are found to be serving predominantly in urban areas leaving the rural areas underserved where more than 75 percent of the poor live. The paper further argues that microfinance institutions provide dedicated small-scale financial services to the poor and are found to have positive effects on the poor in terms of access as well as use of unconventional financial products and services. However, the tight repayment schedule and lending in small amounts has resulted in the existence of informal credit market along with formal and semi-formal financial markets in rural areas across developing countries.

Our paper suggests that mainstream formal financial services offered by traditional commercial banks act as a medium-direct channel of FSD to affect the poor whereas the unconventional semi-formal financial services offered by MFIs act as a direct channel of FSD and serve and benefit the poor in an improved manner. We, thus, suggest that future research on the finance-poor nexus need to assess the impact of each channel of FSD separately and provide comparative empirical evidence with respect to the effect of financial services offered by commercial banks and MFIs across regions and countries. Such evidence is all the more relevant for the South Asian region where not only the financial sector is growing leaps and bounds but poverty and inequality is also a major source of concern. The existing studies in the region have attempted to analyse the link between access to finance and the poor using economy wide measures of FSD such as money supply, private credit, and market capitalization. While such evidence provide important information on the effect of financial sector as a whole, the effect of different segment of the financial markets, which have different lending models, remain unexplored. From policy perspective, such evidence is expected to give more meaningful insights to the policymakers and national and international funding institutions allowing them to make better informed decision with respect to channelizing funds to developing economies.

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