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Product Innovation for the Poor: The Role of Microfinance

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RESEARCH PROGRAM MISSION

The research program titled Rural Financial Policies for Food Security of the Poor seeks to identify policies and institutional arrangements that help the poor integrate themselves into sustainable savings and credit systems in order to increase capacity to invest, bear risk, and preserve livelihoods.

FOCUS COUNTRIES

- Bangladesh
- Cameroon
- China
- Egypt
- Ghana
- Madagascar
- Malawi
- Nepal
- Pakistan

ABOUT THE AUTHOR

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This policy brief reviews evidence and draws lessons regarding the role of microfinance for income and consumption smoothing by the poor, and highlights potential areas for product innovation by the micro-finance sector to address the demand for financial services for income and consumption smoothing.

The Poor Demand Financial Services to Avoid Shortfalls in Consumption

Poor, food-insecure households seek to avoid the risk of falling below a minimum level of consumption of food and other basic goods that would threaten their survival. In general, there are two types of risk coping, income smoothing and consumption smoothing. Households can smooth income by making conservative production or employment choices, diversifying economic activities, or taking steps to protect themselves from adverse income shocks before they occur. Households can smooth consumption by borrowing and saving and by employing formal and informal insurance arrangements. These actions help insulate consumption from income variability.

In short, improved access to financial services can have two principal effects on households. First, it can raise the expected value of income and therefore of consumption and future investment and asset accumulation. This is the traditional and often sole argument for provision of services by MFIs. Second, it can decrease the downward risk of too low an income to satisfy basic consumption needs. Poorer households, for which this consideration is especially important, tend to value financial services that address the risk-coping motive relatively more, while wealthier households tend to place higher value on financial services that generate income and aid the accumulation of assets.

Empirical Studies

A number of studies reviewed in a synthesis paper by IFPRI (see references) show that lack of access to financial services for income and consumption smoothing can have serious implications on livelihood. For example, the nutritional status of children in poorer households in Bangladesh severely suffers in the aftermath of disastrous floods as a result of insufficient informal coping mechanisms and access of credit. Similarly, a study in Peru found that during adverse times, credit-constrained parents tend to withdraw children from school and put them into income-earning jobs. In India, child labor plays a significant role in the self-insurance strategy of poor rural households.

Most formal credit and savings services are not useful for consumption smoothing because they may be approved only after considerable waiting time, carry high transaction costs, or specifically given for production purposes. In the same vein, many commonly found savings products are of little use to those who wish to save because of precautionary motives, e.g., some savings deposits may only be withdrawn after a waiting period or, as is common in the majority of credit-focused microfinance schemes, a fixed percentage may be held to secure a loan.

IFPRI's studies point out that much of the savings behavior of the poor is motivated by the wish to hold precautionary savings so as to retain capacity for future consumption smoothing. It is important to recognize that such savings can be held in four different forms. First, households may hold buffer stocks in the form of assets that can be liquidated in the event of transitory income shocks. Livestock, food, and money under the pillow are common forms of precautionary savings in developing countries. These informal savings are subject to a number of risks, such as inflation, animal disease, and theft. Second, households may choose not to fully utilize available credit limits but preserve the option to borrow for "worse" times. Third, precautionary savings can be held in the form of human capital, for example, by having more children to meet unexpected future shortages in family labor due to health risks, or by having better-educated children. Finally, investing in personal relationships and membership can generate precautionary savings in the form of social capital, for example, in social and other institutions at the community level. It is not unreasonable to expect that social capital, like any other form of capital, can be used more intensively in future periods when transitory income shocks occur. The culture of reciprocal gift giving is deeply embedded in many societies. Having more social capital can increase one's (insurance) claims toward society.

Product Innovation by Microfinance Institutions

It is important to distinguish between idiosyncratic and covariant risks, that is, risks that affect only some individuals or larger groups of people in the same locality, respectively. Covariant risks include, for example, drought and flood, whereas individual risks are disability to work or old age. Since most MFIs in developing countries at present are too small in terms of number of clientele and geographical coverage, their ability to effectively cover covariant risks is very limited. However, as MFIs grow over time and reach operational scales like those achieved by Bank Rakyat Indonesia (BRI), BRAC, or the Grameen Bank, there is also considerable potential to sustainably address covariant risks. For example, the Grameen Bank and BRI have rescheduled loans to clients in areas of natural disasters. BRI can do this without assistance from the state because of its high profits and its business conviction that the loss of a good borrower is also a loss to BRI. The Grameen Bank has also rescheduled loans for clients affected by flood. The Grameen Bank requires members to deposit small amounts of savings into a so-called emergency fund. The pooling of such funds over larger areas can, in principal, address covariant risks.

A few innovative MFIs have developed financial products that address idiosyncratic risks. While MFIs should not be overburdened by being asked to provide health insurance services, MFIs can provide precautionary savings services and consumption credit that can indirectly address health risks. For example, village banks that follow the FINCA model or the model developed by the French NGO Centre International de Développement et de Recherche (CIDR) raise funds for internal consumption loans for their members. Other examples of MFIs that explicitly provide consumption credit, include Caja Social in Mexico and BRAC in Bangladesh. SEWA in India, which targets microloans to very poor women, allows borrowers to stop loan repayment during pregnancy. Health risks can also be addressed by the provision of precautionary savings services. This type of service is useful for many types of risks, provided that the maturity of the deposit, its interest rate, and its transaction costs for deposits and withdrawals on short notice are adjusted accordingly. For health risks that occur relatively frequently and demand immediate response, the cost and time for withdrawal must be minimal. A current account at a village bank or a nearby bank branch offers such features as does a term deposit that can be withdrawn at short notice with a penalty. Examples of banks that successfully offer savings services to a diverse clientele, including the poor, are BancoSol in Bolivia and BRI in Indonesia.

A number of MFIs offer life insurance to cover risks of death or lack of care during old age. Most often, however, the contract only covers the borrower's outstanding debt in case of death. This is the case, for example, for BRI or ASA in Bangladesh. BRAC, on the other hand, offers a life insurance contract that pays a predetermined sum in case of the member's death.

Because of sociocultural constraints, women often cannot get a loan unless they are married and their husband is a cosigner. MFIs ought to refuse to practice such discrimination. By providing women with individual credit lines and savings accounts, their household bargaining power may increase. Moreover, individual accounts for women will enable them to have a much stronger economic position in case of family breakup.

Policy Implications

Access to microfinance has the potential not only to assist the poor to earn income from microenterprise, but also to smooth income and consumption. The first potential effect is what primarily motivates the microfinance movement today. Yet, the second-effect increases in relative importance as the poverty level of MFI-clients increases. MFIs, especially if they seek to benefit the poor, should concentrate more effort on credit, savings, and insurance services that can mitigate risks. The largest potential for microfinance is seen for addressing idiosyncratic risks, such as those related to health, disability, old age, and divorce. When MFIs grow in scale and increase their outreach to both poor and nonpoor groups, they also increase their potential to help their clients' address covariant risks.

A number of innovative MFIs offer financial products that respond to these risks. These include flexible saving services that permit prompt withdrawals, consumption credit, and even explicit health and life insurance.

The poorer the target group of an MFI, the more important is that MFI's experiment with new products for income and consumption smoothing. Through pro-poor product innovation, the MFIs' costs of targeting the poor may decrease. However, when MFIs choose to broaden their offering of financial services, they must be aware of the greater portfolio and liquidity risks that such a strategy entails. Prudence would suggest that MFIs first target areas with low covariant risks, and gradually expand client outreach to higher risk areas. Higher liquidity reserves and larger equity capital appear also to be appropriate responses to covariant risks. Client-funded emergency funds that are pooled over large areas have the potential to spread these risks at sustainable levels. ■

Selected References

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