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IFPRI®

BANKING ON THE POOR

Unleashing the Benefits of Microfinance

Until the 1980s only a handful of institutions offered credit and savings services to poor people in developing countries. Today microfinance institutions number more than 7,000 worldwide, a level unimaginable 20 years ago. Yet while microfinance services have grown, so have the number of poor. In Sub-Saharan Africa about 48 percent of the population lives on less than US$1 per day. In South Asia alone, more than half a billion people still live below the poverty line. As policymakers look toward financing innovative programs that help curb the growth of burgeoning poverty, microfinance can offer some hope—but only if policymakers and development practitioners understand the services that the poor demand and if they can learn from the experience of government and nongovernmental programs that have allowed innovation to flourish and the particular finance needs of the poor to take center stage.

This policy brief is designed to help policymakers and practitioners understand the financial services needed by the poor. It is framed within lessons learned from a five-year IFPRI research program that examined, among other issues, the roles government should play in providing financial services to meet the needs of the poor. Insights presented here are based on a series of detailed household surveys conducted in nine countries of Africa and Asia: Bangladesh, Cameroon, China, Egypt, Ghana, Madagascar, Malawi, Nepal, and Pakistan.

Microfinance, once a colossal leap of faith for many governments and donors, is now considered a viable business. IFPRI's research shows that it is most successful when designed with a tight and mutually reinforcing fit between the larger financial environment, the mechanism of service design and delivery, and the particular needs of the poor that microfinance institutions serve.

THE POOR NEED MORE THAN CREDIT

It was once assumed that poor people had no need for financial services, or perhaps needed only credit. Yet the conditions under which the poor live suggest otherwise. For poor people, risk is familiar and high. Strategies for managing and coping with risk are part of everyday life. Research and experience have shown that the poverty and uncertainty poor people face require diverse financial services. Borrowing helps households achieve food security and alleviate their poverty. In times of stress, the poor need to borrow to pay for essential consumption. But borrowing alone is not enough to pull households out of poverty. Poor people also require savings services to help them better manage their resources over time and to enable them to plan and finance their investments. And perhaps most important, the poor need access to insurance to lessen the blow when, for instance, a breadwinner falls ill, crops fail, or prices for their products plummet. In short, the demand of poor households for microfinance services has been significantly underestimated. The poor should not be shut out of financial services because of the risk they bear; on the contrary, the poor need additional services to mitigate that risk.

SAVINGS FOR GETTING THROUGH TOUGH TIMES

Savings services are necessary because many poor households are not in a position to take advantage of credit for investing in human or physical capital to increase and diversify their incomes. Other households require additional services besides credit to manage the household budget and risks. In many cases households are too poor and the fluctuations in their incomes and the risks they face are too high for them to rely on borrowing strategies alone. Currently, the poor in many areas of the developing world pay enormous transaction costs in their efforts to save. Yet many microfinance institutions offer no savings services at all.

Ample evidence exists that the poor save to build assets for future planned activities, such as children's education or marriage. Savings may also decrease the amount of credit a household has to seek at high cost from informal lenders and reduce the sale of assets at low cost during times of distress. Moreover, poor people can save in the form of human capital by improving their health, nutritional status, and education. Microfinance institutions, governments, and donors need to recognize that this form of saving can produce real future benefits by raising productivity and speeding development.

The poor also save to help smooth their consumption in the face of possible income shocks or expenditure increases, due to illness, for example. Downturns in income or shocks can have severe consequences for households that are struggling to subsist. Even households whose income is adequate on average may face transitory food insecurity or the risk of it. Savings are needed to simply maintain adequate consumption. Households in the lowest third of the income scale at times spend as much as 91 percent of their consumption budget on food, yet they still often go hungry. For the poorest people, one large shock or a series of small ones can lead to major reductions in food intake, which can lead to permanent disability, especially of children, and lasting impoverishment of the entire household. The poorer, more risk-averse, and vulnerable a household is, the more important precautionary saving becomes.

THE UNMET DEMAND FOR INSURANCE

In addition to borrowing and savings services, the poor need insurance to protect themselves from uncertainty. In the absence of insurance, the poor often avoid risky but potentially profitable economic activities and enter into informal insurance arrangements or rely on precautionary savings. Some microfinance institutions have begun to offer insurance products. The Bangladesh Rural Advancement Committee offers life insurance contracts to women who live below the poverty line, and Nirdhan, a group-based microfinance institution in Nepal, provides livestock insurance to those who borrow to finance livestock investment. Yet examples like these are relatively rare, and microfinance institutions have yet to tap the potential for innovation in sustainable insurance services. Of the three financial services described here, the largest gap between demand and access is for insurance.

The poor face two types of risk: personal misfortune such as illness, accident, or theft, and misfortune that is common to the community, such as drought or flooding. Whereas a personal misfortune would affect only a few people in a village at the same time, a drought or flood would affect almost everyone. Because of these characteristics, providing insurance services is fraught with special difficulties. The existence of insurance may cause people to engage in riskier behavior that ultimately imposes higher costs on the insurer. Or, if an entire community is affected by drought, an insurer may have difficulty in meeting all of its commitments to pay out simultaneously. Public support for innovations that address these problems will ultimately lead to higher public and private returns on investments.

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LOCAL PROGRAMS FOR LOCAL NEEDS

Perhaps the most important factor to consider in increasing access to financial services to the poor is that programs must fit the specific context of a particular area and its population. Blindly replicating successful programs will not work, as there is no blueprint for success. A lending approach that succeeds in one context may not bring positive results in another.

For example, the poor generally lack traditional forms of collateral, so microfinance institutions must find collateral substitutes based on local conditions to greatly improve credit access. Likewise, repayment arrangements should be based on local production cycles. Although group lending and joint liability have ensured high repayment rates at low cost in Bangladesh and other countries, they have not been effective in Malawi. Peer monitoring may not function well for various socioeconomic reasons, and there may be social costs to applying peer pressure. In Malawi joint liability caused some members to default based on unwillingness, not inability, to repay. In fact, in many cases groups actually performed better when they did not expect joint liability to be enforced.

Microfinance institutions should avoid standardizing services excessively even within countries. They may need to decentralize their decisionmaking and service delivery. Innovation in fact will have to consist largely of adapting organizational set-up, structure, and conduct to local settings. Microfinance institutions will need to adjust their services to the local occupational patterns, household spending and savings behavior, culture, resources available, agroecological characteristics, division of labor by gender, and historical experience.

RESPONSIVE POLICIES SET THE STAGE

The poor who borrow—most of whom are in rural areas—face greater obstacles than the nonpoor who borrow. They are often small farmers. They are often women. They often lack education and health services, are primarily dependent on agriculture, and support larger families. Their poverty is due not only to a lack of access to financial services, but also to a lack of access to infrastructure, markets, improved agricultural technology, and social services such as health and education. Ensuring that these elements exist is the responsibility of the government. Without them, credit access is likely to have a negligible impact on poverty.

In Malawi, for example, farmers who borrowed failed to become better off than those who did not borrow, mainly because of land scarcity and a lack of high-yielding maize seed. Farmers also found it difficult to make profits given the relatively poor market conditions they faced for their goods.

If poor farmers are to use financial services to make profits and develop new market niches, they require better agricultural technology, extension services, and well-developed local markets that are well integrated with the rest of the economy. In fact, two of the main reasons why the poorest do not borrow are their lack of profitable investment opportunities that could carry the cost of the loan and their inability to risk indebtedness. A conducive environment could remedy both of these problems.

It is therefore essential that governments develop the necessary infrastructure in rural areas, liberalize markets, and implement other policies to support market integration. These steps are also essential for creating a rural financial system, which would allow for greater outreach and more cost-effective services. Better infrastructure, education, and land titling can also help reduce transaction costs for buying and selling goods in the long run.

Policymakers must also set conditions at the macroeconomic level that will enable microfinance to thrive. Interest rates for borrowing must be stable and modest so that the poor have incentives to invest. Inflation must be controlled, and trade policies should encourage the production of goods in which small farmers have a comparative advantage. If complementary inputs and a conducive macroeconomic environment exist, credit will generally have high returns. These factors are less essential for savings and insurance services, but they do need to be present before the very poor can make a transition from these services to using credit for productive purposes.

STRENGTHENING FINANCIAL NETWORKS

In addition to funding nongovernmental organizations (NGOs) engaged in microfinance, the state must take the initiative in developing or expanding commercially viable financial institutions. In spite of their growing importance in the field of microfinance, NGOs alone cannot create an

INDONESIA'S NETWORK OF RURAL FINANCIAL INSTITUTIONS

In Indonesia in the 1980s, village units of the public Bank Rakyat Indonesia were restructured to resemble private banks. They adopted decentralized decisionmaking, a profit orientation, incentives for employees and clients, and other reforms. The government assumed the full costs of the transformation and guaranteed savings. As a result of the reforms, branches of the Bank Rakyat Indonesia developed new credit and savings services.

At the same time the financial sector was deregulated, the small, private People's Credit Banks (Bank Perkreditan Rakyat, or BPRs) were given greater flexibility. By 1993 around 900 new People's Credit Banks were operating. This large system of private financial institutions adopted new methods of reaching rural areas, such as financial linkages with other institutions, and incentives for people to save. Before the 1997 East Asian financial crisis, Indonesia's rural financial system, characterized by heavy public sector involvement and technical and financial links between institutions, supported a wide diversity of microfinance programs, cooperatives, and small, competing People's Credit Banks, and thus reached a large number of the poor.

impact on poverty—they need to work in tandem with the larger commercial banks that have wide networks of branches. The state needs to initiate innovative pro-poor reforms in the wider banking sector or support partnerships between state banks, commercial banks, and microfinance institutions that make it less costly to deliver services to the poor. Many countries have state-owned banks set up for the special purpose of serving the poor. But political meddling and inefficient administration have meant that their goals remain unrealized and in some cases caused serious distortion in the overall financial sector. Reforming government-owned banks would grant many more poor people access to financial services and provide these services with greater security and lower transaction costs.

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PROVIDING THE REGULATORY FRAMEWORK

In order for microfinance institutions to thrive, governments must create a policy and legal framework that makes it feasible and attractive for them to operate in rural areas and to serve the poor on a sustainable basis. These reforms too ought to be seen as innovations. While addressing market failures in microfinance, the government must instill confidence in the regulatory framework in both poor clients and other institutions. The regulatory framework must be clear and flexible, and supervisory bodies must have the means to enforce the rules. In order to fit the needs of microfinance institutions, the system of regulation should be developed with the strong involvement of these institutions. Regulations in three areas are particularly important: (1) to enable secure and sustainable internal financial management, including transparency in management and proper accounting, (2) to govern transactions between financial agents and institutions, and (3) to ensure competitive conditions.

Protecting clients, especially savers, is perhaps most important, because it increases confidence in transactions. The regulations are also important, however, for enabling microfinance institutions to gain the confidence of other financial institutions.

Regulations must strengthen the microfinance movement and not impede its development with rigid rules or narrow definitions of institutions that can block innovation. For example, ill-conceived usury ceilings on interest rates can impede the financial viability of institutions and future access to financial services by the rural poor. The framework should be defined by decree in order to remain flexible and adaptable to changes and failures.

Along with establishing the appropriate regulatory framework, governments need to ensure that supervising agencies have a strong knowledge of the concepts and technologies related to microfinance and the capacity to oversee the large number of emerging institutions that operate with unconventional methods.

INTEGRATING MICROFINANCE IN ANTIPOVERTY STRATEGIES

How can governments and donors ensure that their investments in microfinance institutions will help to bring about the necessary innovations? They can monitor and evaluate the performance of microfinance institutions and request that these institutions self-monitor as well on an ongoing basis. Meaningful client participation in monitoring and evaluation, as well as in governance and management, is also essential so that microfinance institutions can more clearly understand the needs of poor people in the areas they serve.

Along with efforts to improve the impact of microfinance institutions, policymakers and donors must decide whether investing in microfinance is the most socially cost-effective means of achieving poverty alleviation, food security, and other outcomes for the poor, especially for the poorest. Is the shifting of resources from other poverty alleviation programs to microfinance programs good social policy? They must decide on the relative weight to be attached to microfinance services compared with infrastructure, health, education, agricultural extension, and various social safety net programs. As they make these decisions, policymakers might consider how providing microfinance services will affect technology adoption, income generation, attainment of food security, nutritional adequacy, and educational attainment.

When microfinance institutions are geared to the needs and conditions of local people and situated within a larger set of poverty alleviation and food security policies and programs, they will mean the difference between destitution and a healthy and productive life.

MICROFINANCE CHECKLIST

- **What kinds of financial services do the poor value? What economic activities are the poor engaged in, and what implications does this have for the type of services to be provided? What are existing sources of financial services, and how do the poor use them?**
- **What combination of financial instruments—credit, savings, insurance—are best developed, given specific demand from different types of clients? Do delivery systems (credit union, village banking, group-based lending) take into account the prevailing socioeconomic environments or local organizational systems?**
- **What nonconventional methods do the poor use to secure loans? Can these collateral substitutes be used within a more formalized banking system?**
- **In the lending or granting of public resources, are incentives in place to encourage competitive, sustainable, efficient, and entrepreneurial microfinance institutions?**
- **Are regulations in place that govern mutually supportive transactions between the clients (borrowers) and institutions (lenders), such as deposit insurance and contract enforcement?**
- **Are prudential regulations, such as accounting practices and reporting requirements, balanced so that they ensure sustainability, good management, and accountability of microfinance institutions without stifling innovation?**
- **Would the introduction or expansion of microfinance services in a region be one of the most socially cost-effective ways to alleviate poverty there, given the state of infrastructure and markets, the availability of services, and the existence of other antipoverty and development programs in the region?**

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