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CGAP

CONSULTATIVE GROUP TO ASSIST THE POOR

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CONSULTATIVE GROUP TO ASSIST THE POOR

Washington, D.C.

Building financial systems for the poor

Photographs, front cover (background, then left to right): Two women holding money, Cambodia (Tim Hall/Getty Images); Women removing fish traps, Okavango River, Botswana (Peter Johnson/Getty Images); Farmer on carriage, Egypt (Hisham F. Ibrahim/Getty Images); Woman selling flowers at market stand, Ecuador (Corbis); Bulls pulling carts on a rainy day, India (Corbis).

Photographs, back cover (background, then left to right): Outdoor market, Bombay, India (Eyewire Collection/Getty Images); People making food, Burkina Faso (©1993, The World Bank Photo Library/Curt Carnemark); Hawallah in Kabul, Afghanistan (© CGAP/Doug Pearce, 2003); Man with water buffalo cart, Philippines (©1975, The World Bank Photo Library/Edwin G. Huffman).

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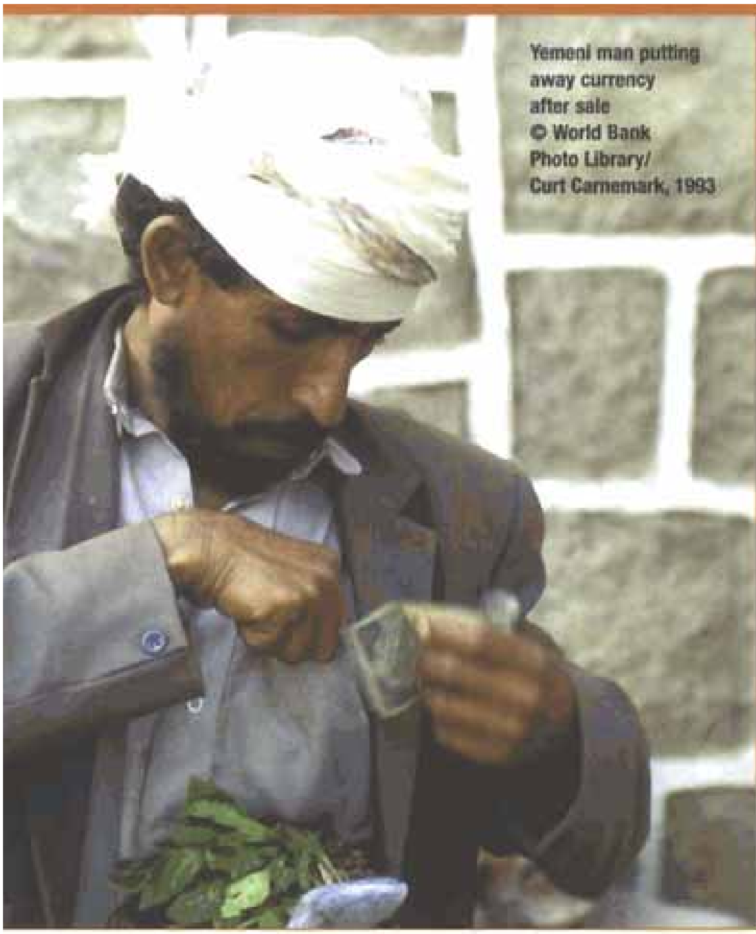

Yemeni man putting away currency after sale © World Bank Photo Library/ Curt Carnemark, 1993

Sustainable microfinance can be a key component in creating sound financial market structures in the world's poorest countries....G8 countries will work with the World Bank-based Consultative Group to Assist the Poor to launch a global market-based microfinance initiative. To assess the status and effectiveness of current microfinance programs, G8 countries will work with CGAP to promote best practices in microfinance for developing countries.

—G8 Action Plan: Sea Island Summit 2004

FINANCIAL SERVICES FOR THE POOR: THE BASICS

WHAT IS MICROFINANCE?

Like everyone else, poor people need and use financial services all the time. They need financial services to take advantage of business opportunities, invest in home repairs and improvements, and meet seasonal expenses, such as school fees and holiday celebrations. They also need financial services to prepare for life-cycle events, such as a daughter's wedding, or to cope with emergencies, like the sudden death of a family wage-earner or a monsoon that wreaks havoc on their village. Access to financial services enables the poor to increase income, build assets, and reduce their vulnerability to external shocks.

Poor people use a wide range of financial services and have done so for centuries. Some are already clients of formal institutions, such as savings and credit cooperatives, government-owned development banks, postal banks, commercial banks, and state banks. Most of the poor, though, usually lack access to the formal financial system, so they have developed a variety of informal financial relationships with, for instance, moneylenders, savings clubs, rotating savings and credit associations, and mutual insurance societies. These informal systems are pervasive in nearly every developing country: vendors may sell goods such as seed or fertilizer on credit and the poor may use informal savings devices like livestock, jewelry, or cash under the mattress to provide liquidity when the need arises or opportunity knocks.

However prevalent, the mostly informal financial services currently available to the poor have serious limitations in terms of cost, risk, and convenience. Moneylenders generally charge extremely high interest rates on loans. Buying supplies on credit is far more expensive than paying cash. Rotating savings and credit associations usually offer little flexibility in the amount or timing of transactions. A cow is not a divisible asset that can be sold incrementally to meet small cash needs; and it can be stolen, get sick, or die. Lastly, formal financial institutions may not offer financial products that are appropriate to the needs of the poor.

Efforts to extend formal finance to the poor began centuries ago. More recently, in the 1950s, development projects began to introduce subsidized credit programs targeted at specific clienteles. For example, governments and donors subsidized agricultural credit for small and marginal farmers with the goal of raising productivity and incomes. These schemes were rarely successful: subsidized lending was usually associated with massive delinquency, and the benefits of such lending were often captured by the elite instead of the poor.

The general failure of large subsidized credit schemes inspired social entrepreneurs in developing countries to test alternative ways to offer credit to poor people. Beginning in the 1970s, experimental programs run through non-governmental organizations (NGOs)—in Bangladesh, Bolivia, and a few other countries—extended tiny unsecured loans to groups of poor "micro-entrepreneurs," mainly women. This type of microenterprise credit was based on solidarity group lending in which every member of a group guaranteed the repayment of all the other members.

Throughout the 1980s and 1990s, these NGO-based microcredit programs improved upon the original methodologies and bucked conventional wisdom about financing the poor. First, it was shown that poor people, especially poor women, repay their loans. Near-perfect repayment rates, unheard of in the formal financial sectors of most developing countries, were common among the better microcredit programs. Second, the poor were willing and able to pay interest rates that allowed microfinance institutions (MFIs) to cover their costs. Third, the combination of these two features—high repayment and cost-covering interest rates—enabled some MFIs to cover their costs and achieve profitability. Microfinance differs from many other development interventions in that it serves massive numbers of clients without needing continuing subsidies.

CHALLENGES AND LIMITATIONS

By the late 1990s, however, a number of limitations inherent in the microenterprise credit model became apparent:

- Not all poor people run microenterprises. Supply-driven microenterprise credit methodologies don't reach the millions of poor people who don't need business loans, but do need other services, such as savings, consumption credit, insurance, and money transfer services. Convenient and safe deposit services are particularly crucial.

- NGOs, while essential for conducting research and developing new models, face serious challenges in terms of governance and legal limits on their operations. Most have not reached massive scale or independence from donors, although there are major exceptions.

- Microfinance institutions generally do not have large existing infrastructures to deliver microfinance services, but institutions such as commercial and state-owned banks, savings and loan cooperatives, and even retail chains, do.

HOW DOES MICROFINANCE HELP THE POOR?

Microfinance allows poor people to protect, diversify, and increase their sources of income. It helps cushion poor households against the extreme vulnerability that is a feature of their everyday existence and can push a family into destitution. Loans, savings, transfers, and insurance help smooth out income fluctuations and maintain consumption even during lean periods and emergencies. Microfinance gives people more options, empowering them to make their own choices and build their own way out of poverty.

Based on the available quantitative and qualitative studies on the impact of microfinance, the emerging evidence suggests that microfinance:

- reduces poverty and hunger, by allowing the poor to improve assets and incomes
- improves education levels: households with access to microfinance spend more on education than non-client households. Improvements in school attendance and the provision of educational materials are widely reported in microfinance households.
- promotes gender equality and women's empowerment. Most microfinance clients are female; microfinance empowers women by increasing their contribution to household income, the value of their assets, and their control over decisions that affect their lives.
- Reduces child mortality, improves maternal health, and combats disease.

Key Principles of Microfinance

1. **The poor need a variety of financial services, not just loans.** Just like everyone else, poor people need a wide range of financial services that are convenient, flexible, and reasonably priced. Depending on their circumstances, poor people need not only credit, but also savings, cash transfers, and insurance.

2. **Microfinance is a powerful instrument against poverty.** Access to sustainable financial services enables the poor to increase incomes, build assets, and reduce their vulnerability to external shocks. Microfinance allows poor households to move from everyday survival to planning for the future, investing in better nutrition, improved living conditions, and children's health and education.

3. **Microfinance means building financial systems that serve the poor.** Poor people constitute the vast majority of the population in most developing countries. Yet, an overwhelming number of the poor continue to lack access to basic financial services. In many countries, microfinance continues to be seen as a marginal sector and primarily a development concern for donors, governments, and socially-responsible investors. In order to achieve its full potential of reaching a large number of the poor, microfinance should become an integral part of the financial sector.

4. **Financial sustainability is necessary to reach significant numbers of poor people.** Most poor people are not able to access financial services because of the lack of strong retail financial intermediaries. Building financially sustainable institutions is not an end in itself. It is the only way to reach significant scale and impact far beyond what donor agencies can fund. Sustainability is the ability of a microfinance provider to cover all of its costs. It allows the continued operation of the microfinance provider and the ongoing provision of financial services to the poor. Achieving financial sustainability means reducing transaction costs, offering better products and services that meet client needs, and finding new ways to reach the unbanked poor.

5. **Microfinance is about building permanent local financial institutions.** Building financial systems for the poor means building sound domestic financial intermediaries that can provide financial services to poor people on a permanent basis. Such institutions should be able to mobilize and recycle domestic savings, extend credit, and provide a range of services. Dependence on funding from donors and governments—including government-financed development banks—will gradually diminish as local financial institutions and private capital markets mature.

6. **Microcredit is not always the answer.** Microcredit is not appropriate for everyone or every situation. The destitute and hungry who have no income or means of repayment need other forms of support before they can make use of loans. In many cases, small grants, infrastructure improvements, employment and training programs, and other non-financial services may be more appropriate tools for poverty alleviation. Wherever possible, such non-financial services should be coupled with building savings.

The best judges of the value of microfinance are poor customers themselves. Their view of the matter is evident from their actions. When good microfinance services are offered, poor customers almost always take advantage of them. Borrowers are willing to pay interest rates that cover the full cost of lending. Most importantly, the near-perfect loan repayment in well-run programs demonstrates how highly the poor value their access to loans: the main motive for repaying unsecured microloans is the clients' desire to maintain access to future services.

Of course, microfinance on its own is not sufficient to end poverty. Fighting poverty requires concerted efforts on many fronts. Financial services for the poor should be complemented by other interventions, such as education, health services, adequate physical infrastructure, and fair markets. It is also important to recognize that in some circumstances microcredit is not the best tool to fight poverty. The destitute, who do not have any source of income, are usually not appropriate clients for microcredit and may be better served initially through targeted safety-net or grant programs. Successful models in a few countries demonstrate that very poor households are better able to assume the risks that microfinance entails after participating in grant and skills development programs that enable them to slowly build assets and develop their skills. ■

"Like everyone else, poor people need and use financial services all the time."

Key Principles of Microfinance

7. **Interest rate ceilings can damage poor people's access to financial services.** It costs much more to make many small loans than a few large loans. Unless microlenders can charge interest rates that are well above average bank loan rates, they cannot cover their costs, and their growth and sustainability will be limited by the scarce and uncertain supply of subsidized funding. When governments regulate interest rates, they usually set them at levels too low to permit sustainable microcredit. At the same time, microlenders should not pass on operational inefficiencies to clients in the form of prices (interest rates and other fees) that are far higher than they need to be.

8. **The government's role is as an enabler, not as a direct provider of financial services.** National governments play an important role in setting a supportive policy environment that stimulates the development of financial services while protecting poor people's savings. The key things that a government can do for microfinance are to maintain macroeconomic stability, avoid interest-rate caps, and refrain from distorting the market with unsustainable subsidized, high-delinquency loan programs. Governments can also support financial services for the poor by improving the business environment for entrepreneurs, clamping down on corruption, and improving access to markets and infrastructure. In special situations, government funding for sound and independent microfinance institutions may be warranted when other funds are lacking.

9. **Donor subsidies should complement, not compete with private sector capital.** Donors should use appropriate grant, loan, and equity instruments on a temporary basis to build the institutional capacity of financial providers, develop supporting infrastructure (like rating agencies, credit bureaus, audit capacity, etc.), and support experimental services and products. In some cases, longer-term donor subsidies may be required to reach sparsely populated and otherwise difficult-to-reach populations. To be effective, donor funding must seek to integrate financial services for the poor into local financial markets; apply specialist expertise to the design and implementation of projects; require that financial institutions and other partners meet minimum performance standards as a condition for continued support; and plan for exit from the outset.

10. **The lack of institutional and human capacity is the key constraint.** Microfinance is a specialized field that combines banking with social goals, and [illegible]ty needs to be built at all levels, from financial institutions through the regulatory and supervisory bodies and information systems, to government development entities and donor agencies. Most investments in the sector, both public and private, should focus on this capacity building.

11. **The importance of financial and outreach transparency.** Accurate, standardized, and comparable information on the financial and social performance of financial institutions providing services to the poor is imperative. Bank supervisors and regulators, donors, investors, and more importantly, the poor who are clients of microfinance need this information to adequately assess risk and returns.