FINANCE FOR THE POOR: FROM MICROCREDIT TO MICROFINANCIAL SERVICES

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Abstract: This paper reviews the achievements of the ‘microfinance revolution’, through reference to the now extensive literature. It finds that there are many opportunities to improve and innovate. To illustrate this finding, the paper concentrates on examining what we need to know to design and deliver better financial products to the poor, especially the poorest. It argues that financial services for the poor are essentially a matter of helping the poor turn their savings into sums large enough to satisfy a wide range of business, consumption, personal, social and asset-building needs. The range of such ‘swaps’ should be wide enough to cater for short, medium and long-term needs, and they must be delivered in ways which are convenient, appropriate, safe and affordable. Providing poor people with effective financial services helps them deal with vulnerability and can thereby help reduce poverty. However, the relationship is driven by complex livelihood imperatives and is not simple. Microfinance is not a magic sky-hook that reaches down to pluck the poor out of poverty. It can, however, be a strategically vital platform that the poor can use to raise their own prospects for an escape from poverty. Copyright © 2002 John Wiley & Sons, Ltd.

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1 INTRODUCTION: POINTS OF DEPARTURE

After an initial wave of faith that state-mediated and subsidized credit provision could reduce poverty, countered by a second wave during the 1980s that deregulated financial markets would suffice, there is emerging evidence of a ‘new wave’ of microfinance experiences that are meeting the needs of the poor (Hulme and Mosley, 1996; Lipton et al., 1997; Johnson and Rogaly, 1997). This new wave, sometimes called the ‘microfinance movement’, has generated considerable enthusiasm among academics, donors and development practitioners of diverse intellectual persuasion (Montagnon, 1998; Dichter, 1997). This is reflected in the figure that by the mid 1990s the microfinance industry had extended around US$ 7 billion in loans to more than 13 million individuals around the world (World Bank, 1996) and claims that by 2000 the number of clients would be approaching 20 million.

Despite these recent advances, there are still many opportunities to improve practice. A better understanding of the financial service preferences and behaviours of the poor and poorest is needed to expand the scope of microfinance initiatives and address emerging concerns about microfinance and the poor and poorest (Morduch, 1998, 2000; Matin, 1998; Matin and Sinha, 1998; Rahman, 1998; Zaman, 1998; Gulli, 1998). The logic underpinning most of the recent innovation in microfinance starts from a set of assumptions about the financial service needs of the poor. The focus has been mostly on the design and institutionalisation of a microcredit ‘template’—a delivery model that is believed to best answer those needs. Millions of poor households around the world now benefit from this model. However, more useful and varied financial products can be developed if a fuller understanding of the existing money-managing efforts of the poor informs practice.

Debates about finance and poverty-reduction have been shaped by changing conceptualisations of who the poor are and the nature of poverty. During the early development decades (1950s, 1960s and 1970s) the bulk of the poor were seen as the members of families headed by (male) small farmers. Their poverty could be overcome by subsidized agricultural credit that would raise productivity and incomes. From the early 1980s a new image began to dominate thinking and action: the poor were mainly women (and their dependants) who coped with their situation by running microenterprises. Small business loans would permit them to expand (or establish) income generating activities, raise their income and socially empower them.

Most recently, the poor have been conceptualized as a heterogeneous group of vulnerable households with complex livelihoods and varied needs (Carney, 1998; Scoones, 1998; Ellis, 2000). From such a perspective microfinance is seen as a means for achieving household priorities (e.g. paying school fees, meeting funeral expenses), reducing vulnerability (e.g. a sudden drop in consumption, income or assets) and/or increasing income. It is this broader understanding of poverty that informs our paper and leads us to argue that ‘microfinancial services’ is the concept that should inform external agents intervening in the area of finance for the poor.

In the following section we summarize the contemporary understanding of how poor people manage their finances. We then review the experience of financial service delivery to the poor by informal, formal and semi-formal institutions. The fourth section reviews the ways in which financial market interventions can assist the poor. The final two sections draw out our conclusions.

2 THE POOR AND FINANCIAL SERVICES

2.1 The Economic Environment of the Poor

The economic environment of the poor has two features that have particular significance in shaping their use of financial services.\(^2\) The first is that they operate in a mini-economy in which production, consumption, trade and exchange, saving, borrowing and income-earning occur in very small amounts. The effect of this is that transaction costs (both direct and indirect) tend to be high as the ‘unit’ of transaction is generally minuscule. This has important implications for the use of formal sector institutions where the charging of any standardized administrative cost will commonly make transactions unattractive to the poor.

The second characteristic is that there are high levels of insecurity and risk. These arise because flows of income and expenditure commonly do not coincide, because of household-specific factors (loss of earnings through sickness, urgent medical expenses, premature death, theft, insecure conditions of employment, difficulties of contract enforcement), and because of broader environmental factors (natural hazards, harvest failure due to drought or flooding, national economic crisis, bank failures in the formal sector, a breakdown in security). The co-variant nature of the risks associated with this latter group are particularly problematic as they weaken the capacity of community-based social security networks to provide support.

These characteristics have a number of consequences.

(i) They limit the interactions of poor people with formal sector institutions.

(ii) They foster strategies of risk-spreading by the poor: these encourage diversification of economic activities and the development of financial relationships with networks of individuals, groups and agencies.

(iii) They lead to the use of savings and credit mechanisms by the poor as substitutes for insurance (Platteau and Abraham, 1984; Alderman and Paxson, 1992; Fafchamps, 1992) so that savings, credit and insurance cannot be treated as ‘separate’ services.

Demand for financial services from poor households calls for short- and long-term credit lines for financing inputs and investments in both physical and human capital, and for provision of savings opportunities with different rewards and maturities. In general, the poorer the household the greater the need to use savings and credit as insurance substitutes. Thus the contribution of financial services to coping with risks (the ‘protective’ role of financial services) becomes more important than the

\(^2\)For detailed empirical information on how the poor in Bangladesh manage their finances (and cope with their financial environment) see the 'Bangladesh financial diaries' on the Finance and Development pages of the Institute for Development Policy and Management website (http://www.devinit.org/findev/index).
expected return of the financial service alone (the ‘promotional’ role of financial services).3

2.2 The Money Management of the Poor: Towards A Typology4

Misconceptions still shape much external intervention in the financial markets of the poor. One of the most prevalent is that the poor do not and/or cannot save. Commonly, the poor are seen as ‘wasteful, immoral and irrational’. This is a cause of their misery and also helps to ‘explain’ their failure to better their lot.5 While we recognize the problems that can arise from alcoholism and gambling our experience is that the vast majority of poor people are actively seeking to improve their personal and household circumstances. A second image holds that the poor cannot save because: ‘they spend all their income and still don’t get enough to eat.’ Paradoxically, it is precisely because of such survival uncertainties that the poor need to and do save, though in ways that are not self-evident according to the conventional understanding of savings as income surplus after consumption. Such an image gives rise to the widespread view that the poor in general cannot save, and leads to an over-emphasis on the promotional role of financial services as credit for investment.

People (including the poor) may save money as it goes out (keeping a few coins back from the housekeeping money) as well as when it comes in (deducting savings at source from wages or other income). Even the poorest have to spend money to buy basic items like food and clothing, and each time they do so there is the opportunity to save something, however tiny. Many poor housewives try to save in this way, even if their working husbands fail to save anything from their income.6 That they sometimes succeed is shown by their habit of lending each other small amounts of money (as well as small amounts of rice or kerosene or salt). This ‘reciprocal lending’ is very common and makes up the bulk of financial transactions for many poor people (Matin and Sinha, 1998; Dreze et al., 1997) and demonstrates the poor’s capacity and willingness to save.

Given the interconnectedness of the roles of savings, credit and insurance, the motivation behind savings can be expected to be diverse. These needs can be categorised into three main groups.

Life-cycle needs
The poor have many life cycle needs that can be anticipated (though the timing cannot accurately be predicted) and which require that relatively large sums of money be amassed. These vary from region to region but include childbirth, education, marriage, home-building, old age, funeral expenses, festivals and the desire to bequeath a lump sum to heirs. The amount of cash needed to meet such expenses is much larger than can

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3See Dreze and Sen (1989; 1991) using this distinction in the discussions of different forms of ‘entitlement’ and ‘social security’ and an application of the concept in microfinance by Hulme and Mosley (1996).
4Several paragraphs in this subsection are drawn from Rutherford (1999).
5With great sarcasm, Bouman (1990, pp. 154–155) writes, ‘[...] and the lucky few who produce a surplus, do they not indulge in wasteful consumption, squandering their money on wasteful consumption, social-religious expenses?’
6Gender differentiated credit repayment behaviour has received a lot of interest (see Khandker (1998) for a gender differentiated impact argument and Morduch (1998) disputing it). However, the gender difference in savings behaviour, especially of tiny amounts, most relevant for poorer households, is also widely acknowledged and supports popular impression.
normally be found in the household. The anticipation of such outlays is a constant anxiety for many poor people.

Emergencies
Emergencies, that create a sudden and unanticipated need for a large sum of money, come in two forms—idiosyncratic and covariant. Idiosyncratic emergencies are ‘personal’ and include sickness or injury, the death of a bread-winner, the loss of employment, and theft. Covariant ones include events such as war, floods, fires and cyclones, and—for slum dwellers—the bulldozing of their homes by the authorities. Each creates a sudden need for more cash than can normally be found at home. Finding a way to insure against such events could help hundreds of millions of poor people.

Opportunities
As well as problems, the poor also have opportunities: to invest in an existing or new business, to buy land or other productive assets, or to pay a bribe to get a permanent job. One opportunity—the setting up of a microenterprise or expanding an existing one—has recently attracted a lot of attention from the aid industry and from the new generation of microfinance institutions (MFIs) that work with the poor.

How do the poor get access to the lump sums that life cycle needs, emergencies and opportunities demand? Apart from gifts or charity—which cannot be relied on—there are only three common methods. The first is to sell assets they already hold (or expect to hold); the second is to take a loan by mortgaging (or ‘pawning’) those assets. The third is to turn their many small savings into larger lump sums. The first method—the sale of assets—is usually a straightforward matter that does not ordinarily require any ‘financial services’. However, poor people sometimes sell, in advance, assets that they do not currently have but expect to hold in the future. The most common example is the advance sale of crops. These ‘advances’ are a form of financing, since the buyer provides, in effect, a loan secured against the yet-to-be harvested crop. The advance may be spent on financing the farming costs required to provide that crop. But they may equally be used on any of the other needs and opportunities identified earlier. The second method—mortgage and pawn—enables poor people to convert assets into cash and back again. It is the chance (not always realized) to regain the asset that distinguishes this second method from the first. As with the straightforward sale of assets, such services require the user to have a stock of wealth in the form of an asset (such as land or gold) of some sort. They allow the user to exploit their ownership of this stock of wealth by transforming it temporarily into cash.

Whereas these first two methods require that the users have assets, the third method enables poor people to convert their small savings into lump sums. This requires the users to have a flow of savings, however small or irregular. It allows them to exploit their capacity to make savings through a variety of mechanisms by which these savings can be transformed into lump sums. The three main mechanisms are:

- **Savings deposit**, which allow a lump sum to be enjoyed in future in exchange for a series of savings made now
- **Loans** which allow a lump sum to be enjoyed now in exchange for a series of savings to be made in the future (in the form of repayment instalments), and
- **Insurance**, which allows a lump sum to be enjoyed at some unspecified future time in exchange for a series of savings made both now and in the future.
Thinking about financial services for the poor as a matter of providing ways of turning small amounts of savings into larger useful lump sums helps us to understand the wide variety of informal arrangements that the poor themselves innovate and use. The nature of the financial service used varies, depending on local knowledge, history, context and need, but the essence of such arrangements is similar: turning small amounts of savings into usefully large lump sums.

3 MICROFINANCE: THE PROVIDERS AND THEIR SERVICES

3.1 An Overview

The conventional provider categories of ‘informal’ and ‘formal’ have been complicated by the arrival of microfinance institutions (MFIs) that may be regarded as ‘semi-formal’ (World Bank, 1997). While the informal sector has commonly been viewed as unregistered sources of credit, such as money lenders, pawnbrokers and traders, we also include savings services provided by rotating savings and credit associations (RoSCAs), accumulating savings and credit associations (ASCrAs) and deposit takers. Formal providers are those who are subject to the banking laws of the country of operation, provide conventional retail services to customers and engage in financial intermediation. Semi-formal providers are MFIs that are usually registered as NGOs or cooperatives and occasionally as banks with a special charter (such as the Grameen Bank).

This threefold categorization aids our analysis but it should not obscure the dynamics by which informal providers become semi-formal (as when managed RoSCAs register as chit funds in India) and MFIs convert from being semi-formal to formal (as when PRODEM became BancoSol in Bolivia).

3.2 The Informal Providers and Their Services

Informal providers are a heterogeneous group. More importantly, the distinction between informal providers and their users is often fuzzy since they are often one and the same. This commonly results in a relatively localized scale of financial intermediation. The conventional image of the informal provider is of the moneylender. However, the range of informal providers and their provision is in fact far more diverse. The fuzziness of the savings-credit-insurance nexus is most evident in the informal sector.

Our knowledge of informal financial service providers is relatively sketchy. They do not usually operate out of offices, they maintain few records and many such arrangements are temporary. In some countries, such as Indonesia, such services are illegal—though quite common. As the transactions tend to be relatively small, financing mainly consumption smoothing and working capital needs, informal finance is not very visible, despite its

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7Ghate (1988, pp. 4–5) found the theme of ‘informal credit market’ to be very restricted for his research: ‘The subject matter of the research project was initially ‘informal credit markets’, but as the study proceeded it became clear that informal finance is much more inclusive.’ Bouman (1990, p. 167) in a similar spirit writes that, ‘It is a fallacy to regard the informal financial market as the exclusive domain of the village moneylender… he forms only a small, often minor part of the protective network of mutual assistance that is chameleon-like and kaleidoscopic in nature.’

8For an explanation of the widespread time-bound feature of many informal arrangements, see Rutherford (1999).
ubiquity (Ghate, 1988). Moreover, the sensitivity that attaches to financial transactions, on the part of both borrowers and lenders, makes it a particularly difficult subject for empirical research.

The main providers of informal financial credit services are illustrated in Figure 1. According to this schema, a distinction is made between five broad categories: (i) lending by individuals on a non-profit (and often reciprocal) basis; (ii) direct but intermittent lending by individuals with a temporary surplus; (iii) lending by individuals specialised in lending, whether on the basis of their own funds or intermediated funds; (iv) individuals who collect deposits or ‘guard’ money; and (v) group finance.

This figure distinguishes between services extended by individuals to other entities and provision within mutually organized groups. A second distinction (among informal lenders who lend to other entities) can be made between regular and intermittent lenders. The latter extend credit intermittently, although not necessarily infrequently, whenever they have a temporary surplus of funds. More often than not, such lenders become borrowers, when the need arises. Such role reversals form the basis of informal insurance networks that have been examined extensively by researchers (Morduch, 1997; Fafchamps, 1995; Udry, 1994). Regular lenders, on the other hand, remain net lenders over an extended period of time.

Among regular lenders, a major distinction arises between those who ‘tie’ lending to other market transactions, and those who extend ‘untied’ credit. A distinction that cuts across both tying and non-tying lenders is that between lending out of lenders’ own funds (also referred to as ‘direct financing’) and lending based on funds borrowed as deposits.
when the lender acts as a financial intermediary. In group finance, intermediation can be thought of as taking place between members of the group.

Importantly, many transactions, which on the surface appear as credit, are on a deeper analysis, very closely linked to savings and insurance. Udrey (1994), based on his study of credit transactions in Nigeria, has described such transactions as ‘insurance substitutes’, Fafchamps (1995) refers to them as ‘quasi-credit’ and Rutherford (1999) as ‘advances against future savings’. Several researchers also point out that such fuzzy financial transactions are more important for the poor⁹ (Matin and Sinha, 1998; Morduch, 1997). Most intermittent lending (which is often reciprocal) and mutual group finance falls under this category.

Credit

The credit function of informal finance has received the most widespread attention, particularly as a source of initial working capital for micro enterprises.¹⁰ Intermittent and sometimes reciprocal lending for businesses also takes place between households and can help smooth out short-term cash flow problems and ease longer-term credit constraints. This is important in financial markets for the small enterprises of the non-poor. The size of this market in India has been estimated to be equivalent to 13 to 25 per cent of total bank credit to industry (Ghate, 1988, p. 25).

Getting access to a useful lump sum through building mutual savings is central to informal group finance schemes. In such arrangements, groups of individuals pool their savings and lend primarily to each other. In RoSCAs, the equal periodic savings of every member are pooled and given to each member in turn: there are therefore as many poolings as there are members and the cycle comes automatically to an end when each member has taken her ‘prize’. In an ASCrA by contrast, the pooled savings of the members may accumulate until such time as one or more members are willing to take them on loan. The device is therefore not time-bound like RoSCAs though many groups limit the life of their ASCrA in order to ensure a satisfactory outcome. The widespread use of such mutual finance models across time and space has generated much interest and careful study.¹¹ These arrangements have been shown, in the extensive field literature, to exist in developing and developed countries in both rural and urban areas, among both females and males and among all classes including the poor.¹²

The basis and the gains to members that such arrangements offer is predicated on the difference in preferences (in terms of current and future consumption) that might exist among the participants at any particular point in time. Besley et al. (1992) argues that RoSCAs are predominantly a means of acquiring indivisible consumer durables. As such, RoSCAs are often classified under informal credit although it can be argued that the insurance motive¹³ also plays an important role, especially in

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⁹It however must be pointed out that most empirical studies have shown sharp limits to these arrangements, especially as far as their access to the poorest group goes. A substantial number of households, especially the poorest, appear ill-equipped to handle even small-scale, localized risk that most of these arrangements are designed to cope with. The reasons and dynamics of such exclusion lies in broader socio-economic forces (Osmani, 1989; Dreze and Sen, 1989).

¹⁰However, personal savings remain the most important source of start-up capital for rural non-farm activities (Khandker, 1998). It is as high as 50 per cent even for Grameen Bank borrowers.

¹¹For an illustration see the papers in Bouman and Hospes (1994) and for a listing of relevant references see Robinson (2001).

¹²Much of this large literature is cited in Ardener and Burman (1995)

¹³However, it should be noted that RoSCAs are better able to insure against event uncertainty than against income uncertainty (non-idiiosyncratic risk).
bidding RoSCAs. The continuing prevalence (and rise) of these arrangements have often intrigued researchers. Part of the reason for this may be the inability of the participants to access other financial services, but recent research (Brink and Chavas, 1991) shows that these institutions are built on solid microeconomic foundations.

**Savings**

The credit extended by intermittent lenders and group finance arrangements are essentially hybrid financial products, incorporating savings mobilization and insurance functions. This is important given that poor households tend to use these forms of financial services to a greater extent than the non-poor. The building up of small amounts of savings and innovative intermediation across a network (see Rutherford, 1998, for ingenious examples) is the basis of the informal financial services that the poor predominantly use.

The savings contribution of the informal sector is often discussed in the context of deposit mobilization. However, when savings are viewed as deferred consumption, it is seen that the informal sector provides opportunities for saving both through direct lending and intermediation. A large part of informal credit is from friends, relatives and neighbours deferring current consumption to lend to others directly. In fact the bulk of rural investment consists of direct finance, with lenders using their own funds built up over a period of time.

The type of informal finance that makes the greatest contribution to additive savings (that is savings that would not have been mobilized by the formal sector in the absence of the informal) is mutual finance—group-based or reciprocal financial services of one kind or another, including savings clubs. The major attractions of such arrangements as a means of savings are: (i) reciprocity, or the in-built provision of borrowing at short notice, especially for the bidding varieties of ROSCAS. This serves as a kind of access to a liquidity-guaranteeing function which is especially important to business; (ii) being able to save in small instalments, which is particularly attractive to the poor; (iii) the provision of a disciplined environment for saving, once the initial decision to join a club has been made; (iv) convenience and absence of formalities; and, (v) meeting illiquidity preferences by permitting savings to be hidden away from the demands of friends and relatives.

In many countries of Africa, above all in West Africa, itinerant deposit collectors collect savings from their customers and charge a fee for the service (see Aryeetey and Udry, 1997 for a review). There are itinerant deposit takers in Asia (see Rutherford, 1998 for an example from southern India) but their prevalence is low compared to Africa. One reason suggested to explain this is that in Asia it is more often the case that the poor acquire lump sums as loans from money lenders, rather than by microsavings.

### 3.2 Informal Financial Intermediation: Savings and Credit

It has been argued that—outside mutual devices such as RoSCAs and ASCrAs—intermediation is often either absent or very localized for informal finance. Binswanger et al. (1984) observe that the traditional moneylender relies on his own funds and does not

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14One of the important differences between RoSCAs is in the variation of determining the sequence of fund receiver. This may be random (lottery RoSCAs), pre-determined and bidding. In each category, there are variations as well.
accept deposits. He gives three reasons for this. First, the seasonality and synchronic
timing of agriculture means that if depositors and borrowers are both engaged in
cultivation, depositors will want to withdraw deposits exactly when borrowers want to
borrow—at the beginning of the production season. Similarly, depositors will want to
make deposits exactly when borrowers will want to make repayments—after harvest.
Second, the covariance of yield risk in agriculture leads to covariance of default and to
covariance of income between depositors and borrowers. Unless the moneylender has a
very high level of reserves, he may not be able to repay depositors. 15 Third, since the
information gap between a depositor and a lender both engaged in the same occupation is
likely to be smaller than would be the case were they engaged in different occupations, the
possibility of direct lending places a limit on the difference between borrowing and
lending rates the moneylender can charge. Since he must have a high reserve ratio if he
accepts deposits, and only the lent-out part of his funds earn interest, he is not in a position
to offer depositors a good enough return to prevent them from lending to borrowers
directly. 16 Yet another reason is the limited number of borrowers that the moneylender can
possess information on. This limits the size of his market to a small number of borrowers,
for whom he can usually cater with his own funds.

Despite such arguments, the volume of intermediation in some rural areas by informal
institutions has been reported to be high. This is especially in areas with diversified
agriculture and a well developed non-agricultural sector such as Kerala (Ghate, 1988). It is
conducted by agencies that often have several partners and employ staff to appraise loans.
They take advantage of Kerala’s agriculture, with its large variety of commercial crops
which reduces the severity of seasonality and covariance of risk and income. Moreover,
the importance of deposits from non-agricultural sources, such as remittances from
abroad, greatly increases the possibilities of intermediation by increasing the hetero-
genecity of depositors and borrowers.

Insurance
The insurance role of informal finance has already been mentioned 17—credit often serves
as an insurance substitute. However, empirical studies have shown that the scale and
effectiveness of most informal insurance is narrow. A substantial number of households,
especially the most poor, appear ill-equipped to handle even small scale, localized risks
(Alderman and Paxson, 1994; Morduch, 1995). 18 Most informal insurance arrangements
work on the basis of self-enforcement, for example, when slum shopkeepers set up a fund
to spend in the case of a fire. They tend to operate best when participants have a cushion
from poverty. Importantly, many of these mechanisms are costly. In risk prone rural India,
for example, households may sacrifice as much as 25 per cent of average income to reduce
exposure to shocks. In addition, informal insurance mechanisms appear to be particularly
fragile when most needed—for poor people during widespread covariate shocks.

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15 To the extent that farmers grow different crops with different cropping calendars, the effect of seasonality and
synchronicity will be dampened somewhat.
16 This argument can be challenged on the grounds that the poor are so keen to save that they are prepared to
accept low interest rates and/or even pay for savings services. Binswanger et al. (1984) do not consider the
possibility of such imperfect markets for savings.
17 It should however be noted that implicit informal insurance arrangements encompass a much broader set. For an
excellent discussion see, Morduch (1997).
18 For the initial optimism with informal insurance mechanisms, see Townsend (1994). For later more pessimistic
findings, see Alderman and Paxson (1994).
Nevertheless, some specific risks appear to be well-covered by informal insurance devices in some localities. Burial or funeral funds were found by Rutherford and Arora (1996) to be working well in the slums of the southern Indian city of Cochin, and reaching the very poor in greater numbers than most other informal schemes. There are reports of similar devices in southern and western Africa. Related schemes such as marriage funds—where parents save small sums regularly in order to enjoy a substantial sum when their child marries—are also common in southern India and elsewhere.

3.3 The Formal Providers

There is a plethora of studies evidencing the failure of the formal financial sector to serve the poor. The existence of capital market imperfections in the rural areas of developing countries has engaged the attention of economists, social scientists and policy makers for decades. Following the green revolution and a greater need for credit to small farmers to facilitate their adoption of technology, the question of improving small farmers access to institutional credit received considerable attention. In many parts of the world subsidised agricultural credit was viewed as a key strategy for promoting economic growth and poverty reduction.

The empirical record suggests that these efforts have seldom benefited poorer farmers or poorer people (Gonzalez, 1981; Lele, 1981; Lipton, 1976). The reasons for this include urban biased credit allocation (Lipton, 1976), the poor’s lack of collateral, the higher transaction costs faced by small borrowers, interest rate restrictions on formal lenders (Gonzalez, 1981) and patronage, arbitrariness and corrupt practices. In addition, high default rates prevented these interventions from becoming financially viable and most had to be abandoned after years of public financial support. The reasons for poor loan recovery, it was argued, are related to inappropriate design features, leading to incentive problems, and politicisation that made borrowers view credit as political largesse (Lipton et al., 1997).

Such failures stimulated the ‘new wave’ of microfinance and provided benchmarks against which the success of these new ideas are assessed. Interestingly, the formal financial sector has in general shied away from drawing lessons from the microfinance revolution. Their approach to banking and financial service provision has remained largely unaltered. The reasons for this are not clear: it could be scepticism about profitability (Montagnon, 1998), lack of pro-poor organizational values, or simply a market niche that has been shown to be better served by specialized microfinance institutions. One exception to the general state of affairs is the Bank Rakyat Indonesia (BRI)—see Robinson (2001) for a detailed discussion—which manages to deliver conventional banking services to low income clients (Box 1). In addition, in many countries the post office run savings schemes that are widely used by low-income households (e.g. Kenya, Malawi and Sri Lanka), and in some countries (e.g. Sri Lanka and the Philippines) formal banks engage in pawnbroking.

Evidence is only presently emerging about the provision of insurance services by the formal sector but, at least in South Asia, this may well be on a much wider scale then previously recognized. In India, the state controlled insurance companies provide life insurance policies to large numbers of people, in both slums and villages, through extensive networks of agents. In Bangladesh, Delta Insurance launched a Gono Bima (popular insurance) in 1994 that had more than half a million clients by 1997 (Box 2).
3.4 Semi-formal providers: the Services of MFIs

At the time that the Ohio State School (Adams et al., 1984) was criticizing conventional rural finance a set of innovative financial institutions in several corners of the world began to prosper and attract attention—especially in Bolivia, Bangladesh and Indonesia. These microfinance institutions (MFIs), share a commitment to serving clients that have been

Box 1. The Bank Rakyat Indonesia’s Unit Desa Scheme

The Bank Rakyat Indonesia (BRI) is notable for its success in delivering conventional banking services to low-income clients. By setting up small sub-branches—or ‘units’—BRI is able to reach a mass rural clientele. It does not have an exclusive ‘poverty’ focus but has developed products that have enabled it to work profitably with low-income households as well as its more conventional bank clients. Foremost among these are its savings services which offer convenient banking hours, a friendly interface, unconstrained withdrawals, and a range of incentives including bonuses and raffles. Clients may also take loans with a range of convenient terms and repayment frequencies. Unlike the group-lending methodologies of the Grameen Bank and Village Banks BRI acts as a conventional intermediary. Borrowers are dealt with as individuals, and only a minority of its clients—including its low-income ones—are borrowers at any one time. The Unit Desa scheme proved highly resilient to the shock of Asia’s ‘financial crisis’ in the late 1990s.

Box 2. The Gono Bima (Popular Insurance) Scheme of Bangladesh

Gono Bima (Popular Insurance) is a subsidiary of a large private insurance company in Bangladesh, Delta Insurance. It markets a life insurance product that has been designed to reach the poor in large numbers, and has clearly benefited from the experience of MFIs like Grameen Bank. The product itself is simple. It is a ten-year contractual savings account with fixed monthly premium payments leading to a one-time lump sum payout at maturity along with accumulated interest. The insurance element is provided by the guarantee that the death of the insured at any time during the term will trigger a full payout as if the term had been completed.

Its delivery mechanism is equally simple. There are no medical examinations and application procedures are minimal. Gono Bima rents simple office accommodation in rural and urban centres staffed by field workers who collect the premium payments from customers arranged in groups in the villages and slums. The smallest monthly premium accepted is about two dollars. The office then re-lends the premium income to its customers in loans whose terms are similar to those of the Grameen Bank.

Started in 1994, the Gono Bima service had reached many villages and by the end of 1997 there were more than half a million policy holders in the scheme. However, the scheme is now facing major problems because of administrative problems that threaten its financial viability.

3.4 Semi-formal providers: the Services of MFIs

At the time that the Ohio State School (Adams et al., 1984) was criticizing conventional rural finance a set of innovative financial institutions in several corners of the world began to prosper and attract attention—especially in Bolivia, Bangladesh and Indonesia. These microfinance institutions (MFIs), share a commitment to serving clients that have been

19We borrow this phrase from Morduch (1998).

20This term itself is new—the earlier version, ‘microcredit’ is still widely used (as the microcredit summit exemplifies), underpinning the belief that credit is the vital element for poverty alleviation. As we hope to show, the credit first vs. savings first dichotomy is false and is detrimental to the prospects for future innovations in microfinance.
excluded from the formal banking sector. While they often claim to work with ‘the poorest of the poor’, the socio-economic position of their clients varies greatly.

How are these new institutions different from their predecessors? First, many MFIs are financially successful, boast repayment rates above 95 per cent,\(^{21}\) and keep a watchful eye on subsidy levels and institutional efficiency. The second, often-cited difference is a real innovation: the group-lending contract,\(^{22}\) which has been the subject of much interest to economic theorists.\(^{23}\) A third difference is the acceptance that what households need is access to credit, not cheap credit. Finally, these MFIs are either independent of government and/or have a high degree of autonomy from bureaucrats and politicians.

Many MFIs permit people to access useful lump sums through loans. The currently most popular product (that offered by the Grameen Bank and copied by many other MFIs) which allows borrowers to repay the loan in small frequent manageable instalments represents a pivotal innovation. Supported by quick access to larger repeat loans, this can to a large extent explain the widely touted success of these programmes. In a study by Mosley and Hulme (1998), defining success in terms of arrears rate and subsidy dependence index, two features—frequency of instalment and repayment incentive—correlate strongly with success. (Repayment incentives may include several devices including larger repeat loans, access to loans for other group members and ‘cash-back’ for clients who repay on time.) It also correlates with savings facilities, but interestingly, not with the tendency to lend through the group-formation model.

The participation of the poor in such programmes is thus made possible by the key feature of microfinance lending—tiny, often weekly, repayments\(^{24}\) (Matin and Sinha, 1998; Todd, 1996). Such a regime allows borrowers to repay out of existing income, freeing the borrower to invest the loan in whatever use best fulfils their needs of the moment. This is not to deny that for some borrowers, usually the relatively better-off, these loans are directly invested in productive enterprises where the returns on additional investment is sometimes enough to service the regular repayments.\(^{25}\) But even for this class of borrower repayment by instalment remains attractive, giving them an option to maintain good repayment records even if investments fail.

Some MFIs have tried to monopolize their clients’ financial service needs, and some even believe that after using their services for a spell clients will become ‘self-reliant’ and

\(^{21}\)Repayment rates, however, are not uniformly calculated and can be misleading: see the CGAP note by Rosenberg (1998) for a good discussion.

\(^{22}\)It should be pointed out at the outset that the group contract approach is far from universal and the success of the model is mixed. Recent empirical (Matin, 1998) and theoretical work (Morduch, 1998; Diagne, 1998) cast considerable doubt on its sustainability and applicability in varying contexts.

\(^{23}\)Recent theoretical studies of the group based approach to microfinance include, Stiglitz, (1990); Besley and Coate (1997); Banerjee et al. (1997); Diagne (1998); and Morduch (1998).

\(^{24}\)The argument would also imply that as instalment size gets bigger due to rapid credit deepening, participation by the poor as new entrants might be adversely affected and repayment suffer. Evidence for both of these tendencies is found in Matin, (1998).

\(^{25}\)The debate around market saturation and declining returns as loans get larger has been aired for some time but never seriously examined. Montagnon (1998) argues that at initial stages (and low loan size), it is possible to generate adequate return from investing loan money to manage repayment with interest, but not at later stages as both the business and loan size gets larger. This is because, initially most microenterprises are labour-intensive with few fixed assets. Thus credit extended can make huge difference to productivity. However, as loan size gets larger, the turn-over slows down as more and more of the capital is used as fixed investment on which returns may be lower and slower to materialise. On the other hand, Rutherford (1999) argues that loan terms which require the capital to be returned in weekly instalments within one year, and starting the week following receipt of the loan, require very high internal rates of return for the businesses in which the loan is invested and that in Bangladesh at least there is only a very narrow range of businesses that can tolerate such terms.
able to do without financial services altogether. (This is the essence of the Finca Village Banking Model.) Observation of the actual financial service preferences and behaviour of poor people tells a very different story. Where they are available, many poor people choose to use every service or device they can. For example, a visitor to a borrowing group set up by an MFI will often find that its clients have their fingers in several other ‘financial pies’. Typically they will also belong to RoSCAs, and sometimes to more than one RoSCA, using each RoSCA to satisfy a particular need with a particular term. One RoSCA to help pay an annual tax burden, another to deal with school fees, and a third to replenish stock in a small business, is not uncommon. Meanwhile, the MFI client may not have broken her relationship with her traditional moneylender or deposit collector, maintains her relationship with the set of relations and neighbours with whom she exchanges loans on a reciprocal basis (often charging interest), and stores some cash at home or in a savings account in a bank. Where MFIs are thick on the ground—as in Bangladesh—multiple membership of MFIs is becoming common, despite efforts by the MFIs to discourage it.

4 MICROFINANCE AND POVERTY REDUCTION

4.1 Not One but Many Paths

In conceptual terms, one can distinguish between two types of strategy used by a household to reduce the effects of risk. The first is income smoothing—this is most often achieved by making conservative production or employment choices and diversifying economic activities. In this way, households take steps to protect themselves from adverse income shocks before they occur. Second, households can smoothen consumption by borrowing and saving, depleting and accumulating non-financial assets and employing formal and informal insurance mechanisms. These mechanisms take force after shocks occur and help insulate consumption patterns from income variability. In the absence of access to financial services, both these strategies are costly and can adversely affect the risk-coping mechanisms of the household in the long run, further exacerbating poverty. Based on this, the ways in which financial services impact on household welfare and food security, can be grouped into three (Zeller, 1996). The first is income generation, which decreases the cost of income smoothing by allowing households to engage in more risky but also more profitable activities. The second and third impact pathways are related to decreasing the cost of consumption smoothing through allowing households to hold and retain better combinations of assets and liabilities or through increasing liquidity for direct consumption smoothing.

Path 1—income generation

This has been the traditional and most widely claimed rationale for intervention, evident both in the earlier (largely unsuccessful) agricultural credit schemes and the present generation of microfinance institutions. The argument is that loans provide additional capital on a temporary basis that can be used to enhance the level of the household’s

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26Rutherford and Arora titled one of their reports, Almirahs Full of Passbooks, after discovering very intense multiple-use of financial services in the slums of Cochin in Kerala. An almirah is a secure steel or timber cupboard found in most homes on the sub-continent.
productive physical capital. For farm households, in particular, the demand for financial services arises out of the requirements of the agricultural cycle. Borrowing may also allow the household to take advantage of potentially profitable investment opportunities that are too large to finance out of its own resources. Furthermore, easing capital constraints through credit can reduce the opportunity costs of capital-intensive assets relative to family labour, thus encouraging labour-saving technologies and raising productivity, a crucial factor for development.

A second indirect effect stems not from borrowing per se, but from access to credit. This is expected to increase the household’s risk bearing capacity. Just the knowledge that credit will be available to cushion consumption against an income shortfall if a potentially profitable, but risky investment should turn out badly, can make the household more willing to adopt more risky ‘technologies’.

Path II—more cost efficient management of assets and liabilities
Improved access to credit may make it possible for the household to smooth consumption at lower costs compared to other strategies. It is argued that improved access to financial services induces the following changes in the household’s composition of assets and liabilities.

- A decrease in the holding of assets with lower risk-adjusted returns, specially if they have access to less risky savings options
- A reduction in the level of assets held for precautionary savings
- An increase in the level of assets held for speculative purposes
- A decline in the level of credit obtained at high cost from informal sources
- A decline in the level of asset sales at low prices

Path III—direct use for immediate consumption needs
Households attempt to smooth their consumption by adjusting their disposable income. Informal systems of savings, self-help and insurance, as well as high-cost lending, appear to have comparative advantages for covering idiosyncratic shocks, but may not be an efficient institutional response to covariate risk. Moreover, access by the poorest to the informal arrangements, might be restricted. More formalized financial services can, on the one hand deepen access and on the other hand allow households to smoothen consumption in the face of covariate risk.

4.2 The Depth-of-Outreach Problem

Such a nuanced perspective of financial service allows us to understand the difficulty that poorer households face in participating in and sustaining benefits from some of the current innovations. It is possible to identify two distinct responses to these concerns. The first comes from the ‘poverty-focused’ quarter who argue that non-credit and more direct income generating interventions are required for the poorer for whom the ‘poverty escape through credit’ route is much too risky and inappropriate (see Hashemi, 1997;
Greeley, 1997 for an elaboration of this view). The second response is from the ‘scale-is-all’ quarter, which argues that as long as a large enough scale of outreach is reached, the concern with ‘depth of outreach’ (i.e. the proportion of poor in total membership and the depth of poverty of the poor reached)\textsuperscript{28} is inconsequential.

In the first view, provision of financial services is seen as playing an instrumental role in poverty alleviation. However, as we argue in this paper, it might be worthwhile considering the importance of financial service provision to the poor as intrinsic value, irrespective of its promise as a poverty-alleviating tool. Viewed from such a vantage point, the challenge is placed on the design of suitable financial service products that the poor would find useful. This in turn warrants an understanding of financial behaviour and preferences of the poor. The second view, on the other hand, can lead to the unfortunate turning back of the achievements that have been made in the provision of finance to the poor. Ignoring the depth of outreach issues and concentrating solely on the scale of outreach might encourage exclusive upmarket product innovations\textsuperscript{29} leading to further regression in the development of financial services for the poor. In this sense, both these views share the common assumption that financial service is not important for these excluded poorer households—a view that has been shown in this paper to be false. Much of the informal arrangements that the poor use reflect the importance that financial service has on their lives.

The issue of contemporary microfinance institutions in failing to attract\textsuperscript{30} the poorest of the poor is an important one for the purpose of this paper and for an understanding of the possibilities and limitations of the current innovations in general.\textsuperscript{31} The depth of outreach problem of microfinance institutions can be seen in terms of demand and supply forces. Most studies focus on the demand side forces leading to the conclusion that not all categories of the poor can make good use of the services. However, it must also be noted that such demand side constraints are underpinned by certain supply side factors like the nature of the service provision and the terms of the contract. It could be argued that changes in these supply side features—through better product design and delivery methods—would alter demand in ways that deepen outreach. This would warrant serious research into the financial behaviour and preferences of the poor, which as argued above, can be very different from those of the non-poor. In general, poorer households tend to use

\textsuperscript{28}In the poverty measurement literature, distinction is made between several poverty indices of a particular class of measures. The most common class of such measurement is the Foster Greer Thorbeck indices, popularly referred to as FGT indices. There are three measures within this class. The first, popularly known as the $P_0$ measure tells us about the incidence of poverty, or the head-count ratio which is the number of people below the poverty line as a proportion of a population. The $P_1$ measure tells us about the depth of poverty or the average shortfall in expenditure per head of a poor person from the poverty line. The $P_2$ measure captures the inequalities amongst the poor which $P_1$ measure does not. The $P_2$ measure allows for an expenditure improvement of a person far below the poverty line to be valued more than the same gain for a person just below the poverty line. The concern for microfinance programme outreach is that, it might score well in terms of $P_0$ measure, but not in terms of other FGT poverty measures.

\textsuperscript{29}Moving upscale only in terms of quantity (loan size) while maintaining other elements of the contract unaltered has not been very successful (see Matin, 1998 for the Grameen Bank experience and Motagnon, 1998 for a more general discussion). This has been well-recognized and recent upscaling attempts involve radical changes in the nature of the contract, like the microleasing of Grameen Bank or the MELA loans of BRAC (see Zaman, 1997).

\textsuperscript{30}We prefer to use the word ‘attract’ rather than the more well-known ‘reach’ because our preferred term implies a client-driven, bottom-up perspective where the client decides to use the provision based on its usefulness.

\textsuperscript{31}The conceptual and methodological problems of measuring the depth of outreach, and changes in it, are considerable. They arise because of the lack of baseline studies of MFI clients and the difficulty of including in the analysis. In addition, there are the standard problems of deciding whether to adopt a narrow or holistic concept of ‘poverty’ to the client group.
financial services through path II (see above)—not so much through direct income generation, the much championed rationale for microcredit initiatives.

5 A FINANCIAL SERVICE-OUTREACH PERSPECTIVE

We propose a perspective that highlights the relationship between the nature of financial services being provided and the client set it attracts. The ‘nature of financial service provision’ includes the core features of the ‘products’ that link provider and client and other wider supply factors like institutional values and the dynamics through which they are translated into practice. What seems to influence the depth of outreach in an important way is the content and the flexibility of the programme and its terms and conditions: the degree to which the products offered meets poor people’s specific needs by tailoring the characteristics of the products to them. The poorer strata of the population might be better reached if a broader range of financial services is provided. In Sri Lanka, for example, SANASA’s poorest clients use savings services more than credit services (Hulme and Mosley, 1996) and small, high-cost emergency loans more than larger, lower cost investment loans.

One can think of three main ways of making MFI services more poverty focused. These are: (i) identifying and reaching the poor; (ii) attracting the poor; and, (iii) discouraging or excluding the non-poor. A recent study (CGAP, 1998) assessed the relative emphasis that existing MFIs place on each of these dimensions. The results show that most emphasis is placed on identifying and reaching the poor and the least on attracting the poor, which lies at the heart of the financial service-outreach framework that we would propose.

Throughout the 1990s, development researchers and practitioners have been discussing the relative importance of deposit services and loans, especially for poorer clients. The emphasis is shifting from the microcredit-poverty alleviation equation to one that recognizes the intrinsic importance of building sustainable financial systems that offer a wide-ranging menu of financial services (microcredit, microsavings and insurance facilities). It is argued that provision of a wide range of financial services will not only better fulfil clients’ needs, but also improve outreach-depth, and improve access to sources of funding.

Although, to date, the microfinance industry has emphasized loan provision, opportunities for opening savings accounts and deposit services are especially important for the poor. The advantages that deposit facilities show over informal savings are a good mix of accessibility to cash, security, return and divisibility. Additionally, the ability to mobilize savings can contribute crucially to the long term sustainability of the deposit-taking institution. Savings deposit and withdrawal behaviour can be a useful proxy for debt capacity, which can be used along with the traditional membership length proxy widely used. However, regulatory framework issues pertaining to deposit protection need to be

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32 Several studies stress the importance of organizational commitment to working with the poor as a condition of actual outreach (Jain, 1996; Hulme and Mosley, 1996; Johnson and Rogaly, 1996). Also, it is possible to think of ways in which the nature of the service provision can influence staff incentives. For instance, several studies show how credit disbursement pressures lead staff to select better-off clients (Hulme and Mosley, 1996; Matin, 1998). Such staff incentive can change if the service provision emphasizes small savings mobilization.

33 Using membership length as a proxy for debt capacity is not without problems. Several studies show how this is leading to default for some institutions (see Matin, 1998).
addressed. Moreover, donors would need to examine whether low cost loans and grants threaten organizational incentives for savings mobilization.

Above all, mobilization of the savings of the poor requires an understanding of the nature of such savings, which, as we argued in the first section, are tiny temporary surpluses that accrue to the household with high frequency and seasonality. Along with this, it is also important to understand the motivations behind the savings of the poor—this we have argued is driven by the need for useful lump sums which are used to meet a diverse set of needs. To meet such varied and changing needs more flexible products are required. An example of the form that these might take is provided by SafeSave (Box 3).

Evidence from many countries demonstrates that the demand for deposit services is high and that such services have benefits for both the institution and their clients. Some analysts argue that savings and credit facilities can serve the same purpose and the choice of one over the other is a part of the household’s risk management and coping strategies. For instance, a small credit to cope with a crisis at a time when saved resources are inadequate does not necessarily make a household more vulnerable—it depends on the terms on which the credit is extended and the overall financial situation and debt burden of the household.

There is also an important difference between savings and credit—loans provide an opportunity of accelerating investments when the amount saved is inadequate (Gulli, 1998). People need a plan and a disciplined opportunity to save and they save slowly while...
they can borrow relatively quickly. For a poor tailor, the opportunity to buy a sewing machine today as opposed to after a year of saving might make a big difference.

What may also make the difference, however, is the availability of all three types of financial services. Availability of financial services does not mean that all poor households need to be in debt or save at a certain point in time. However, all households, including the poor will benefit from the availability of financial services that allows them to save when they want, cope with a crisis when it occurs and borrow to take advantage of opportunities when they arise.

6 CONCLUSION

The last fifteen years have seen significant advances in both the understanding of the needs of the poor for financial services and of the provision of financial services for them. We now understand that:

- The poor need financial services that help them maintain and improve livelihoods. Innovations that address the constraints faced by the poor due to an imperfect financial market can allow them to take up direct income generation, increase productivity of existing enterprises, and also help smoothen consumption, invest in longer term human capital formation and cope with contingencies and life cycle needs.
- Both informal (including self-provision) and formal providers can help meet these needs. Many poor people strive to develop a complex portfolio of microfinance assets and liabilities.
- Understanding the existing financial service behaviour and preferences of the poor can be a good guide to product design and development by MFIs and formal banks.
- Financial service innovations for the poor need to be dynamic, context-specific and adapt to the changing needs.
- Better-designed financial services can act as an important mechanism that increases the poor’s ‘room for manoeuvre’. Providing poor people with effective financial services helps them deal with vulnerability and can thereby help reduce poverty. However, the relationship is driven by complex livelihood imperatives and is not simple. Microfinance is not a panacea that converts the poor into the non-poor. Rather, it can be a platform that raises the likelihood of success of the strategies to escape poverty that poor households pursue.

However, as we have shown in this paper, provision still lags behind the knowledge that has been generated—there remains a great need to narrow this gap and deepen understanding. Provision has advanced in terms of recognizing the need for products that meet the preferences and circumstances of poor people—access to ‘lump sums’, regular and small savings and repayments, appreciating the importance of incentives and commitment to sustainability. However, it remains weak on developing processes that rapidly identify high quality ‘new products’, creating organizations that can cost-effectively deliver such products and on mechanisms for increasing depth of outreach. The first ‘microfinance revolution’ has shown that the ‘poor are bankable’—the second revolution is faced with the challenge of showing that it is possible to offer a set of financial services to the poor that meet their complex livelihood needs rather than pretending that they are simply small farmers or micro-entrepreneurs.
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