

The Poor and their Money: what have we learned?

Ana Marr

This series of Poverty Briefings aims to provide up-to-date insights on the issue of poverty, including the state of current understanding or opinion. Each paper covers new as well as old thinking on the issue, areas of debate, new approaches which are being tried, the options available, and the recent findings of research and experience.

Already published in the series:

Promises to the Poor: the Record of European Development Agencies
Aidan Cox and John Healey

Approaches to Sustainable Livelihoods for the Rural Poor
Diana Carney

The Meaning and Measurement of Poverty **Simon Maxwell**
Simon Maxwell

Forthcoming:

Poverty Reduction Agendas in North and South Compared
Ed Clay and Liz Dowler

Globalisation and Freer Trade and Poverty
H.-B. Solignac-Lecomte

Structural Adjustment Programmes and Poverty
Tony Killick

Public Expenditure and the Poor
Aidan Cox and John Healey

Poverty, Natural Disasters and Complex Political Emergencies
Margie Buchanan-Smith

At the time of writing *Ana Marr* was a Research Fellow at ODI.

Emails will be forwarded:
publications@odi.org.uk

ODI wishes to acknowledge grants from the Swedish International Development Cooperation Agency, Sida, and the UK Department for International Development towards this series. However, the opinions expressed are those of the authors.

The picture in brief

Money markets ought to allocate finance where it is most needed, and thus contribute to greater productivity, employment and the reduction of poverty. Yet in practice they have not performed this function at all well. Vast segments of the population are still unserved, inappropriate financial services are offered and inflexible contracts are extended. Poor farmers and small businesses are generally excluded from conventional financial institutions like the big commercial banks, and have to resort to informal ways of saving, insuring and borrowing, such as paying shopkeepers to keep their savings safely, or borrowing from moneylenders at very high interest rates. What then are the obstacles to better access by the poor to finance in these markets and how can governments and aid agencies intervene to improve matters?

New approaches have tended to concentrate on the problem of collecting information about the degree of risk involved in lending to poor people. Informal arrangements devised by the poor themselves give a crucial clue: if a group of people who know each other fairly well start contributing to a pool of money which will be lent to each one of them in turn, they will naturally want to keep themselves well informed about each other's capacity and/or willingness to pay the money back. By extension, the conventional banks could adopt this group-lending technique to improve information about poor borrowers, thus reducing their own costs. This apparently market-based solution implies that those organisations already working with credit groups, notably NGOs, could eventually become financially sustainable themselves. But the new approaches face fresh challenges.

Some challenges for development agencies

- Group borrowing and joint liability can have costs for borrowers in terms of peer pressure, loss of trust, and the likelihood that the poorest and most vulnerable will remain excluded. The true costs of taking part in these schemes need to be measured when assessing the net benefit to poor borrowers.
- Targeting the poor by means of self-selection and incentive mechanisms has certain advantages and disadvantages compared with direct targeting by the officials of the credit institutions. A combination of strategies may help reach the poor more effectively.
- It is not enough just to provide money for productive purposes. Funds for consumption to tide people over vulnerable spells can also help reduce impoverishment in the long run.
- To be effective, MFIs must provide a wider range of services and more flexible contracts. Greater responsiveness to poor people's needs has the potential to increase impact and achieve sustainability.
- Governments and donors have learned that subsidising the management of the MFIs is more effective than subsidising interest rates for the poor but despite plans for a massive increase in the scale of micro-finance we still do not know whether government and donor subsidies to MFIs might be more effectively used to help the poor in other ways.

I. Past attempts to break the constraints on finance for the poor

Our understanding of the main constraints on lending to the poor has evolved slowly over the last half century. A number of key lessons have been learned from the experience of earlier diagnoses and remedies, and the consequent impact on the poor, the financial institutions themselves and the markets.

The diagnosis of the 1950s and 1960s was that poor farmers should have access to conventional banks rather than depending on moneylenders who, it was then believed, exploited their monopoly and charged excessive interest rates. The remedy was seen as concessionary loans directed or targeted at the poor primarily for productive agricultural purposes. Development Financial Institutions (DFIs) were created, and co-operatives and credit unions were established in Latin America, Asia and Africa as mirror images of those in Europe and North America. These DFIs had a mandate to target loans at subsidised interest rates, and to select and monitor borrowers. Governments and DFIs had to differentiate between landless peasants, part-time and medium-sized farmers and in principle measure the impact of their loans. The commercial banks were also obliged to lend a large proportion of their portfolios to small farmers, directly or indirectly.

This policy did not work, partly because the approach was too top-down. The subsidies seldom reached the poor, the better-off appropriated the funds and loans were used for unintended purposes. The debt-bearing capacity of borrowers was barely assessed. What is more, years of low fixed interest rates discouraged savings, and the rural mobilisation of savings was neglected. Excessive government restrictions made the formal financial institutions insolvent and they withered away or had to be recapitalised. The moneylenders and other informal organisations escaped the financial regulation and survived.

New perceptions emerged in the 1970s. Controls on credit allocation and ceilings on interest rates were seen as undermining the financial systems, penalising savings and discouraging risk-taking and investment by the financial institutions. The unsatisfied demand for credit in these restricted formal markets spilled over into the informal markets where interest rates were uncontrolled and high, to the detriment of the poor who used these markets. The new remedies were seen as the removal of government controls and the end of directed credit, the liberalisation of interest rates, and the integration of informal and formal markets - and hence access to financial services by the poor. More market efficiency (i.e. greater competition, the privatisation of inefficient formal banks, higher interest rates and increased mobilisation of savings and credit) was now seen as a condition for greater equity. The implication was that the poor were best left to themselves and the informal market until such time as economic growth allowed them to graduate to being viable clients for finance from the formal banking system.

But this did not work either. Full-scale liberalisation policies were carried out abruptly in the 1980s in many developing countries in the midst of macroeconomic instability, with inadequate supervision and regulation, which intensified failures in the credit markets. Charging high interest rates encouraged borrowers to excessive risk-taking to earn higher returns. At the same time, higher interest rates did not improve the poor's access to formal financial markets.

II. What was overlooked? the strengths of informal financial institutions

It became clear that the liberalisation of markets as a potential remedy had overlooked two important factors. First, information in financial transactions was far from perfect - and information is crucial. It is difficult to predict what will happen to the use of loans for investment, or to know very much about the risks facing individual borrowers and the prospects for repayment of their loans. Moreover, repayment contracts are costly to enforce.

Secondly, the costs of financial transactions are considerable. For example, loans to, and savings of, poor people are usually small; it costs a lender just as much to screen and monitor a client for a small loan as for a large one - especially for the formal banks. Equally important are the transaction costs to the poor. The process of asking the formal banking institutions for small amounts of money involves the cost of collecting the information that the banks require, as well as the costs of transport from the remote villages into the towns. And few of these people own substantial productive equipment that could be used as collateral.

The key point here is that the informal financial markets, especially in rural areas, were seen to have good ways of dealing with these problems of risk and cost. There were groups taking joint liability for the repayment of loans amongst their members, with a peer-monitoring system to ensure timely repayment. These groups had ways of selecting borrowers, including self-selection and rules which make access to further credit obtainable only after repayment is made. In this way they were able to achieve higher repayment rates at lower costs, while the poor gained better access to finance as they could use social collateral (joint liability) instead of the more difficult conventional collateral requirement (e.g. land title).

These systems provided the clue to how formal financial institutions could overcome the difficulty of catering for the poor whilst still remaining profitable. What is involved here is not a return to subsidising interest rates, but a role for governments in inducing profit-oriented financial intermediaries to overcome the constraints. For example, the adoption of group-lending techniques by private banks can be facilitated by changes in official regulations that permit the use of joint liability in place of conventional collateral. Helping to build institutional capacity is now the key to government policies, which include using resources to bring about sound financial and legal regulatory systems that would help ensure information flows and contract enforcement.

III. Changing Practices in the 1980s and 1990s

In the 1980s and 1990s, widespread disillusion with government programmes for poverty reduction including credit schemes, led to the mushrooming of non-governmental organisations (NGOs) as channels for donors' assistance. NGOs experimented with savings and credit groups, following a bottom-up, demand-led approach. Many of them learned from the group-lending methods of the Grameen Bank in Bangladesh, and implemented similar incentives for credit delivery (for an example in Peru see the box below).

PROMUC and 'La Chanchita': a piggy bank for the poor

By means of a pyramid-type structure, PROMUC aims to reach the poorest women in Peru (the name derives from a Spanish phrase meaning Promotion of Women and the Community). The organisation has developed the programme La Chanchita, or piggy bank, to encourage the creation of communal banks in the shanty towns of Lima and in other provinces.

La Chanchita, via a system of franchising, provides technical assistance and money at commercial rates primarily to NGOs. These, meanwhile, rely on their roots in the community to assemble groups of 20–25 individuals who will draw on these funds to form a communal bank to issue credit to the members. The groups themselves take every decision in the management of their banks. At first the loans are of the order of US\$50 per person. If repayments proceed satisfactorily, further loans may be extended, with a maximum of US\$325 per individual at any one time. Bad payers are removed from the group. Good payers are rewarded with a Certificate of Solvency which will help them to obtain larger credits from other institutions when they leave the group. The participating NGOs are also encouraged to share their particular skills and technical resources with other members of the programme, leading to useful economies of scale. PROMUC hopes to grow horizontally, extending its franchising system to cover more and more of the poor women of Peru.

Source: Marr, A. (forthcoming)

At the same time, targeting for poverty reduction shifted from targeting categories of spending (e.g. agricultural activities) to targeting types of people (e.g. the very poor). Indicators to identify poor people included type of landholding, gender, nutritional status, disability and household size. Self-selection was facilitated within an incentive structure that discouraged the rich from participating: only small, short-term loans were disbursed, and regular attendance at group meetings was compulsory. Similarly, some rural banks, both public and private,

co-operatives, and the big commercial banks also started implementing a range of incentive structures, including group-lending, to reach the poor.

These Micro Finance Institutions are characterised primarily by the provision of small/micro credit and savings, and by their type of clientele: micro-enterprises, landless farmers, women, and small households.

The role of governments and donors also changed. Support shifted from subsidising interest rates towards temporary assistance to MFIs to help them cut their operating costs and enhance their human resource capability, information systems, and pilot programmes in remote areas and augment their seed capital for expansion. Incentive structures for MFIs to minimise dependence on subsidies and attain sustainability include: (i) professionalisation of their operations by separating their banking operations from other non-financial programmes; (ii) the adaptation of regulatory and supervisory systems to the new credit delivery methods; (iii) setting up governing boards which are immune to political pressures and accountable for their financial performance; (iv) introducing monetary and promotion incentives to improve staff performance; and (v) the conversion of NGOs' financial operations to become fully-fledged commercial banks.

There is evidence that the allocation of credit for income-generating activities and micro-enterprises can be achieved sustainably, although the degrees of official subsidy have varied from 180% for the Grameen Bank to 0% for the Bank Rakyat Indonesia. Many MFIs are not expected to become financially viable for five years. Moreover, some questions remain about the impact of their services:

- most of the schemes have had more impact on their relatively rich clients than on the poorer ones;
- they have not substantially reduced the vulnerability of borrowers to sudden falls in income;
- the poorest of the poor, including landless labourers, tend to remain excluded from these programmes;
- MFIs have often failed to diversify their services or to improve their contract terms and conditions;
- they have achieved negligible penetration of new market niches amongst the poorer groups, particularly in remote rural areas;
- the MFIs that lend to the better established micro-enterprises achieve greater impact than those lending to small farmers.

IV. The unfinished agenda: some challenges

While the new approach puts considerable emphasis on the reduction of costs for lenders, there are major challenges in terms of the costs and benefits for poor borrowers.

1. Is self-selection too costly for the poor? The advantage of peer-monitoring over traditional practices lies in its social connectedness, as local knowledge about others' assets, capabilities, and character traits is used to sort and self select. In theory, the dynamic of joint liability implies that groups screen and self-select their own members to form relatively homogeneous groups i.e. the members share very similar probability of defaulting a loan. It is also assumed that social solidarity will ensure that the successful members cover for the defaulters. However, if circumstances change over time, peer pressure and the costs involved in group formation can lead to the erosion of mutual trust and unwillingness to support one another. This increases the likelihood that the poorer and more vulnerable will be excluded, and threatens the survival of the group.

In volatile environments, individual risks fluctuate over time and may diverge so significantly as to threaten the survival of the group. Although investing more in building a larger social capital may seem a necessary safeguard in this situation, it imposes costs that are borne only by the borrowers themselves, and this may lead ultimately to reluctance on the part of borrowers to participate in peer-supervision groups, particularly as alternative ways to access sources of capital become more attractive.

Alternatives to group lending have emerged to suit various contexts; one such option is individual-based lending. This technique can still include the poor who are unable to obtain loans from banks for lack of conventional collateral. Lenders develop close relationships with potential borrowers in order to assess the likelihood of repayment without collateral, making frequent visits to people's homes and businesses to select and monitor clients. The problem here is that it is still very costly for lenders to operate this method and remain profitable. Recent evidence shows that individual lending does not reach the poorest people.

2. Is credit all that the poor need?

In some quarters credit for income-generating activities as the solution to poverty reduction has been overemphasised. It is implied that a vicious circle of low investment-low income-low investment keeps poor people poor; hence, when capital is injected in the form of credit, poor households will generate productive employment, more investment and higher incomes.

Vulnerability to economic stresses caused by natural calamities, seasonality and life-cycle changes induce fluctuations in income. This compels households to smooth their consumption expenditure and hence sacrifice potential investment. Liquidity constraints often force poor people to take costly actions that reduce their productivity. In rural Thailand, for example, poor farmers tend to buy gold instead of, say, a plough, because it can be easily sold when consumption levels drop. For these circumstances insurance, savings, and loans for consumption purposes are more effective financial services than productive credit.

Hence, diverse and more flexible services can provide positive incentives for remaining in the joint liability group as perceived benefits rise. The availability of consumption loans and voluntary savings reduces the default risks that arise when borrowers face sudden cash-flow fluctuations. Greater responsiveness to poor people's needs has the potential of decreasing the likelihood of their exclusion from peer supervision groups. Recent research (Marr, forthcoming) shows that programmes with a wider range of financial products and more flexible contracts retain their clientele for much longer than those that offer only a few services.

3. Will 'financial sustainability' lead to more diverse financial services for the poorest?

The link between loan-size and the financial needs of the poor has also been over-stressed. Provision of micro-credit as the chief indicator of a financial institution's ability to reach the poor can have adverse effects on incentives. For example: (i) financial institutions strive to offer just one product, micro-loans; or (ii) potential recipients of micro-credit schemes face incentives to misrepresent their financial needs, either to become or simply to remain eligible. These responses have undesirable consequences for both lenders and borrowers. For the financial institutions, the lack of risk diversification in their portfolios increases their financial vulnerability. For borrowers, the use of inappropriate financial products inhibits their economic efforts, and can lead to over-indebtedness.

Financial sustainability, although not explicitly mentioned, was intended to remedy these faults; the drive to raise private funds was expected to lead to more competition, more diverse products/services, and better terms and conditions being offered. To this end, many lenders have set new rules to increase staff productivity: promotions and higher salaries now depend on how many and how quickly loans are allocated

and recovered. Some recent evidence suggests that this is leading to the exclusion of poorer clients, particularly in remote rural areas. New products appear to be introduced to attract relatively richer clients. Thus it is necessary to evaluate institutional changes affecting both the inclusion of poorer clients and the improvement of market prices and products.

4. What role for donors and governments?

The donor community can still have a role in supporting some MFIs. The objective of the 1997 Micro-Credit Summit, sponsored by the World Bank and other donors, was to launch a global campaign to reach 100 million poor people - particularly women - by the year 2005 with estimated required funding of US\$22 billion. However, some caution is necessary. The real issue is whether the marginal impact on poverty from this type of policy is greater than if the same resources were put to the best alternative use. At present, we know too little to permit effective comparisons between micro-finance interventions and the main alternatives in poverty reduction. The lack of comprehensive cost-benefit estimates (including the costs of participation of the poor, disincentives, bargaining costs and benefits) makes it extremely difficult to compare alternative ways to intervene and hence design policies.

A possible solution to this problem lies in designing interventions as policy experiments, or as learning processes. Thus, programmes designed for micro-finance purposes would run in parallel with programmes directed towards geographically isolated people and the very poor. Effective monitoring of what happens to poor people's livelihoods in this twin-track approach may well provide a ready counterfactual analysis.

References

Hulme, D. and Mosley, P. (1996) *Finance Against Poverty*, London: Routledge

Marr, A. (forthcoming) *How Can Finance Work for the Poor?* London: ODI

Yaron, J., Benjamin, M., and Piprek (1997) *Rural Finance: Issues, Design and Best Practice*, Washington D.C.: World Bank.

© Overseas Development Institute 1999

ISSN 1465-2617

Readers are encouraged to quote or reproduce material from ODI Poverty Briefings for their own publications, but as copyright holder, ODI requests due acknowledgement and a copy of the publication. The views expressed in this paper are those of the authors and do not necessarily reflect any official position of ODI.

Email: publications@odi.org.uk

[Poverty Briefings List](#)



[Overseas Development Institute Home Page](#)
