Financing Productive Assets in Social Funds and CDD

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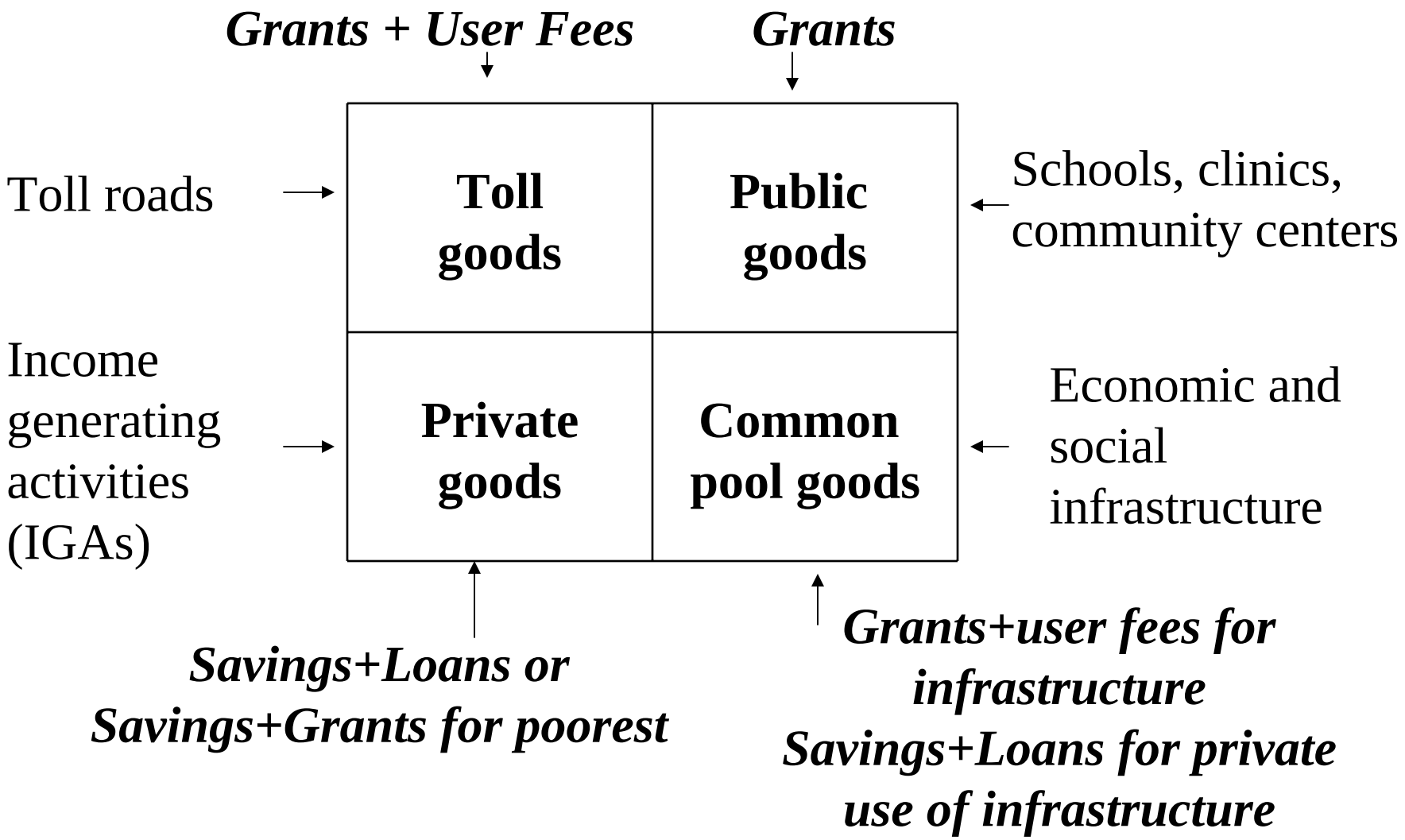
January 17, 2005

Should Social Funds and CDD Operations Have Components aimed at Financing Productive Assets?

- **Arguments in favor**:
  - **Communities often cite "income generation" as a critical need, but the poor don't have the financial resources to start micro-enterprises.**
  - **Poor people have difficulty getting access to loans from formal financial institutions without support from a project**
- **Arguments against:**
  - **There are often no easy solutions to improving access to loans for income generation: banks aren't interested, MFIs often don't operate in the project area, especially if it's a rural area, and local communities don't have skills to manage revolving loan funds.**
  - **Sustainable microfinance is a complex *business* requiring specialized skills, yet staff of SF and CDD projects often don't have the capacity to develop sustainable financing options for the poor.**

Principal Financing Options
Depend on the Type of Good: Public or Private



Issues surrounding provision of grants for private goods

- **Grants for income generating activities (IGAs) can reduce responsible use and increase subsidy dependence**
- **May undermine a culture of financial discipline and forestall development of sustainable microfinance**
- **Has limited outreach**
- **May be subject to political favoritism or corruption**
- **Potential conflict in communities over allocation of grants**
- **Is a temporary "fix": people need sustainable sources of financial services, including savings as well as loans**

Loans for Financing Private Productive Assets: The Best Option in Many Cases

- **Why?**
  - There is substantial evidence over many years that people only value what they pay for
  - One-time infusions of money through grants pay for the asset, or a portion of it, but not for the operation of the business
  - Developing relationships with financial institutions enables people to access a range of necessary financial services, not just credit, over the long term
- **Constraints?**
  - There are few well-managed financial institutions serving the poor, especially the rural poor.

Financing Private Goods: When are grants an acceptable option?

- For the very poor, who are too vulnerable to take loan risk (loan=debt and many are over-indebted)
- For poor people living in an emergency or post-conflict situation, who have fragile and insecure livelihoods, and few assets
- For demonstration of a new technology or economic activity that the poor would be unwilling to invest in, as they do not know a) level of risk and b) if they would be able to realize increased income sufficient for loan repayment
  - **Example: provision of tube wells in Niger to risk averse farmers who lack water most of the year, constraining their ability to grow a range of food crops**

Grants to the very poor for IGAs: Key Considerations

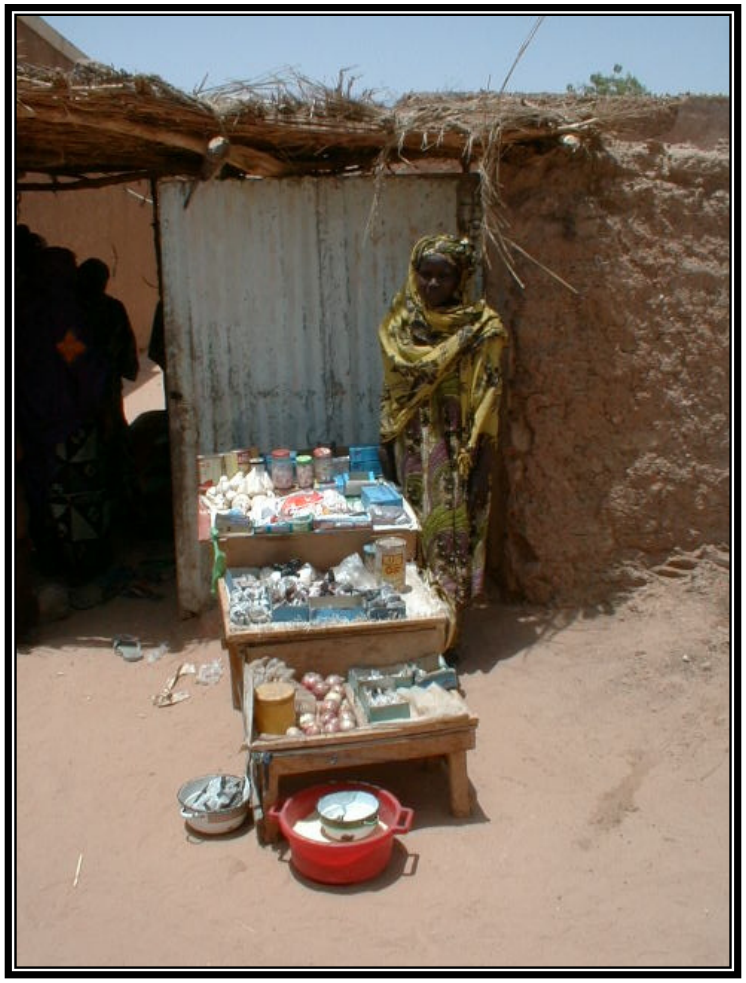
Very poor may need a package of assistance:

1) Income support while establishing IGA

2) Technical training

3) Management training

4) Followed by integration into mainstream savings and loan program



Financing Private Goods:
When would a combination of grants <u>and</u> participant savings make sense?

- **For the poor who have some earning capacity but not enough to fully repay an expensive asset**
- **Example: PADEP, Tanzania**
  - **Grants matched 80% / 20% for infrastructure projects**
  - **Grants matched 50% / 50% for new / improved agricultural technology**
  - **Farmers must open bank accounts to save their match and then add to savings regularly**
- **Advantages of this approach?**
  - **Poor can acquire risky new technologies that will help to lift them out of poverty**
  - **Link to banks facilitates access to other types of financial services over the long term**
  - **If banks not accessible, can manage savings at village level**

General Principles to Overcome Constraints of Grants Programs for Income Generation

- Careful targeting (to avoid capture by elites)
  - E.g. participatory wealth ranking by communities to identify poor and poorest; measuring assets rather than income
- Administration of the program by a well-managed entity within the community that can ensure the integrity of the program
- A match from the beneficiaries that is as high as can be reasonably expected, given economic circumstances (usually higher for private goods than for public goods)
- Savings promotion and access to other financial services via linkage to banks and MFIs, or managed within participant groups if no formal financial institutions (Note: NOT managed by grant-giving entity)
- Technical and/or management training
- Avoid group loans for economic assets

Major Issue: Group Ownership and Management of an Asset or an Enterprise

- Fact: Most people do not want group ownership and management of an asset or enterprise, and it frequently leads to conflict
- How can this situation be avoided?
  - **Grant to the group for the economic infrastructure and loan to the individual for the asset that will use the infrastructure**
    - Example 1: grant to group for milk processing center, loans to individuals for the cows
    - Example 2: grant to group for marketing facilities, loans to individuals for the products they will sell
  - **Strong rules on groups**
    - **Groups must have history of effective cooperation**
    - **Groups must develop mechanism to manage the commonly owned asset, including raising funds for maintenance**

Why are financial services important for the poor?

- **Financial services improve the ability of households to manage risks & build economic security**
  - **Savings** services enable people to put aside small sums of money that grow to usefully large sums for emergencies, festivals, health and education
  - **Insurance** services allow people to protect their assets
  - **Payment** services allow people to send and receive remittances from family members living in other places
  - **Credit** services enable people to start or expand small businesses, improve their homes, acquire assets and manage cash flows
- **None of these services are useful unless they are <u>always</u> available; that is, provided by sustainable institutions**

Why sustainable microfinance is important for SF/CDD projects

- SF/CDD projects without an “income generation” component are often not able to address the poor’s lack of opportunity to earn a livelihood
- Low incomes decrease ability to benefit from other interventions such as health and education
  - There is strong evidence that women spend increased income on food, education and health care
- Sustainable microfinance has more long-term benefits than one-time provision of grants

How can SF/CDD projects build sustainable institutions serving the poor?

- **Strategy 1. Banks and/or MFIs <u>reaching down</u> to provide services directly to individuals or groups in low-income communities**
  - SF examples: Creation of MFIs (Yemen, Albania), strengthening existing MFIs (Bosnia), providing funding to MFIs for expansion to rural areas (Morocco), supporting MFIs through commercial banks (Chile).
- **Strategy 2. Community-based financial organizations <u>linking up</u> to banks so their members can receive additional services**
  - CDD example: Linkage of self-help groups to banks in India

Pros and cons of ‘reaching down’ vs. ‘linking up’

- **Banks and/or MFIs reaching down:**
  - ***Pros: (i) Competent banks and MFIs know how to run a complicated financial business (ii) poor can obtain many services, not just loans***
  - ***Cons: Banks often not interested in serving rural poor***
- **Community organizations linking up:**
  - ***Pros: interested in serving the poor***
  - ***Cons: requires specialized skills and systems that communities often don’t have and have difficulty acquiring***

Banks and/or MFIs reaching down

- Choose this approach if competent banks, MFIs or cooperative networks exist or can be attracted to the project area
- Focus on building sustainable institutions, not projects
- Select partner organizations using performance criteria and link continued funding to performance
- Provide capacity building support to participating financial institutions; a common mistake is to assume that they know how to competently operate financial services for the poor.

Community organizations linking up (1)

- Choose this approach only if competent banks, MFIs or cooperatives don’t exist or can’t be attracted to the project area.
- Use a savings-first approach, and ensure that savings are protected from fraud and mismanagement.
- Link to banks rather than providing external loan funds
- Focus on building sustainable institutions, including a strong governance structure, with regular elections.
- Train large numbers of members: enables new leadership to take over after elections, prevents organizational collapse when skilled members are recruited by other organizations, and strengthens transparency and accountability.
- Develop low-cost ways to train members; e.g. train skilled participants to become para-professionals

Community organizations linking up (2)

- **Develop business relationships with banks rather than providing a donor-financed loan fund**
  - Initiate the relationship by opening savings accounts
  - As the bank gets to know its new customers, it will become more interested in providing other services
- **Support community organizations efforts to build federations**
  - Federations can provide access to services such as audit and training, and may be able to negotiate financing facilities from banks for well-performing community organizations
  - Creation of federations should be driven by the CBOs, not the donors

Both approaches

- Do not subsidize interest rates
- Monitor a few key performance indicators:
  - Outreach and poverty level of clients
  - Loan collection performance
  - Ability of organization to fully cover costs
- Pay attention to the enabling environment at both the national and regional levels, but do not attempt to influence policy unless project has expertise in this area

Conclusion

- **Improving access to financial services has greater long-term impact than one-time provision of grants to the poor**
- **The preferable strategy is to support efforts of formal financial institutions to <u>reach</u> <u>down</u> to the poor**
- **However, if this is not possible, supporting the efforts of communities to organize themselves to <u>link up</u> to the formal sector can be considered**

Case Study:
“Reaching Down” vs. “Linking Up” Strategies for Post-Conflict Rural Irrigation Project

- Discuss the four options and decide:
  - Which is the best option, or combination of options?
  - Why?
  - What are the key constraints to your proposed approach?
  - How can the design overcome these key constraints?