Imp-Act

Policy Note

IMPROVING THE IMPACT OF MICROFINANCE ON POVERTY: **ACT**ION RESEARCH PROGRAMME ISPN: 1 85864 849 1 • NUMBER TWO • 2005

Working with formal financial institutions

Expanding access and achieving social performance

Imp-Act is a global action research programme designed to improve the quality of microfinance services and their impact on poverty. ***Imp-Act*** promotes the development of reliable social performance management systems, which include impact assessment. These systems reflect and respond to client needs, as well as the priorities of microfinance institutions (MFIs) and their stakeholders. The programme is a collaboration between 30 MFIs in 20 countries and a team of academics from the UK universities of Bath and Sheffield, and the Institute of Development Studies, Sussex University. The ***Imp-Act*** programme was initiated by the Ford Foundation, which funds all ***Imp-Act*** activities.

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Summary of key issues

MFIs HAVE made important progress in demonstrating that financial services can be provided cost-effectively to poor people. These services have been shown to have a significant impact on the social goals of reducing poverty and social exclusion and hence make an important contribution to the achievement of the Millennium Development Goals (MDGs). However, growth of supply is slow in relation to the huge demand for savings as well as for credit, money transfer and insurance services. In order to expand and deepen access it is necessary to work with a range of formal financial institutions.

The rationale for governments, donors and social investors in working with the formal financial sector is to expand and deepen access in order that these social goals can be achieved. They must therefore use their funds carefully with the purpose of providing appropriate and affordable financial services to poor people who are the most financially excluded – that is, those who have least access to the formal sector and usually depend on informal services. In order to achieve this, they should:

- Adopt clear social goals for their interventions related to access to appropriate and affordable services for the most financially excluded
- Clearly identify how interventions are supporting innovation to address the needs of particular market segments and are therefore "smart"
- Develop workable definitions and methodologies for measuring access
- Undertake sector-wide studies to monitor progress in reducing financial exclusion.

1 Why work with formal financial institutions?

MICROFINANCE PRACTICE has provided significant evidence that poor people are bankable: that their demand for financial services can be served at cost-covering prices. While some of this experience has its origins in the efforts of non-governmental organisations (NGOs), banks and credit unions have also made key contributions. However, the challenge of expanding and deepening access to reach the huge numbers of poor people who remain un-served goes beyond that which a strategy of building new specialised institutions can deliver.

Working with the formal financial sector offers the prospect of addressing two key constraints that have become increasingly evident as a result of working with MFIs:

1. The need to provide a range of services to poor people
2. The need to address high costs involved in expanding and deepening access.

The wide range of financial services that poor people need to support and develop their livelihoods: These include opportunities to save and borrow to cope with crises and accumulate resources over the longer term, to transfer money and to insure themselves against shocks. While lending using peer-collateral has made an important contribution to microenterprise development, many challenges for lending to poor people remain if outreach is to be significantly widened and deepened. These include lending for agriculture and in areas of low population density. MFIs have mostly been credit-led but the range of credit services needed – and ubiquitous demand for appropriate savings services – has been a significant challenge, not least because of regulatory restrictions. The development of insurance and money-transfer services is even less developed than savings.

The priority is to develop these services and scale up provision at a much faster rate, given the huge unmet demand and the relatively slow progress in achieving this through a resource intensive approach of building one institution at a time. Even as some NGOs transform under new regulatory legislation into deposit-taking institutions, the rate of growth of overall outreach is slow and the costs involved substantial. By contrast there are a range of players in the financial sector with wider outreach and better infrastructure in place – both physical and institutional (especially in terms of governance and management structures) – that could be effectively harnessed to this end (see Box 1). Moreover there is a growing recognition that financial sector development is important for economic development and poverty reduction and that microfinance can and should be part of the mainstream financial sector (see Box 2).

Working with formal financial institutions also offers new opportunities:

- Liberalisation of financial sector regulation and policy over the last ten years has expanded the opportunities for existing financial institutions and raised interest amongst policy makers in finding ways that markets can be harnessed to serve these needs.

BOX 1 THE OUTREACH OF MFIS IS EXCEEDED BY OTHER FINANCIAL INTERMEDIARIES

The potential importance of a diverse range of financial institutions has been highlighted by the Consultative Group to Assist the Poor (CGAP), which has made tentative estimates that some 750 million accounts already exist in what they term 'alternative financial institutions' (AFIs) in developing and transition countries. These include accounts in state-owned agricultural, development and postal banks; member-owned savings and loan institutions alongside other types of savings institutions and rural banks and specialised microfinance institutions. While MFIs account for an important 33 per cent of loan accounts, they constitute only some 18 per cent of total accounts. Data is not available to indicate clearly the poverty outreach of these institutions. However, while many MFIs may have a stronger poverty orientation than AFIs, average account sizes in MFIs are not uniformly smaller (CGAP 2004).

Findings from research conducted by *Imp-Act* also show the importance of other financial institutions in serving poor people. Research undertaken in and around the town of Karatina in Central Kenya shows that, even though this is an area where MFIs have been operating for ten years, savings and credit co-operatives accounted for 38 per cent of the number of accounts, while locally-managed savings and credit associations (ASCAs) accounted for 8 per cent, and the mainstream MFIs accounted for only 4 per cent. Similar research into the supply of financial services in Guntur in Andhra Pradesh, India, demonstrated the importance of daily "doorstep savings" services provided by non-bank finance companies and the post office. Estimates suggested that these accounted for 37 per cent of savings accounts in Guntur town and 25 per cent in the nearby but smaller town of Sattenpally (Johnson, forthcoming 2005).

BOX 2 GROWTH, POVERTY REDUCTION AND THE ROLE OF FINANCIAL SECTOR DEVELOPMENT

Research has shown increasing evidence of strong links between financial sector development (FSD) and growth and in particular that the relationship running from FSD to growth is more important than that running from growth to FSD. This suggests that financial sector under-development is more likely to hold back growth in developing countries.

The links from growth to poverty reduction are mostly indirect and the distribution of increases in income matters. FSD can also have a direct impact on poverty reduction where improved access allows poor people to use financial services to mobilise savings, manage risk, acquire information about and become social investors in investment opportunities, and improve their access to markets. For these reasons it is important to start to build microfinance principles and practice into financial sector development.

Source: DFID 2004

- The pace of technological change is raising the prospect that rapid expansion of access is possible as transaction costs fall and this offers new opportunities for existing financial institutions to profitably expand their services to un-served markets.
- The opportunity to develop "layering" in the financial system – for example, through linkage models between self-help groups and other financial institutions.

These developments provide the opportunity to challenge formal financial institutions to reach new market segments of those who have been the most financially excluded.

2 Working with formal financial institutions brings new challenges

WORKING WITH formal financial institutions to provide a wider range of services and significantly expand and deepen access produces new challenges for donors, social investors and government policy makers in designing their support.

A response to the failure of formal financial institutions to deliver these services: It is important to recall that the experience of the last 20 years in developing MFIs has been a response to the failure to find sufficiently profitable means of providing these services. This can in part be attributed to "market failure", consisting both of weak incentives for suppliers to develop products and services that poor people want and can afford, and of barriers to access that prevent some clients using services that they are willing and able to pay for. There are many reasons why this occurs. On the supply side, it may not be possible to cover the costs of provision for a range of reasons including geographical distance and risks where transaction sizes are very small. For clients, barriers to access not only include the costs of access such as geographical proximity and the financial costs of the service (fees and interest rates), but also having the relevant information about the services available. There are also many social dimensions that cause barriers to access. Examples are education, gender, race and ethnicity, which mean that people are excluded because of the terms and conditions under which the services are provided, such as the requirement for a husband's signature or the need for an identity card etc.

The role of public funding (subsidies) in markets is to overcome these market failures by investing in innovations that enable clients to receive a service at a price that they can afford and allows providers to cover the costs of supplying that service. Innovations may involve designing products differently, finding alternative delivery mechanisms, or finding new ways to design institutions. There are a number of means through which such subsidies might be provided. They may be used to fund research and development for the sector as a whole, or directed to particular financial institutions to undertake particular initiatives.

BOX 3 COMMERCIAL BANKS MOVING "DOWN MARKET"

Improved macro-economic stability in many countries is creating the conditions under which banks are being forced to look for new markets and move "down market". A key reason for this is that governments significantly reduce their own borrowing from the banks in the form of treasury bills. As a result treasury bill rates fall and this risk-free, high-return source of income is no longer available to the commercial banks, which then have to start to look for new markets in which to lend.

This trend has been supported by the liberalisation of financial sector regulations that has also resulted in the new entry of banks in many countries. The increased competition for customers at the high-end of the market produces knock-on effects for middle income customers who have become the new focus of banks' marketing efforts.

However, in providing subsidies to private sector providers it is necessary to be aware of the potential pitfalls:

- First, subsidies are given for services that would have been provided anyway. In this case the subsidy gives the provider an unfair advantage compared to others in the market, and may actually reduce the effectiveness of the market to provide.
- Second, the service may only be provided for as long as the subsidy lasts and the financial institution fails to use the subsidy to learn how to serve the market profitably.

In the context of current developments in the financial sector these concerns are compounded by two further factors:

- **Developments in the macro-economic environments and financial sectors of developing countries:** These changes are creating incentives for financial institutions to move "down market" (see Box 3). The risk is that subsidy is used to give incentives to the private sector to do what they are doing anyway as a result of market forces.
- **Commercial banks are often operating in the same environments as many MFIs:** The risk is that they are subsidised to develop loan products that are more attractive than existing MFI offerings and simply "cream off" MFI clients as a result. This means that they are not necessarily deepening outreach. Moreover, subsidies have already been heavily invested in developing new products and services for this group.

As a result it is necessary to design subsidies that are "smart": that is, subsidies that deliberately seek to avoid these problems while effectively expanding and deepening access.

3 Setting social goals for expanding and deepening access

THE OVERALL PURPOSE for donors, social investors and governments in working with formal financial institutions is **to provide appropriate and affordable financial services to poor people who are the most financially excluded.** Expanding and deepening access in this way will enable the achievement of social goals of reducing poverty and social exclusion.

Extensive evidence has clearly demonstrated that poor people use a range of financial services: While few may use the commercial banks, they may have accounts in other formal financial institutions such as post office savings banks or co-operatives. They may also use these accounts alongside informal services such as rotating savings and credit associations (ROSCAs) and moneylenders. It is usually the very poorest people who do not even have access to informal services. There is a spectrum of access in which better-off people usually have access to a wider range of more formal services. Those who have least access to formal services and depend on the informal sector face lower quality services. In particular, this usually means that the risks of losing their savings are higher and that the conditions and costs of credit are more onerous. It is deepening access to these most excluded people that must be the core of the social goal and the key purpose of using subsidies.

Services must be appropriate and affordable if they are to reach the most excluded: Appropriate services are those that enable poor people to manage a range of livelihood needs related to both consumption and production. These include coping with shocks and hazards through saving, borrowing and insurance; meeting regular demands for credit for income generating activities including agriculture; and making long-term investments in housing as well as productive assets. Designing appropriate services also means taking into account the different roles of individuals within the household and at different stages of their life-cycle. Appropriateness is therefore about identifying categories of clients and tailoring services towards them – that is, identifying and responding to the needs of particular market segments.

The focus of the microfinance industry to date has been the sustainable provision of services and this has taken precedence over concerns about affordability. One consequence has been that in many contexts there is a limited range of activities that provides profits sufficiently high to cover the costs of credit and as a result investment is primarily in retail activity. In order to meet a wider range of livelihood needs, especially – for example – investment in agriculture and credit for consumption smoothing, it will be necessary to ensure that services are offered at prices that allow for significant and sustainable improvements in poor people's well-being.

4 Designing "smart" subsidies and assessing performance

TO EXPAND and deepen access through working with formal financial institutions, it is critical therefore that donors, social investors and governments set clear social goals for their interventions. Moreover, progress towards these goals must be monitored in order that performance can be assessed and accountability for public funding provided.

In order to arrive at projects that deliver according to clear social goals, donors, social investors and governments should themselves have a clear focus and should work with formal financial institutions to achieve this focus also. They should both answer the following five questions, which have been adapted from the *Imp-Act* social performance management framework:

These questions require a clear identification of the market segment – that is, the customers to be served, and their needs; an analysis of how the products and services being designed respond to these needs; an evaluation of whether these needs are in fact being met; and the use of this information to improve the services. The advantages of doing this for the financial institution will be a clear focus on market segments and an explicit 'feedback loop' (see *Imp-Act* Practice Note 1 on the feedback loop) that enables it to understand and respond to the needs of the financially excluded people identified.

Answering these questions helps ensure that subsidies are "smart" by enabling market failures related to the provision of services to particular market segments to be clearly identified and addressed. Subsidies may then be focused on financing the costs involved in innovation. This approach therefore seeks improvements in overall access by building on the existing strengths of formal financial institutions to expand and deepen access to new market segments.

	Questions for donors, social investors and governments:	**Questions for financial institutions:**
1	What are your social performance objectives in working with this financial institution; how will the initiative contribute to the goal of appropriate and affordable services for the most financially excluded?	What market segment do you intend to serve? What evidence do you have of the existing financial service use and needs of this segment? How do you intend to serve it?
2	How will you monitor whether the financial institution is reaching the intended market segment?	How do you monitor take-up and use of the new services offered? How do you know whether the clients using them are the intended market segment?
3	How will you know whether the clients in this market segment find the service appropriate to their needs and continue to use them?	How do you monitor how satisfied your clients are with your services? How will you know whether the services are appropriate and affordable and effectively meeting their needs?
4	What evidence is there that the financial institution has assessed the use of its services by clients and improved the design of their services to respond to this market segment?	How do you use this information to revise the products and services offered?
5	How will you assess the quality of the information being provided by the financial institution and validate the claims made?	How are you validating and improving the quality of the information on which you are making decisions?

5 Evaluating performance at the sector level

AS DONORS, social investors and governments work with formal financial institutions to expand and deepen access it will be necessary to demonstrate that subsidies are producing results in line with the overall purpose and that financial exclusion is being reduced. In order to monitor progress systematically, it will first be necessary to agree on indicators of access and methodologies for measuring it, and then to set in place systems to report on progress.

Indicators of access

The key factors determining access differ across countries and it is necessary to experiment to see what definitions of access are workable in each. Access means that clients have the choice of whether or not to use a service. So they may have access but choose not to use a service. In the context of very little choice, use is much easier to measure than access and in most developing countries would be an adequate proxy indicator. However, this means that it is also necessary to conduct research into the reasons that clients do not use services where they are available.

Reporting on progress

The information needed to monitor and evaluate improvements in access must go beyond that collected by specific institutions because people use a number of services at the same time. The changing landscape of access can therefore be examined from both the supply and demand side. On the supply side, information is needed on formal and informal providers, geographical coverage, client outreach and product range. Monitoring changes in product offerings will also help to understand how the landscape of access is changing.

On the demand side, survey data on take-up and use of financial services that is representative of the population is a key component (see Box 4). This allows an overall assessment of how services are being used which can be analysed in relation to the demographic and socio-economic characteristics of users. This in turn enables particular market segments – especially the characteristics of those who are most excluded – to be identified. This allows attention to be focused on these potential users and their barriers to access.

In developing this analysis, governments, donors and social investors must work with the formal financial institutions to promote the monitoring of progress. However, it is also important to ensure that independent assessments are made and that accountability for public money used in subsidising the private sector is transparent. This can be achieved through the publication of independently commissioned and published sector-wide studies of access.

BOX 4 MONITORING ACCESS TO FINANCIAL SERVICES AT THE SECTOR LEVEL

Finscope in South Africa has carried out survey work to identify different degrees of access to banking services. The findings suggest categories of access termed the "fully banked", "partially banked" and "unbanked" – and enable identification of these different degrees of access by different socio-economic and demographic groups. This allows profiles of clients who are financially excluded or very poorly served to be identified. The data set has two main uses. First, it offers opportunities for commercial providers to use it to identify market segments and undertake further market research to develop products and services to reach them. Second, it can be used to monitor trends in patterns of access and assist in evaluating the effectiveness of interventions. (See *www.finscope.co.za* for more information.)

Resources

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