Microfinance

Building financial systems that serve the rural poor

Presented by: Anne Ritchie
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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 **always** 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
Why is sustainable microfinance hard to achieve?

• Sustainable microfinance is a complex *business* requiring specialized skills and excellent systems.

• Many of the people and organizations that care about the poor don’t have these skills and systems, and have difficulty acquiring them.

• Banks are usually not motivated to serve the poor – they can earn more from corporate clients and middle-income customers and their systems, products, staff and culture are often not suitable for the poor without significant adaptations.

• Sustainable microfinance needs to be accompanied by a supportive enabling environment, including policies such as removal of restrictions on interest rates.
How can SF/CDD projects build sustainable institutions serving the poor?

• **Strategy 1.** Banks and/or MFIs reaching down 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 savings-based financial organizations linking up 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 savings-based 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 savings-based organizations linking up (1)

- Choose this approach if competent banks, MFIs or cooperative networks don’t exist or can’t be attracted to the project area.
- Focus on building sustainable institutions; community financial organizations should not be viewed as just a way to deliver services to project participants.
- Recognize that managing a financial operation is far more difficult than managing infrastructure sub-projects.
- Design should use a savings-based approach to ensure commitment.
- Critical that savings be protected from fraud and mismanagement.
Community savings-based organizations linking up (2)

• Grant-financed loan funds not recommended, as these funds usually do not have high repayment rates and thus often revolve down to nothing

• Develop business relationships with banks if possible
  o Initiate the relationship by opening savings accounts
  o As the bank gets to know its new customers, it will become more interested in providing other services

• Develop a strong governance structure, including regular elections and turn-over of leadership
Community savings-based organizations linking up (3)

- Train large numbers of members so that they understand how to run a financial business
- Develop low-cost ways to train members; e.g. use of para-professionals
- Have an appropriate, standardized accounting system
- Support community organizations efforts to build federations for access to services such as audit, training and financing from banks
- Creation of federations should be driven by the community organizations, 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
Concluding Remarks

- Financial services improve ability of households to manage risks & build economic security
- Poor people need these services over the long-term
- Formal financial services are preferable, but community groups can be a viable alternative if savings-based
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?