

## **Microfinance: A Tool for Poverty Reduction**

by

Joe Remenyi

### **Abstract**

*Poor people remain poor for many reasons. Advocates of microfinance are convinced that an important contribution to their inability to escape from poverty and rise above the poverty line is their lack of access to microfinance services. Since microfinance deals with a market composed essentially of poor households and very small enterprises, formal banking sector has found it impossible to service. The poor are also not a homogenous mass, but a heterogenous collection. In order to serve each of the very many different categories of clients that microfinance institutions (MFI) find in a poor village, it must deliver services that are flexible enough to meet individual needs. The literature on which criteria ought to be applied in identifying a successful MFI is increasing and a discernible consensus is emerging. In all these studies there are essentially only two criteria of 'success'. The first focuses on whether the MFI is moving towards a level of financial viability that will enable it, in the near future, to achieve a self sustaining growth. The second criteria concerns the extent to which MFI is achieving substantial outreach to its target population. There is no one 'optimal' model for the spread of microfinance. It may vary from country to country depending on socio-cultural and institutional conditions.*

### **What is Microfinance?**

A feature of development in the decades since the close of the second world war has been the spread of the money economy into sovereign territories where subsistence production in a rural setting was the norm. A consequence of this 'global' change has been the need that households have for banking services, especially credit and savings. When banks provide these services, we describe the function as an "intermediation", through which the independent acts of savers and borrowers are brought together to facilitate one another's goals. Microfinance is no different except that it deals with a market composed essentially of poor households and very small enterprises (Micro-enterprises), that the formal banking sector has found it impossible to service.

With some well known exceptions, typically microfinance institutions (MFIs) are non-bank financial intermediaries that provide clients from poor households and the operators of micro-enterprises with a full range of money management and banking services, which can be grouped into five basic types of products.

- (i) **credit**, especially a reliable source of working capital, dispersed against 'collateral substitutes' such as standing in the community, group guarantees and compulsory savings.
- (ii) **deposit services**, designed to offer poor households alternative savings options to the hoarding of cash or other stores of value:
- (iii) **insurance products**, including insurance against loan default due to misadventure, illness, death, natural disasters or unanticipated economic crisis, plus anticipated life-cycle related savings goals to prepare for weddings, funerals or other socio-cultural obligations:
- (iv) **financial advisory services**, specific to money management and household level financial planning and
- (v) **advocacy services**, whereby the views and needs of the poor are given a voice and brought to the attention of policy makers, regulators and those with the authority to influence the environment in which poor households and informal sector institutions have to operate.

### **Where are the MFI Providers?**

Microfinance is not a recent discovery. Very early in the history of recent development in the Third World, development specialists recognized that rural development must involve attention to banking and finance issues. However, in the 1950s and 1960s, more attention was given to the mobilization of savings for the finance of 'modernization' of developing economies than for re-lending to the sector from which these savings were gathered. Moreover, the conventional wisdom was that poor folk had little to invest in, and that the social return to savings would be improved if scarce domestic savings could be transferred into investments in new industries that were typically urban based and no rural.

Nonetheless, the early attempts to modernize the rural sectors in developing countries did not totally ignore the need for finance, but believed that it was not possible to rely on traditional money lenders or what we term today as informal sectors 'non-bank financial institutions' to deliver the credit that was needed for on-firm investments and working capital. As a result, in the 1950 and 1960s most developing countries established government owned and funded developing banks, cooperatives or rural associations to bring cheap credit for rural development to the countryside. Massive amounts of money devoted to these programs, many of which were wrapped into a package described as 'integrated rural development'. However, the resources that were so delivered failed to reach poor farmers, landless

households in the rural areas. It was as a response to this failure that today's MFIs appeared, first in South Asia but then also in Latin America, South East Asia and more recently, Africa, the South Pacific and the economies of the former Soviet bloc.

The most famous of the MFIs and possibly the most successful are the Grameen Bank (GB) and the Bangladesh Rural Advancement Committee (BRAC), both established in the late 1970s as pilot projects and then formalized in the early 1980s, in the case of GB as a private sector bank with a limited license, and in the case of BRAC as a non-government organization(NGO). These two institutions have had a global influence and there have been many successful attempts at replication in other developing countries.

The GB 'model' has four key features. First it is a licensed bank and as such can present itself as part of the legally recognized network of financial institutions able to access the due processes of the law to protect depositors and its other members. Second, it operates using 'group' procedures for client selection, risk management and loan repayment enforcement, based on small group of not more than five members with similar interests. These small groups meet regularly and take responsibility for collecting small amount of money on a frequent schedule. Third, it only lends to women households that are below the poverty line, typically households that own no farmland or other significant assets. Fourth it is a nominalist' program, specializing in the delivery of small loans for short duration at a rate of interest that is above the inflation rate and the cost of capitals, but with cost of client training, deposit and loan repayment collections and participant motivation work 'externalized' onto groups and group leaders. Group formation and group activities are crucial to the GB model.

The BRAC model shares many of the features of the GB model but it also includes 'community and personal development' components that most NGOs with a micro finance program regard as essential to the exercise of their brief. The BRAC model is different therefore, only in so far as it does not specialise in micro finance but use micro finance as part of a broader strategy of work in poor communities that NGO workers in the field often describes 'holistic development'. Hence, the NGO model may use the group approach to lending, but often will be prepared to lend to individuals and may not involve itself in savings because of its lack of legal authority to do so. The BRAC model is somewhat opportunistic in the way it delivers its service but is attractive to NGOs because of its complementary commitments to non-micro finance aspects of the push to help poor household escape from poverty and remain above the poverty line. The BRAC and NGO models are therefore, essentially the same, though some of larger NGOs, such as OXFAM, Save the Children, World Vision, CARE and CONCEN follow implementation and funding strategies that lend their individual programs of microfinance characteristics that are genuinely unique. Most NGOs see their involvement in microfinance as necessary, but the temporary activity forced on them by the inability of formal financial institutions to meet the banking needs of the poor. Typically NGOs are happy to see their microfinance clients graduate into the mainstream and leave the NGO free to pursue its primary goals in social and community development.

The third modal of importance in microfinance relies on revival of the credit cooperative or credit union in a significant number of developing countries, especially Sri Lanka and the South Pacific. This model follows the usual cooperative spirit associated with owner managed firms, where all members have an equity interest in the health of the MFI and the distribution of benefits flows not only from the use of individualized services, (in contrast to group targeted services), but services provided at costs that are lower than the profits earned can be applied to subsidise credit or boost the return to members on deposits. The cooperative or credit union may offer members complementary community or personal development programs, but normally it specializes in being a financial intermediary. In some countries these types of MFIs are also known as 'thrift and credit' societies, many of which had their genesis in an informal savings club or rotating savings and credit association (RoSCA).

The fourth model is that of the Village Bank or Bank for the Poor, such as the KUPEDES (rural general credit) and BKK (sub-district credit institution) systems in Indonesia. This sort of MFI has the legal status of a 'limited bank' serving a specified market, and to do so eschews the physical infrastructure of a formal sector bank and may well be a part-time service provider, operating out of rented accommodation. Indonesia has led the world in experimenting with village banks, offering rural communities the opportunity to access banking through banks that are 'mobile' operate on a schedule that does not require it to open every business day all day, and specializes in the recycling of rural savings through small loans to rural households and micro-enterprises.

All other models are in one way or another a variant or an amalgam of the four described above. For example, the much celebrated Self Employed Women's Association of India, SEWA is a hybrid between the GB, BRAC and a RoSCA.

There is no accurate estimate of the number of MFIs that currently operate in developing countries, but from a base of a handful of MFIs world wide only ten years ago, in 1997 the overall number is in the tens of thousands, if we include every NGO that has a loan program or sponsors a savings club or RoSCA. There is, however, a core of less than 100 major MFI entities in Asia, Africa and Latin America that dominate the scene. Table I summarizes the data provided to Bank Poor '96 for the Asia Pacific region.

What Table I tells us is that unlike the gains in the microfinance arena, GB, BRAC, ASA, BRI and ACCION etc., the typical microfinance provider is NGO based, small in terms of number of clients being served, area specific in focus and sees the simple dispersal of very small loans for microenterprise development or income generation as their primary interest in microfinance.

#### **Who are the Clients of MFIs?**

The target clients of MFIs are the poor, ie. those persons identified as living below nationally defined income based poverty lines. The World Bank, 1996, numbers these at around one billion person or 200 million households. There is a broad consensus that these one billion poor people are also those who have access to not more than a 'dollar a day' to

**Table I : MFIs in Selected Asia-Pacific Countries by  
Number of Clients and Activity, 1996**

Countries	Number of MFIs Clients		Total Value of		Average Size of	
	Number	Millions	Loan Portfolio \$US mill	Members' Savings \$US mill	Loans Made \$ US	Member Savings \$US
Bangladesh	10	5.74	218.23	58.18	38.0	10.0
China	5	0.08	0.93	0.02	11.2	0.2
India	15	2.49	6.87	7.17	2.8	2.9
Malaysia	6	0.08	11.80	6.70	149.7	85.0
Indonesia	2	7.44	0.65	0.09	87.4	12.1
Nepal	9	0.06	1.80	0.28	31.0	4.8
Pakistan	6	0.34	6.20	8.26	18.3	24.4
Philippines	16	0.04	7.98	1.28	191.6	30.7
Sri Lanka	7	0.33	4.90	3.40	14.8	10.3
Thailand	3	0.30	2.25	0.18	7.4	0.6
91 countries	91	9.5	267.14	86.20	28.0	9.0

Source: Data submitted by MFIs attending Bank Poor '96, at APDC, Kuala Lumpur, December 1996 and reported in Getobig, Remenyi & Quinones, 1997, Table 6.

meet their essential basic needs, (i.e. for food, clothing, transport, health, education, housing, social obligations and other requirements). Women and children dominate this mass of humanity, so it is not surprising to find that eighty percent and upwards of the clients of most MFIs are women.

In February, 1997, an international meeting of development professionals met in Washington DC, for the Micro Credit Summit. This meeting, sponsored by the World Bank, the United Nations, several prominent private sector banks from the First World that are also active in developing countries, and virtually every other significant actor in the microfinance sector world wide, drew together thousands of grass-roots level practitioners and development professionals for what was, in effect, a celebration of the achievements of pioneering MFIs in bringing financial services to the poor: an achievement that only a decade ago was widely believed to be impossible.

The Micro Credit Summit set 100 million 'new' clients as the outreach target for MFIs between now and the year 2005. Given that each new client represents one poor household, and assuming that there is an average of five persons per household, achievement of this goal will bring financial services to one quarter of the poor people in the Third

World. If the experience of the MFIs that are active today is any indicator to the future, almost all these 100 million new clients, 70 million of whom will be from the Asia-Pacific region, will be female.

### **The Poverty Pyramid**

When addressing 'poverty' there is always the danger that 'the poor' will appear to be lumped into a unified group or a homogeneous market characterized by widely shared economic disabilities and structural disadvantages. In fact, all successful MFIs, without exception, recognize that the reality is very different. The poor are not a homogeneous mass, but a highly heterogeneous collection of consumers, producers, savers, investors, innovators, and risk averse economic factors. In order to serve each of the very many different categories of clients that the MFI finds in poor villages, it must deliver services that are flexible enough to meet individual needs. In many instances the MFI will find itself needing to have a range of microfinance products if it is to offer poor householders the financial intermediation services they need for escape from poverty.

In another place Remenyi, (1991, 1993, 1994a and 1995), has characterized this diversity as forming a 'poverty pyramid' of poor households, the several strata of which constitute unique markets for microfinance services, each needing tailored financial products and intermediation assistance. At the bottom of the pyramid are the poorest of the poor: the vulnerable or, as Lipton (1993) has described them, the 'ultra' poor. This group of potential microfinance clients are characterized by their dependence on other people's earnings for their survival. Include in their number are pregnant women, old people, children and the infirmed. Typically these members of poor households do not earn a cash income, but their vulnerability is directly tied to the fact that the contribution they make to household income is not sufficient for their own survival. Access to microfinance services by the vulnerable poor can create the means by which their physical productivity is boosted and the value of their economic activities within the home or the village is lifted.

Above this group in the poverty pyramid are those poor people whose main source of income is the sale of their labour, either in the market place or to themselves in the course of subsistence production. This group is poor because the return they receive from their manual exertions is low, whether as paid labour or in return for subsistence production. Rural credit programs of the past were essentially targeted at the agricultural activities of this strata.

Microfinance institutions also serve the needs of poor and subsistence farmers, but there is a deliberate attempt on the part of MFIs to finance those activities of the 'labouring' poor that diversify their sources of income as well as increasing it in total value and in return for effort. An important source of this diversity is investment in economic activities that propel members of poor households up the poverty pyramid and into the next highest strata of poor persons, the self-employed poor who are not engaged in subsistence activity but in producing for the market.

The self employed poor need working capital and are fully integrated into the cash economy when working as self-employed persons. This does not, of course, preclude times when members of this strata might engage in subsistence activity. There is a great deal of movement between the stratas of the pyramid, but the goal is to spend as much time as possible in the highest strata that one can reach, even if the time spent earning income in the higher strata is short and serendipitous. What distinguishes members of the 'self-employed' poor from those on lower strata is that they are dependent on the market for their reward and his reward is at a higher level of average income than the opportunity cost of subsistence activity or contract labouring. MFIs can enable members of the vulnerable and labouring poor strata to migrate into this higher strata by funding their involvement in cash income generating activities, many of which will be part-time and home based self-employment options.

Another group of clients operates at the next level up in the poverty pyramid as microenterprise operators. These persons are distinguished by the fact that they employ other, possible family members and often only part time, to assist them in the conduct of their business. Typically these microenterprises will be directed at value-adding to goods or services that can be described as 'wage-goods' ie. food, clothing, household items, transport, and the like-produced and sold in the informal sector. Here too, working capital is often the critical need of the microenterprise entrepreneur, even though the microenterprise may only be a part-time activity. Nonetheless, microenterprise operators are at the top of the pyramid because the gross return they receive from the operations of their businesses are high enough to support more than self-employment, even if only part-time or family based, and this return exceeds the opportunity cost of working alone or for someone else.

Each strata of the poverty pyramid represents a separate market for microfinance service, each with its unique needs. More than lip-service is needed if the diversity of needs generated by potential clients in each strata are to be met by the MFI. This observation has become one of the most important conventions of microfinance 'best practice'.

### **Dimensions of Poverty**

Poverty is more than economics. Many MFIs have found it important to not only acknowledge this but to include in the range of activities undertaken, some that are directed at the alleviation of the non-economic dimensions of poverty. Circumstance dictates for which MFIs this is essential and for which specialization on the delivery of economic services is the best course of action. If the systemic causes of poverty can be traced to the existence of significant gender bias, gross abuse of human rights, denial of access to justice and due processes of the law, side-effects of economic activity resulting in dangers to environmental health and a deteriorating quality of life, chronic illiteracy or the absence of avenues for the needs of the poor to be brought before the appropriate authorities or persons, then it will be difficult for the MFI to make headway in its poverty reduction efforts unless it addresses these matters. In many instances it is only by addressing these non-economic dimensions of poverty that the systemic nature of chronic poverty can be effectively overcome and the probability of permanent escape from poverty significantly improved.

Many MFIs have a heritage that comes directly from the social welfare oriented NGO sector, at times retaining close links with a First World NGOs as a form of strategic alliance. In other instances, the MFI will deliberately devote significant resources to activities that are not directly related or contributing to their 'banking' functions because their members judge it important to also address the social and community goals as part of their battle to overcome the root causes of poverty. BRAC in Bangladesh, the Self-Employed Women's Association in India, Dunganon in the Philippines, and the Indonesian Welfare Foundation in Java are quintessential examples of MFI for which this is the case. Friedmann, 1992, has depicted the activities of NGOs, MFIs included, directed at non-economic dimensions of poverty as 'empowerment' activities intended to raise awareness among the poor to the base causes of poverty and to mobilise group action to overcome these. Whether these 'empowerment' activities complement or compete with the business of being a microfinance provider is an issue that is actively debated in microfinance circles, but among economists there is a tendency to advocate a minimalist and tightly focused approach to microfinance for the poor as the most effective way of reaping the benefits of specialization.

All of the households in the poverty pyramid have incomes that are below the local poverty line. While this is a matter of definition, the identification of which households in a poor village are in fact below the poverty line and which are the poorest of the poor is not so easily determined. Nonetheless, an MFI needs to be able to target poor households if it is to prevent or minimize the leakage of scarce resources to villagers who have incomes that are above the poverty line. It would be nice if one could simply ask householders what their income is and so distinguish the poor from the not poor households in the village. However, for whatever reasons, it is well known that poor householders are reluctant to divulge details of their income. Depending upon what they perceive as your purpose in seeking such information, they can be expected to tell you what they think you want to hear (See Todd, 1996b). This may understate or overstate their true income. Hence, for the MFI staff member in the field there is always the challenge of accurately identifying who are the genuinely poor in a village in order to concentrate their efforts on recruiting the poor and not the 'near poor' or 'not-poor' into their pool of beneficiaries. Many strategies have been tried to achieve this goal and over-time several cost-effective and reliable 'proxies' for income have been identified.

Proxies for household income normally rely on the fact that poor people are asset poor and will almost invariably live in the worse housing situation. Hence, even a cursory examination of the home of the potential client and the most general enquires as to what animals are owned is often enough to separate the poorest households from the least poor in the village. In other instances it is possible to rely on the fact that the village people themselves know which households in their village are the poorest and the richest. Typically they are able to rank a list of their neighbours on an economic scale from highest to lowest and such lists, (presented as a set of cards, one for each household in the village) are readily assembled in private by each householder and the results then collated into a 'consensus view' of which households in a village are at the bottom of the poverty pyramid. This consensus view is rarely far from the truth, and it is these households that are the target of MFI recruiting of new beneficiaries. Such information is, therefore, essential if the MFI is to

concentrate its recruiting of new clients among the ranks of the poorest and prevent leakage of benefits to those already above the poverty line.

### **The Role of Microfinance in Poverty Reduction**

Poor people remain poor for many reasons, but the advocates of microfinance are convinced that an important contributor to their inability to escape from poverty and retain a place in the economic spectrum above the poverty line is their lack of access to microfinance services. This is not to say that microfinance is a panacea for persistent poverty. The foundations of microfinance based strategies of poverty targeted development are predicted on the belief that persistent poverty cannot be overcome unless investment by the poor in the poor is increased. Investment by the poor is low now because poor people do not save, not it is because they have few investment opportunities or are lazy, but for other reasons. In particular, the low levels of investment by poor households in self-improvement, in the accumulation of productive assets or in income-generating employment opportunities are the direct result of their lack of access to the financial services that:

- meet their needs for working capital;
  - offers relevant investment advice;
  - presents productive savings options to compete with asset hoarding;
  - offers insurance for risk management or life-cycle savings;
  - responds rapidly and flexibly to unplanned changed circumstances or misadventure;
- and
- provides advise on flexible money management tailored to the client's circumstances. Microfinance is important to poverty reduction because by facilitating investment MFIs enable households, failed investments notwithstanding, to realize the positive benefits that such investment are expected to have on the borrower's income, asset base and future capacity to save.

There are many dimensions to poverty but the primary focus of MFI is on the positive impact that greater access financial services can have on the economic welfare of poor households. Typically improving economic welfare is identified with increasing 'disposable' household income. It is well known, however, that increase in earned household income are the result of one or more of the following five economic mechanisms:

1. Less unemployment at existing wage rates of the labour available in the household, thereby reducing the effective dependency rate in that household;
2. Higher wage rates, through productivity improvements in existing employments, shifts to higher paying wage employment(s) or self-employment(s);
3. Investment in upgrading existing productive assets or acquisition of additional productive assets;
4. Improvement in market conditions that result in higher returns for goods and services marketed;

5. Increased disposable income because of a fall in household and livelihood costs, including the cost savings associated with technology transfer, lower costs of financial services and access to cheaper basic needs of goods and services.

Each of the above five mechanisms for raising household income are dependent on added investments expenditure either inside or outside the household. It is not surprising, therefore, that economists depict the engine of income growth as 'investment'. It is investment in people, equipment, inventory, infrastructure and institutions that generates human 'capital' (in the form of marketable skills), physical 'capital' (in the form of machines, technology and inventory not yet sold), public overhead 'capital' (in the form of transport networks, potable water systems, health and education facilities, etc.) and social 'capital' (including community institutions and government systems that oversee the network of obligations and entitlement contained in the customs and cultural mores that are so essential to the survival of the poorest of the poor and to society as a means of handling crises and structural change). Inevitably, therefore, if poverty reducing development is measured by rising levels of household income, then the process of development must involve increasing rates of investment in all of these areas, microfinance institutions included. In contrast, the poverty 'trap' is characterized as a situation wherein poor people invest very little and have little to invest. The non-availability of microfinance is one important reason why this trap persists.

#### **Does Microfinance Help the Poor?**

Microfinance may not be a panacea for poverty, but as a component of the fight against poverty the services that MFIs bring to poor households can make a significant difference to economic welfare and the capacity for self-reliance. There is no doubt that MFIs do benefit the poor, and the weight of evidence from the very few but increasing number of surveys, testimonials and case studies is persistent in confirming this. In a major study of MFIs in Asia, Africa and Latin America, Nule and Mosely, 1996, were drawn to conclude: "... our study confirms that emerging consensus that well designed credit schemes can raise the incomes of significant numbers of poor people....." (p.114)

There are those, however, who question whether attention to improving the functioning of finance markets serving the poor is enough for sustained poverty reduction. In 1995 Michael Lipton and Martin Ravallion, two of the World Bank's most senior and experienced economists specializing in the area of poverty reduction, wrote, "...it is hard to maintain hope that chronic poverty can be reduced appreciably by credit-based interventions. Chronic poverty is not typically due to 'market failures' in credit or other markets, but to low factor productivity, and / or low endowments per person of non-labor factors."(p.263).

The Lipton-Ravallion view is not uncommon among development economists, but neither is it a consensus view. Two equally well respected economists who have similarly had long association with the World Bank's fight against poverty, Paul Collier and Deepak Lal, 1984, argued at the outset of the Bank's reinventing of its approach to persistent poverty, that chronic poverty and the failure of the 'trickle-down' effect of economic growth are the result of the absence or inefficient operations of markets for the factors of production, including finance. The common ground between economists is that all are agreed that an

**Table No. 2 : Increase in Family Income of Borrowers  
Compared to Control Group of Non-borrowers**

Country	Annual average change in family income %1988-92 Borrowers	Annual average change in family income % 1988-92 Control Group	Borrowers as a ratio of the Control Group	Sample size # Borrowers '000
Indonesia	12.9	3.1	3.80	2,500
Bangladesh	29.3	22.2	1.34	608
Sri Lanka	15.6	9.9	1.57	700
India	46.0	24.0	1.91	25

Source: Hulme and Mosely, 1996, p.<sup>38</sup>

environment of economic growth is essential for poverty reduction. In a recent study of 114 World Bank supported poverty reduction structural adjustment programs implemented in the period 1980-93, Jayarajah, Branson and Sen 1996, reported that, 'in no country where growth was negative did poverty decrease'. (p.2).

Lipton and Ravallion can be interpreted as saying that microfinance is but a component of the fight to achieve sustained poverty reduction: necessary but not sufficient. Moreover, the effectiveness of the microfinance component is influenced by the economic and institutional environmental in which they are provided to clients. If the supply of finance is increased in an environment of civil unrest and insecurity or in circumstances of general economic decline, it is unlikely that the results for borrowers will be a permanent improvement in their circumstance. There is, therefore, an important prior question that microfinance advocates cannot ignore: ie. What needs to be done to make microfinance based interventions more effective as a tool for poverty reduction? The answer to this question has several parts.

First, the impact of investment loans on the income of poor households and the productivity of savings is positively related to the macroeconomic environment. Microfinance interventions are more effective in reducing poverty when the economy is improving than when it is in decline. Responsibility for macroeconomic settings are beyond the ken of MIFs, but if these are wrong or inappropriate the MFI will be fighting an uphill battle to nurture sustained poverty reduction.

Second, MFIs, will always remain marginal to the big picture so long as MFIs remain small and insignificant in their outreach to poor households. Currently microfinance providers are reaching out to less than 5 percent of poor households in most poor economies. The exceptions are Bangladesh, Indonesia and Malaysia, where outreach has either approached or exceeded one third of poor households since 1980. It is also in these three countries where the situation of the poor has improved the most over this period. If the outreach of MIFs can be similarly increased to poor households in all developing countries,

the likely impact of a loosened finance constraint is a far higher multiplier effect on sustained growth in the income of poor households than has been the case so far.

Third, microfinance is more than simply credit. It is as important to ensure that savings, insurance and money management services are offered to poor households as it is to bring them access to credit.

Fourth, there is a mounting stock of micro-level data on the benefit that poor households are receiving from access to microfinance that gives us reason to question the Lipton-Ravallion view. The difference that access to microfinance has made to poor households is significant. In recent years there have been at least eight major studies on the impact of micro credit on the incomes of poor household. Without exception these studies confirm that household income of families with access to credit is significantly higher than for comparable households without access to credit. Poor households that have had access to microfinance services also show significant increases in asset accumulation, providing them with both a safety net against misadventure and resources for self-help.

Fifth, although Huylem and Mosely, 1996, found little improvement in the ability of borrowers from MFIs to weather the 'shock' of misadventure or sudden reversals in their economic circumstances, Jones, 1994, 1995, reports that the multiplier effects of greater credit outreach and reduced hoarding in favour of interest earning deposits with MFIs are not trivial. Apparently there is a 'competition' dividend from greater MFI outreach expressed as a reduction in informal sector interest rates and increases in the quantity and variety of finance products offered to poor households, in addition to the increase in productivity associated with the increased levels of investment and less hoarding.

One should not, however, ignore the possibility that microfinance is merely 'deja vu', a return to the unrealized promise of the cheap loan programmes of past decades. This prospect forces us to ask, is there a significant leakage of MFI resources to persons who are not poor? This question is not easily answered. It is not unexpected that researchers have found that the poorest household benefit less from access to loans than households that are located further up the income scale in the poverty pyramid. The poorest households are the most risk averse, have the greatest disadvantages and most limited resource base among households below the poverty line. This is consistent with the finding reported in Groetz and Sen Gupta, 1996, that the return on loans taken up by women is significantly lower, by as much as 50 percent, than the return on loans to men. Directly, therefore, microfinance makes the least difference for the poorest households. It does not follow, however, that MFIs should therefore, concentrate on poor households at the upper rungs of the income range below the poverty line. The vulnerable poor should not be denied access just because they have fewer investment opportunities than their not so poor neighbours. Nonetheless, it should also be expected that if the allocation of loan funds is left to open competition, it is likely that the bulk of funds disbursed will flow to poor clients from the least poor households. Does this matter? Is it enough that MFIs reach out to poor households, even if the majority are not among the poorest of the poor?

There are many practitioners who would be satisfied with the stricture that MFIs recruit new members from the ranks of households that are clearly below the poverty line but not necessarily from amongst the most vulnerable, the poorest of the poor. One might also speculate that because outreach to the poorest of the poor is especially difficult and costly, MFIs will not achieve financially viable growth in business unless they concentrate on the higher strata of the poverty pyramid, leaving the poorest of the poor to benefit from what 'trickle-down' effect is generated as a result of MFI activities. On the grounds of sustainability, too, one might also argue that if MFIs discriminate in favour of the poorest of the poor at the expense of the poor households at the top of the poverty pyramid, these less poor households will slowly but surely slide back into the mire of chronic poverty, cutting off what trickle down of benefits does find its way into the households of the vulnerable and labouring poor. In the absence of evidence on the multiplier effect of micro credit or other microfinance services, it is impossible to decide this issue objectively, but it would be surprising if the trickle down of benefits from investments by households with incomes above the poverty line. Hence, although the overall judgement of researcher is that the direct benefits of MFIs 'rarely' reaches the poorest households, it does not follow that MFIs do not play a vital role in sustained poverty reduction.

An aspect of the distribution of the benefits of microfinance disbursement that has occupied an increasing number of writers is whether the borrower is also the primary beneficiary? This question has been explored by researcher in part because MFIs have claimed a special ability to reach out to women, who dominate the ranks of the most vulnerable at the lowest levels of the poverty pyramid. Several researchers noted in the course of their field work that even though loans are predominantly made to female borrowers, it was not uncommon for control over how loans would be spent to remain with male members of the household but repayment obligations remained with the borrower. This observation caused some researchers to question whether in distribution of loans by gender is a reliable indicator to the distribution of the benefits of microfinance.

Todd, 1996b, questions whether these are important issues. Her in-depth study of the impact of 'Grameen Bank' loans to a group of very poor women after an interval of ten years is a powerful, moving and sobering piece of anthropological research. Her finds confirm that in poor households, and especially the poorest households, resources highly fungible and it is rarely possible to determine whose money is used by who and for whose benefit. Todd shows that the motivation of female borrowers is often drawn from her ability to help her husband, sons or other relatives attain higher status and economic prospects. The act of accessing anew source of loans or other financial services is rarely taken independently. Hence, while research into the gender dimension of the distribution of the benefits of MFI activity should heighten awareness to gender issues, it has not weakened the claim that poor women are major beneficiaries of microfinance programmes, especially in the case of female headed households which represent a large minority in the total number of clients served by MFIs. In the final analysis one is drawn to conclude that most poor households are able to assess what is in their best interests and can be trusted not to squander borrowed funds, irrespective who in the households has borrowed the money or for what purpose the

funds appear to have been expended.

Judgements about whether there is leakage or not are also complicated because of the dilemma of 'repeat business'. If MFIs are successful in helping their poor clients escape from their poverty, they will have a rising number of clients who have graduated to levels of income above the poverty line. There are MFIs that plan to graduate their success cases into the modern banking sector or into the client group of other formal non-bank financial institutions. These 'linkage' programmes MFIs have been the primary focus of APRACA (1983), FDC (1992) and other. They have an important role as 'transition facilitators' in the development of the capacity of formal sector financial markets to serve poor households. However, many other MFIs that do not see themselves as 'working themselves out of a job' in this way. These MFIs, which includes prominent players such as AIM, ASA, BKK, BRAC, GB, SANASA, TSPI and many others, see themselves as permanent entities. Their successful clients are to them an asset to be retained and nurtured. However, as the number of successful MFI clients grows, so too does the pressure on the MFI to divert more and more of its resources to serve the needs of these established clients for repeat business. By responding to this pressure, MFIs inevitably divert resources from their capacity for further outreach. This dilemma is not easily resolved. Each MFI must determine its own optimal balance of old and new clients, based on local priorities and policy pressures. Much of the literature that claims that MFIs are not reaching the poorest of the poor in favour of the not so poor or the near poor, has not appreciated the importance of this dilemma.

### **Characteristics of a Successful MFI**

The literature on what criteria ought to be applied in identifying a successful MFI is increasing rapidly, but there is already a discernible consensus emerging. This consensus has been comprehensively presented in Yaron, 1994. What makes rural finance institutions successful? This consensus is based on a global study of MFIs sponsored by the World Bank, first reported in two volume work reported in Yaron, 1991. Here we have 'pick the eyes' out of these sources and similar studies by Ash and Cosselett, 1989; Hulme, 1990; Drake and Otero, 1992; Wigg, 1993; Bechtel and Zender, 1994; Bouman and Hospes, 1994; Gurgland, et.al., 1994; CGAP, 1995; Conroy, Taylor and Thape, 1995; Christen, 1996; Hulme and Mosely, 1996; Jam, 1996; Pitt and Khandker, 1996; Schmidt and Zeitinger; Seible, 1996; Todd, 1996a; and Getubig, et.al., 1997.

In all of these studies there are essentially only two criteria of 'success'. The first focuses on whether the MFI is moving towards a level of financial viability that will enable it, in the near future, to achieve self-sustaining growth. The second criteria concerns the extent to which the MFI is achieving substantial outreach to its target population. On the basis of these two criteria, it is further possible to identify the following common characteristics of successful MFIs. Namely, all successful MFIs share operating policies and management procedures that are expressed as:

- (i) positive 'real' interest rates on loans that are high enough to also cover the true cost of capital;
- (ii) positive 'real' interest rates on voluntary savings deposit;
- (iii) high (ie:>80 percent) on-time loan repayment rates, supported by a default insurance programme of one sort or another;
- (iv) a rising proportion of the loan portfolio financed from voluntary savings;
- (v) management systems and administrative procedures that are transparent and designed to allow operation and overhead expenses to fall as a proportion of a rising loan portfolio;
- (vi) a business plan based on significantly increased outreach to the poorest households; and
- (vii) use of collateral substitutes, deposit collection and repayment enforcement procedures that are consistent with the 'social capital' of the community within which the MFI operates.

### **Concluding Observations**

In order for a MFI to meet all of the seven strategies for becoming a successful MFI, there are a number of subsidiary requirements that are implied but not always in the control of the MFI. For example, if a MFI is to charge rates of interest on its loans that more than cover the cost of capital, including the opportunity cost of members funds and subsidized funds received from donors, government or other sources, the MFI must be free to charge whatever interest rate is needed. Regulated interest rate ceilings prevent MFIs from doing this. Where such regulations exist, it is necessary for the government to deregulate the financial sector dealing with MFIs. Another example arises in the case of savings mobilization. As already noted, very few MFIs can boast a voluntary savings programme that raises enough in deposits to fund a significant proportion of their lending to members. This is partly due to the use of compulsory savings as pseudo loan and catastrophe insurance. But the more important reason is that most MFIs operate in a legal limbo and so find it difficult if not impossible to present themselves as deposit managers legally able to guarantee the security of deposits. In some countries, notably China, it is illegal for MFIs to gather voluntary savings without specific government approval. In this situation it is difficult for the MFI to present itself to a potential depositor as able to pursue restitution of members' deposits in the case of fraud, a run on the MFI or financial losses covered from members' savings. There is an important role here for close collaboration between government (ie. the Central Bank) and MFIs. In addition to the determination of appropriate prudential guidelines, there are procedural arrangements and documentation standards that must be agreed to. It is possible to set these as a result of 'self-regulation', but the benefits of regulation only flow if 'due-process' exists and is enforced.

The importance of microfinance has increased as the money economy has become the main escape route from poverty for more and more people in poor countries. Microfinance

is an important component of the package of policies and publicly supported programmes that are needed to overcome persistent poverty. The role of microfinance in the package is to boost the self-reliance of poor households, to mobilize household level resources into more productive and more rewarding employments, and to increase the robustness of the economics of survival at household level.

Outreach by MFIs to poor households is poised to increase dramatically across much of the Third World. Practitioners are confident that the knowledge and experience now exists to manage an aggressive program of outreach. The human resources, institutional, policy and financial obstacles that must be overcome before MFIs are able to expand their outreach by a factor of twenty or more are not insurmountable. Increased outreach on this scale is what will be needed if the goals set at the Micro Credit summit in February, 1997 are to be realized.

There is no one 'optimal' model for the spread of microfinance. In some countries the Grameen model will suit, appropriately modified for local socio-cultural and institutional conditions. In other countries the cooperative model, village banks or private associations of group of poor people into RoSCAs, savings clubs or informal money-go-rounds will be the preferred model. In all cases, however, 'success' is the result of well known ingredients: honest, committed and able staff; pricing policies that reflect market determined interest rates and charges; offer of a range of financial services including savings and insurance in addition to loans; judicious use of collateral substitutes; MFI member and staff incentives that respond to self-interest; adoption of operating procedure that build on the social capital of poor communities to manage risk and contain transactions costs; and a commitment to reach out to poor households, especially the poorest of the poor.

### References

- Adams, D.W. and D.A. Fitchett, eds. 1992. *Informal Finance in Low-Income Countries*. Westview, Boulder, CO.
- Adams, D.W. and I. D. Von Pischke. 1992. Microenterprise credit programs: 'deja vu'. *World Development*, Vol.20, #10, p. 1463-70.
- Adams, D.W.D. Graham and J.D., Von Pischke. 1984. *Undermining Rural Development with Cheap Credit*. Westview Press. Boulder, CO.
- Ashe, Jeffrey and Christopher E Cosslett. 1989. 'Credit for the Poor: Past Activities and Future Directions for the UNDP'. *UNDP Policy Discussion Paper*. UNDP, New York.
- Bechete, P.K., and R. Zender. 1994. *Providing Financial Services to the Poor: IEAD's Experience, Challenges and Evolving Approaches*. IEAD, Rome
- Bouman, F.J.A. and Hospes, eds. 1994. *Financial Landscapes Reconstructed: the Fine Art of Mapping Development*. Westview Press. Boulder, CO.

- CGPA. 1995. *Micro and Small Enterprise Finance: Guiding Principles or Selecting and Supporting Intermediaries*. Mimeo. originally published by CGAP predecessors, Committee of Donor Agencies for Small Enterprise Development and Donor's Working Group on Financial Sector Development. Washington, DC.
- Christean, Robert Peck. 1996. Executive Summary, 'Maximize in the Outreach of Microenterprise Finance: An Analysis of Successful Microfinance Programmes', by Christen, R.P., E.Rhyne and R.C. Vogel. 1995. *USAID Programs and Operations Assessment Report #10*, Washington. DC.
- Collier, Paul and Deepak Lal. 1984. 'Why poor people get rich: Kenya 1960-79', *World Development*, Vol.1 2# 10,p.1 007-18
- Conroy, J.D., K.W. Taylor and G.B. Thapa. 1995. *Best Practice of Banking with the Poor*. FDC, Brisbane, Australia.
- Getubig, I.J, Remenyi and B. Quinones, eds. 1997. *Creating the Vision: Microfinancing the Poor in Asia-Pacific: Issues, Constraints and Capacity Building*, Asia Pacific Development Centre, Kuala Lumpur
- Getubig, I. ed. 1993. *Overcoming Poverty Through Credit: the Asian Experience in Replicating the Grameen Bank Approach*. APDC. Kuala Lumpur.
- Groetz, A.M. and Ren Gupta. 1996. 'Who Takes the Credit? Gender, Power and Control Over Loan Use in Rural Credit Programs in Bangladesh', *World Development*, Vol.24., No.1, January, p. 24-64.
- Gurgland, M.,G. Pederson and J. Yaron. 1994. Outreach and sustainability of six rural financial institutions in sub-saharan Africa'. *World Bank Discussion Paper #248*. Washington, DC.
- Holderoft, LE. 1982. 'The rise and fall of community development in developing countries 1950-65: a critical analysis and implications' in Jones, GE and R Rolls. 1982.p.??
- Hossain, Mahabub. 1988. *Credit for the Alleviation of Rural Poverty: the Grameen Bank in Bangladesh*. IFPRI and BIDS. Washington.. DC and Dhaka.
- Hulme, David and Paul Mosely. 1996. *Finance Against Poverty*; 3 Vols. Routledge. London.
- Huylme, D. 1990. 'Can the Grameen Bank be Replicated? Recent Experiments in Malaysia, Malawi and Sri Lanka', *Development Policy Review*. Vol.8. #3. P.287-300.
- Jain, Pankaj S. 1996. 'Managing Credit for the Rural Poor. Lessons from the Grameen Bank'. *World Development*, 24.1. January. p.79-89.

- Jayarajah, Carl, William Branson and Binayaka Sen. 1996. *Social Dimensions of Adjustment World Bank Experience, 1980-93*. World Bank, Washington, DC.
- Jones, J Howard M. 1995. *Women & access to formal and informal finance in a Rajasthan village*, paper presented to the Finance Against Poverty conference, University of Reading, 27-28 March, mimeo.
- Jones J.H.M. 1994. 'A changing financial landscape in India: macro-level and micro-level perspectives', in Bouman and Hospes, eds. 1995. 75-394.
- Khandker, Shahidur, Baqui Khalily and Zahed Khan, 1995. 'Grameen Bank: Performance and Sustainability', *World Bank Discussion Paper #306*, IBRD, Washington, DC.
- Lipton, Michael and Martin Ravallion, 1995. 'Poverty and Policy', in Handbook of Development Economics. Vol. 3, ed. Behrman, Jere and TN Srinivasan. Elsevier, Amsterdam, p.2551-2657: first published as World Bank Policy Research Working Paper, WPS 1120 Washington, 1993.
- Pitt Mark M and Shahidur R Khandker. 1996. 'Household and Intra household Impact of the Grameen Bank and Similar Targeted Credit Programmes in Bangladesh', *World Bank Discussion paper #320*, IBRD, Washington, DC.
- Remenyi, Joe. 1991. *Where Credit is Due: Income Generating Programs for the Poor in Developing Countries*. ITP, London.
- Rutherford, Stuart. 1995. *ASA: The Biography of an NGO*, Association of Social Advancement. Dhaka.
- Schmidt, Reinhard H. and Claus Peter Zeidnger 1996. The efficiency of credit-granting NGOs in Latin America. *Savings and Development*, Vol.20 #3, p. 353-384.
- Seibel, Hans Dieter. 1996. *Financial Systems Development and Microfinance*. Deutsche Gesellschaft für Technische Zusammenarbeit, (GTZ), G.M.B.H. Technical Monograph #258 Rossdorf, Eschborn.
- Todd, Helen. 1996a. Ed., *Cloning Grameen Bank: Replicating a Poverty Reduction Model in India, Nepal and Vietnam*, ITP London.
- Todd, Helen. 1996b. *Women at the Centre: Grameen Bank Borrowers After One Decade*, Westview Press, Boulder Co.
- Townsend, P. 1993. *The International Analysis of Poverty*. Harvester Wheatsheaf, London
- UNDP 1996. *Human Development Report*, Oxford University Press, New York.

- UNIFEM. 1996. *Village Banking*, UNIFEM and SLEEP Network, New York.
- Von Pisehke, J.D. 1991. *Finance at the Frontier*, EDI. World Bank, Washington. DC.
- Von Pisehke, ID, Dale Adams and Gordon Donald, eds. 1983. *Rural Financial Marketing Developing Countries*, Johns Hopkins UP, Baltimore.
- Wigg, David. 1993. *The Quiet Revolution*, World Bank Development Essay #2, The World Bank, Washington DC.
- World Bank. 1996. *Poverty Reduction and the World Bank: Progress and Challenges in the 1990s* World Bank, Washington, DC.
- World Bank. I 993b. *A Review of Bank Lending for Agricultural Credit and Rural Finances; 1948-92*, Operations Evaluations Department Report #12 1431, Washington, DC.
- World Bank. 1990a. *World Development Report, (Poverty)*, Oxford University Press, New York.
- Yaron, Jacob. 1994. What Makes Rural Finance Institutions Successful? *World Bank Research Observer*, 9:1, January, p.49-70.
- Yaron, Jacob. 1991. *Successful Rural Finance Institutions*, 2 Vols. Agriculture Policies Division, World Bank, Washington, DC.