

## Helping to Improve Donor Effectiveness in Microfinance

### THE IMPACT OF MICROFINANCE

*Donors want to ensure a social return on their investment. In the case of microfinance, donors must judge whether providing the poor with access to financial services yields a sufficient social return compared to alternative poverty alleviation efforts.*

*The good news is that impact assessments have demonstrated that financial services for the poor improve people's lives by increasing their incomes and improving their capacity to pay for social services. However, although microfinance is an important catalyst for poverty reduction, it is not a magic bullet. The climb out of poverty tends to be slow and uneven. Donor funding for microfinance needs to complement, not substitute for, investments in core services like health, education, and infrastructure.*

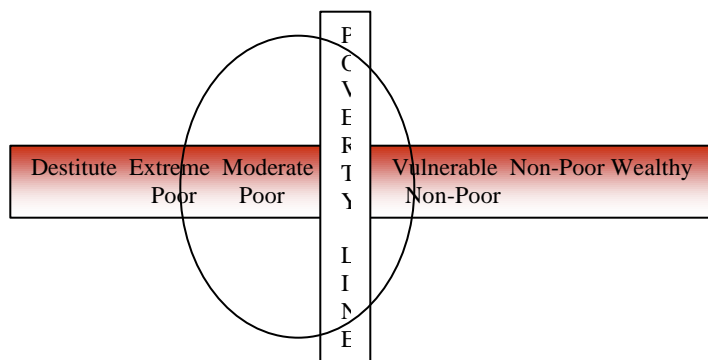
#### What do we mean by “impact of microfinance”?

Impact is about understanding how financial services affect the lives of poor people. To date, most impact assessments have focused on microcredit programs rather than looking at a range of financial services.

- Impact considers income growth, asset building, and reduction of vulnerability.
- Impact indicators extend beyond enterprise measures (assets, employment, revenues) to include multiple dimensions of poverty, including overall household income, social improvements in health and education, and empowerment (in terms of increased self-esteem and control of household resources among women).

#### What do we know about the impact of microfinance?

- **Outreach is important.** Financial institutions must reach poor clients to have an impact. As shown in the graphic, most microfinance clients today fall in a band around the poverty line. The extreme poor are rarely reached by microfinance. (Social safety net programs are often more appropriate for the destitute and extreme poor.)
- **Product characteristics count.** Specific characteristics of financial products, such as loan terms and transaction size, affect impact. Short-term working-capital loans may work well for traders wanting to purchase inventory. For producers who need to make one-time investments in equipment purchases, however, they work less well. These clients may require other services like term savings or longer-term loans.
- **The asset base of clients is relevant.** The initial resource base of a client affects impact. The impact of financial services on clients who begin with more resources (financial, physical, or social) tends to be greater than on clients who start from a very low resource base.
- **Sustainability matters.** The length of time that an individual has been a client of an institution has a positive correlation with impact. Sustainable institutions ensure ongoing impact by providing permanent access to services.
- **Country context is a factor.** The macroeconomic, legal, and policy environments seriously affect impact. Poor economic conditions, weak social and physical infrastructure (education, health, roads), corruption, and lack of security adversely influence the ability of clients to benefit from financial services.



## What is the impact of microfinance?

### Household level

- Microcredit leads to an increase in household **income**. The use of loans and deposit services can result in a diversification of income sources (e.g., Uganda) or enterprise growth (e.g., Eastern Europe).
- Access to financial services enables clients to build and change their mix of **assets**. Microcredit can be used for land acquisition, housing construction or improvements, or the purchase of animals and consumer durables. Clients can also use loans to make important investments in human assets, such as health and education.
- Poor people are very vulnerable and move from one crisis to another. Access to microfinance enables them to **manage risk** better and take advantage of opportunities. In Bolivia, many Pro Mujer clients use loans to protect their level of consumption when crises occur, avoiding large dips in material wellbeing.

### Individual level

- For women, money management, **greater control over resources**, and access to knowledge leads to greater choices and a voice in family and community matters. Economic empowerment is accompanied by growth in self-esteem, self-confidence, and new opportunities. In 2002, 103 women clients from Activists for Social Alternatives (ASA) were elected to local councils in India.
- Microfinance clients tend to have higher levels of **savings** than nonclients, which is very important for building assets. In Zimbabwe, microfinance clients opened accounts in banks or post offices; in Peru, mistrust of formal institutions translated into savings in construction materials and inventory.

### Enterprise level

- **Enterprise revenues** rise as a result of microfinance services, but not always where expected. Loans are fungible and are used where the perceived need or return is highest. Between 1997 and 1999, an overall increase in revenues was observed among all enterprises managed by households in India and Peru. But the same studies showed no impact on the specific enterprises for which loans were presumably taken.
- **Job creation** in single-person enterprises appears negligible. However, when the total number of enterprises is combined, client households often create work for others. For example, in Peru, each microfinance client created three additional working days per month for non-household workers.

## How could financial services achieve greater impact?

To date, microfinance has mostly offered microcredit designed for high-turnover microenterprises. Most impact assessments have focused on this type of microcredit. But evidence shows that clients adapt these rather rigid loans to use them for a variety of purposes like medical expenses, funerals, and school fees. Microfinance could achieve greater impact if it offered a broader range of financial services that better met the varied needs of the poor, including deposit services, microinsurance, and transfer payments.

## How can donors increase the impact of financial services for the poor?

1. Prioritize large scale outreach. Support financial institutions with potential for sustainability and growth.
2. Invest in a range of promising financial institutions to ensure that diverse clients at many income levels are reached, extending outreach both outwards and downwards as far as possible.
3. Promote the twin goals of sustainability and impact; monitor MFI progress against both goals.
4. Encourage market research to better understand client preferences and the constraints that prevent the poor from taking best advantage of financial services (i.e. literacy, land titles, etc.).
5. Support proactive institutions that develop delivery mechanisms and products to meet client needs.

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