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Sustainable Microfinance for the Poor: Evidence for the Design of Development Funds

Lack of access to credit and savings facilities is one of the main constraints on the productive activities of the poor in the South. This assumptionis widely understood nowadays and has been empirically verified. Nevertheless, providing financial services is not an all-purpose 'antibiotic' for combating poverty and low productivity. Furthermore, experience in everyday project activities and credit programs has shown that most global microfinance strategies have failed. There is a need to adjust concepts and make financial instruments more suitable. This paper discusses different concepts of 'microfinance for the poor' and presents experience with the lending activities of development funds associated with the Swiss Debt Reduction Facility.

Microfinance: a history of trial and error over three decades

Different strategies used in the past to provide financial services to the poor constitute an answer to the question: what was the underlying problem? Over the last three decades, three different patterns of diagnosis and assumption can be distinguished.

- *«Financial markets are failing»*

In the 1970s heavy state intervention in financial markets was legitimised by the argument of *market failure*: the state must provide financial services to specific target groups and regions owing to the «non-interest» of commercial banks. In almost all countries of the South, national development banks and credit programs were established in order to channel development funds to target groups. Subsidised credit was seen as an ideal way of stimulating production and speeding up technical change *(«credit-led development»)*. Eventually, most of these banks and programs went bankrupt. Their financial viability and performance were low, and the target groups were reached only occasionally.

- *«The state is failing»*

In the mid-eighties critics attributed inadequate development of financial services to *state failure* rather than to market failure: The need was not for subsidised «one way channels of funding» but sustainable financial intermediaries that combined credit with savings facilities *(«market-led development»)*. This led to a radical change in financial market policy. In order to promote mobilisation of savings and increase incentives for financial institutions, far-reaching financial market reforms were implemented in most countries of the South in the late 1980s.

- *«The concepts are failing»*

However, liberalisation of financial markets did not resolve the problem: After ten years of financial sector adjustment programs, the majority of the population in the South still has no access to financial markets. In other words, not only the state but also the markets failed in the attempt to develop financial services for the poor. This finding provoked intense debate, particularly since it became obvious that microfinance is a key element in strengthening productive activities among the marginal poor. Empirical evidence showed that the «market versus state» debate is not adequate to address the problems of microfinance; what is wrong is the top-down approach concentrating on uniform medium-term credit as the only financial instrument. The so-called «cost-barriers of microfinance» have barely been tackled.

The transaction cost problem: learning at the grassroots level

The high transaction costs of developing microfinance often caused the demise of *formal financial intermediaries* (see box). From the formal lender's perspective, the poor, and the resource poor farmers in particular, are risky borrowers and costly to reach. Since loans are small, the lender's costs often comprise a high percentage of the amount lent. The lender's risk can be reduced by adequate information (on the borrower and his project), but gathering and processing information is not free of cost.

Financial intermediation and transaction costs

Financial intermediation describes all activities which mobilise savings and transfer them into credit and investment. Financial intermediaries like banks or credit and savings co-operatives ensure that, in theory, funds are moved from surplus to deficit units and from activities with low social returns to those with high social returns.

Financial transactions are not similar to transactions in other markets such as goods markets. Since lending means future repayment, information is required about both the borrower's willingness to repay and his project's capacity to generate sufficient profits to support repayment. Lending is a risky business and therefore transaction-cost intensive. The so-called transaction costs reflect «the friction of a market» and are defined as costs that are not directly linked to the production of goods and services. Lender's transaction costs include *risks* (default, payment arrears) and *information* needed to reduce these risks (gathering and processing information). The borrower's transaction costs are the costs of obtaining access to credit. They include out-of-pocket costs and time costs.

However, borrowers, too, are faced with transaction costs. The «costs of access to formal markets», in the form of out-of-pocket costs and costs in time, sometimes exceed the amount of credit applied for. Designing viable ways of providing microfinance to the poor therefore means looking for innovative concepts and instruments that can reduce «transaction cost barriers» on both the lender's and borrower's side.

The informal financial systems

In the 1990s financial development strategists discovered the merits of informal financial markets. Until today a wide range of informal systems in rural and urban areas has been analysed and documented (indigenous banking, community-based money-lending, activities of credit unions). One common characteristic of informal finance is the effective control of transaction costs on both the borrower's and the lender's side. The list of cost-effective financial instruments is endless. Group lending and collective guarantees as a substitute for lack of individual collateral are the most common instruments, and the linkage of savings and credit is another. Transactions are based on confidence and face-to-face relationships, and information on creditworthiness can be obtained relatively easily. The attraction of informal systems for the poor is therefore not low interest rates, which in reality are in most cases higher than in formal markets, but the fact that access to informal finance is relatively easy and, accordingly, that the «costs of access» defined above are minimal. Compared to formal markets, lending procedures in informal finance are very flexible and demand-oriented in terms of amount/maturity of the loan and collateral requirements.

Nevertheless, informal markets have two main weaknesses: one is the low volume of financial resources in circulation, and the second is their sometimes monopolistic nature (usury rates charged by moneylenders). Therefore, (semi-)formal financial systems make sense if they translate the «lessons learned» in the informal sector into the design of comprehensive concepts and appropriate instruments.

A new approach in microfinance: linking financial intermediation with social intermediation

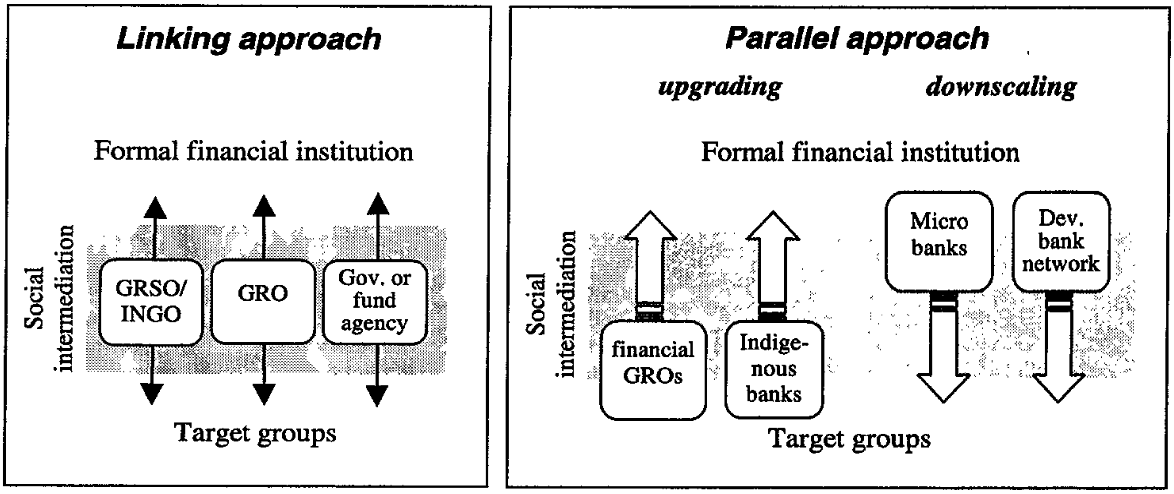
Successful examples of microfinance in the 1990s have taught us one principal lesson: the barriers between formal financial institutions and the poor clients, which translate into transaction costs, have to be overcome by combining microfinance with social intermediation. Social intermediation can be interpreted as a mechanism that reduces transaction costs (see box), and should thus be an integral part of financial intermediation.

In this context social intermediation means capacity building for grassroots organisations which either become eligible for partnership with financial intermediaries (linkage approach) or which will be able to develop their own financial systems (parallel approach).

There are two approaches in microfinance which are based on social intermediation. One is the *linking approach* of seeking formal financial intermediaries as partners. The linking «intermediation institution» can be the GRO itself, a GRSO or an international NGO (INGO), or a development fund or government agency which provides institutional support and/or guarantees. This linking model seks to reduce the «transaction cost barriers» between formal lenders and marginal borrowers.

The second type of microfinance is the *parallel approach*, which does not seek to integrate groups into the formal sector but develops existing institutions into new financial intermediaries geared to specific target groups. According to the strategic goals, there are two options to develop such parallel financial intermediaries: (i) *upgrading* more or less structured informal organisations to (semi-) formal organisations (for example, converting a financial GRO to a co-operative bank), or (ii) *downscaling* national development banks or microbanks to the grassroots level (for example, creation of local branches through a nation-wide operating development bank).

Approaches to social intermediation



Social intermediation
Social intermediation as defined here not only means assisting groups to improve their access to social services and activities that support production; it requires, in addition, the building of human and institutional capacities in target groups so that they function better with their own rules and organisation. *Human capacity building* involves management and administrative training for financial grassroots organisations (GROs) and grassroots supporting organisations (GRSOs), respectively. The aim of building *institutional capacity* is to improve the ability of these groups to define internal rules that foster the self-empowerment, ownership, and self-control that make them eligible for partnership in group-based microfinance.

How can development funds help to promote microfinance?

External resources can make a significant contribution to strengthening microfinancial institutions' capacity to provide financial services to the poor. External funds can be allocated directly to beneficiaries or indirectly, through a microfinance wholesaler or retailer. Successful microfinance is based on confidence and local knowledge. Therefore, *direct allocation* is a viable option only for organisations which are in direct contact with GROs or GRSOs (such as non-financial or financial NGOs and other agencies), while all other organisations, such as (financial) development funds or lending programs, need to focus on *indirect allocation*.

The strategic goal of external funding for microfinancial institutions has to consist of both the financial autonomy of these institutions and long-term administrative and organisational independence. Thus direct and indirect allocating organisations should focus on the above-mentioned combination of viable financial intermediation and comprehensive social intermediation. The time of «fast draining away of funds» is over, as is the widely applied practice of making poorly designed projects more attractive by attaching a credit component. Organisations allocating funds should be cautious about flooding the microfinancial sector with financial resources until there are appropriate human and institutional capacities at all levels of financial intermediation (including the grassroots level). In most cases these capacities do not exist in fact. In other words, capacity-building programs that aim to strengthen the self-empowerment and self-control of GROs as well as the capability of GRSOs are just as important as the provision of external funds.

Evidence from the *lending programs of bilateral development funds* associated with the Swiss Debt Reduction Facility confirms these assumptions. Following are the main general lessons learned from some of these programs.

– *Action-research as an input for designing fund strategy*
Before designing a development fund with a strong credit component, it is crucial to investigate existing financial intermediaries at the bottom and intermediate level in order to assess their institutional capacities and financial viability. This will give some important clues as to how the development fund should best be structured (e. g. as a long-term parallel banking institution or a «refinancing structure» working with existing financial intermediaries), and what financial instruments it should use (direct loans, credit lines or guarantee fund arrangements with existing financial intermediaries, capitalisation of these instruments, etc.).

– *Operational capacity must be in line with the chosen strategy*
Linking approaches and parallel approaches differ considerably in terms of institutions involved, duration of commitment, and reporting and monitoring systems. Therefore, funding instruments have to be compatible with the capacities of the development fund's executive bodies. For instance, if a fund wants to establish itself as an institution extending loans directly to the end-user (credit retailer), it will have to make available sufficient operational capacity to deal with a great number of credit applications.

– *Not every fund can engage in capacity building at all intermediate levels*
According to the chosen structure and funding strategy, the fund must decide whether or not it wants to contribute (or is able to contribute) to resolving any of the problems identified through action research (see first point) by designing and implementing targeted measures of social intermediation as mentioned above.

– *Capacity building also for social intermediaries*
According to the nature of the concept and the instruments applied, capacity-building programs should not only be developed for financial intermediaries but also for social intermediaries, in particular GRSOs. These programmess can be supported by development funds, financial intermediaries, or community-based organisations.

– *Direct lending windows may not be appropriate for (social) development fund*
As a rule, centralised development funds based in the capital city have no comparative advantage in opening up windows for direct lending as opposed to working with existing financial intermediaries. They are not as close to the grassroots as small local financial intermediaries, which makes access to their resources more difficult and expensive. Moreover, for a predominantly grant-making development fund with a medium-term lifetime, opening up, in addition, a direct lending window does not make much sense.

In forthcoming editions of the newsletter, there will be detailed discussions of the different approaches to microfinance. The following concepts will be presented, including examples from development funds associated with the Swiss Debt Reduction Facility, to illustrate the practical lessons learned:
I. Linkage Banking; II. Upgrading of informal financial systems; III. Microbanks; IV. Rehabilitation of former state development banks; V. Synthesis: external support of microfinance institutions.

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