Focus

No. 15
May 2000

Raising the curtain on the 'microfinancial services era'

CGAP

The Focus Series is CGAP's primary vehicle for dissemination to governments, donors, and private and financial institutions on best practices in microenterprise finance.

Please contact FOCUS, CGAP Secretariat with comments, contributions, and to receive other notes in the series:

1818 H Street NW,
Washington DC 20433

Tel: 202. 473 9594

Fax: 202. 522 3744

e-mail:
CGAP@Worldbank.org

WWW:
http://www.cgap.org

From the 'agricultural credit era' (1950s–1970s) through the 'microenterprise era', institutional arrangements and product designs that characterised financial services to the poor were underpinned by a dominant image of the poor. First, the image of the poor as small and marginal farmers drove the disbursement of agricultural loans from special, often governmental, institutions using foreign grants and soft loans. Subsequent views of the poor as women entrepreneurs resulted in the delivery of increasingly large working capital loans by mostly voluntary organisations to poor women organised into groups offering joint liability.

Whatever the strengths and weaknesses of these approaches – and experience has taught us many lessons – the arguments which supported them were clear, even though they may now appear simplistic. Farmers need crop loans. Poor businesswomen need a steady supply of easily repaid loans which grow with their businesses.

Complexity and variety

As we move into the 'microfinancial services era' and begin to deal with 'vulnerable households with complex livelihoods and varied needs'[1], do we have a clear idea about the kinds of financial products that will be required or of the institutions that are going to deliver them? Do we have even a real sense of what 'financial services' mean for poor households? 'Complexity' and 'variety' are words that threaten to lead away from, rather than towards, conceptual clarity.

We can already appreciate that savings and insurance services, as well as credit, will feature in the new complexity. So it looks as if 'agricultural credit' and 'microenterprise credit' are certain to lose their old monopoly on our imagination, and simple uniform products like a 'hybrid wheat package' or the Grameen's one-year business loan are about to be dethroned.

But what will appear in their place? How can we come up with products that address poor people's myriad uses for financial services, which are easy to understand and deliver, and with institutions that can keep tabs on these products and recover their costs from the margin? This note begins to answer the first of these questions, namely, about product design.

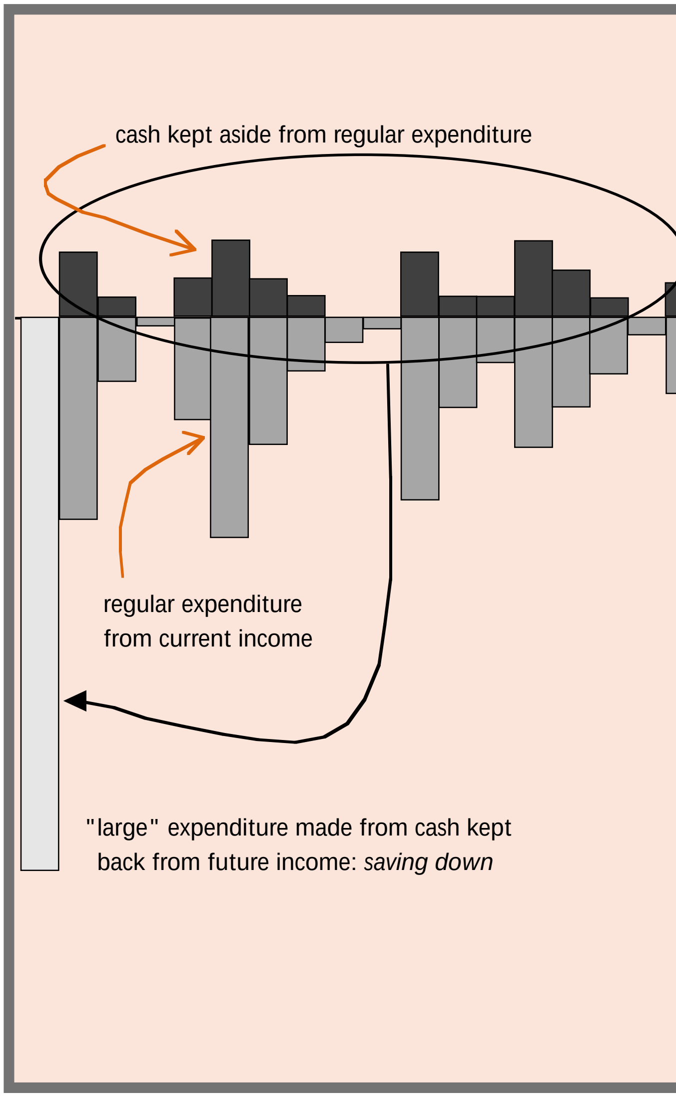
The function of financial services: Managing money

It is the function of financial services – seen from the point of view of the user – to help manage money. This is their primary task, and this is how people actually use them. In the eras of agricultural and enterprise credit, we overlooked the fact that borrowers have many other money management needs besides financing their crops or businesses.

Financial services allow people to reallocate expenditure across time. This means simply that if you don't have the ability to pay for things *now*, out of current income, you can pay for them out of *past* income or *future* income, or some combination of both.

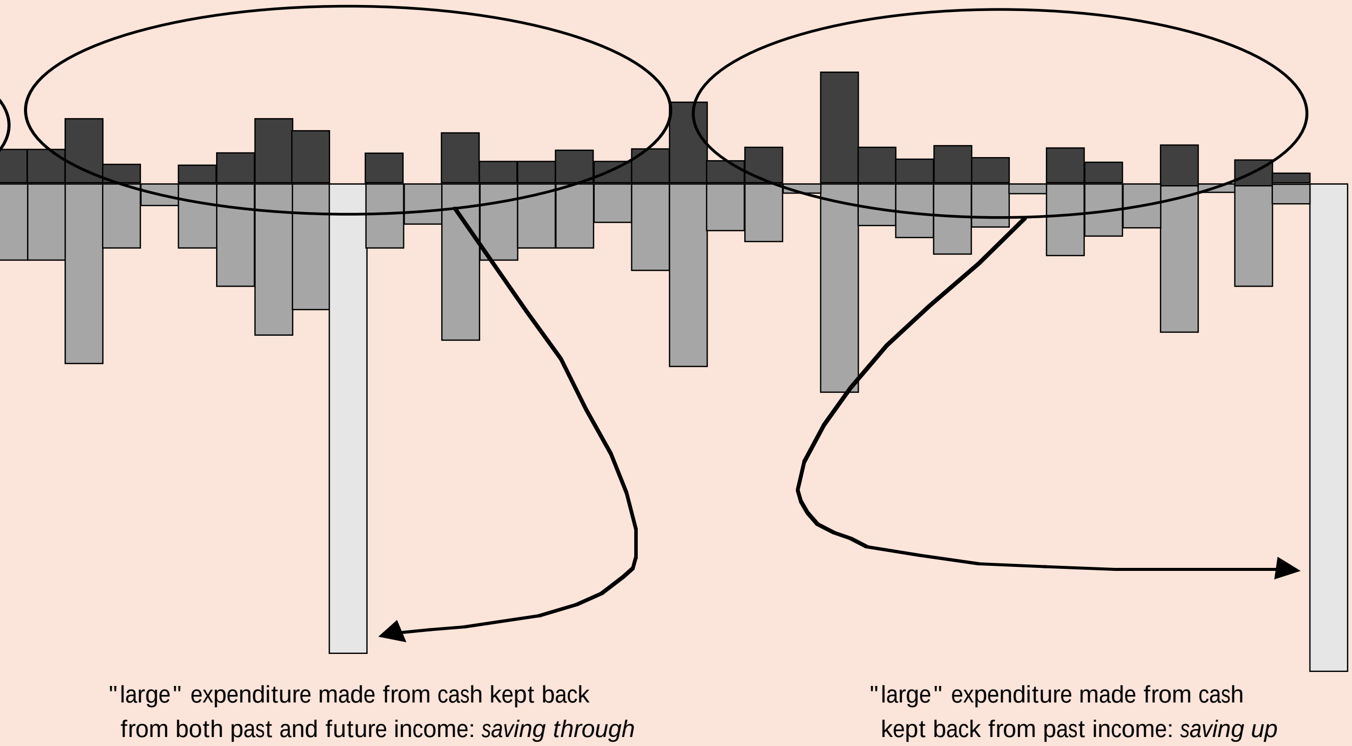
Because our income does not arrive in exact rhythm with our outflow of expenditure, we all need this facility. The poor need it no less than other groups of people. Indeed, *they may need it more*. This is not just because their incomes are uncertain and irregular (which is often true), but because the absolute amounts of cash they deal with are very small. As a result, anything more than the tiniest expenditures will require sums of money greater than they have with them at the time – in their pocket, purse or home. Expenditure of almost any kind can require them to look for a way of financing the expenditure, or part of it, out of yesterday's or tomorrow's income.

Note that I am referring to expenditure *of any kind*, and not just for farming inputs or microenterprises. Life cycle events, such as birth, schooling, marriage, home-making, retirement and death, emergencies including personal ones like illnesses and accidents and impersonal ones like cyclones, fires, floods and droughts, all require the expenditure of sums bigger than those available on an everyday basis. Besides needs, there are opportunities – opportunities to invest in land, business, buildings and comforts like fans and TVs. These too involve spending sums that force the poor to look for ways of using past and future as well as presently available income.



How do poor people tap into past and present income to finance this wide and constantly pressing range of expenditures? They do it in many ways, but it helps if we group them into three main strategies which I call 'saving up', 'saving down' and 'saving through'. They are illustrated in the chart. Let us consider each in turn, from the point of view of a poor household in the developing world.

CHART 1: SAVING DOWN, SAVING THROUGH AND SAVING UP

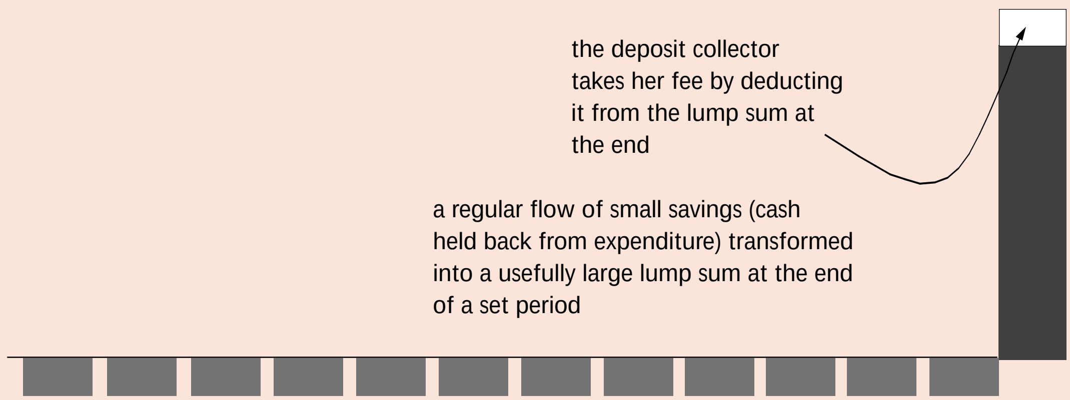


In this and all other charts, the horizontal axis represents time, and the vertical axis values of cash.

Saving up

Saving up – keeping back cash now so that it can be spent in the future—is hard for poor people. Strange as it may seem, this is *not* primarily because they have little or nothing to save (though that may also be true). The difficulty comes not so much with finding the resources from which to *save*, as with the practical problems of saving *up*. It is very hard to find a safe place to store cash. Formal opportunities to do so – at banks and the like—are rarely accessible. Cash kept at an insecure slum or village home can be stolen, lost, burnt, blown or washed away. It can be captured by mothers-in-law with hard voices, visiting relatives with hard-luck stories, and alcoholic husbands with hard knuckles. How do you keep even a few cents back when the children are hungry?

CHART 2: SAVING UP WITH A DEPOSIT COLLECTOR

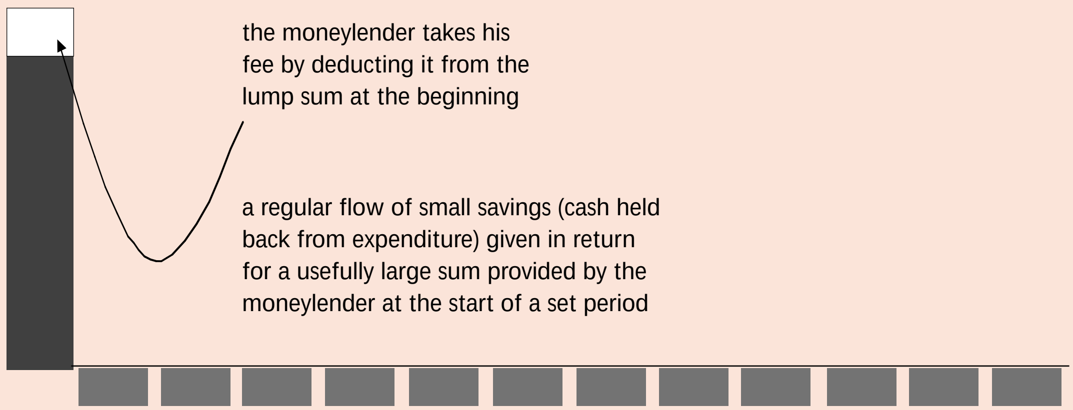


Because holding cash is so hard, savings created by not spending all of yesterday's income are often kept in kind – in livestock, tin roofing sheets, and even trees. Such methods of saving have some advantages: the piglets may produce young, the tree may mature into something worth many times its original value as a sapling. But there are disadvantages, too. The piglet may die. The tin sheets rot. Above all, when you need to realise the value of these 'in kind' savings, it is bothersome. You can sell a piglet in order to have cash to buy some medicine, but it may be a bad time of the year for piglet prices, and what are you going to do with the ten dollars left over when you've bought the medicine? Spend it, perhaps, if you don't have a good place to save cash. There is also the problem of how you keep the rain out if you sell the tin sheets. Finally and crucially, how and where do you save up the cash to buy the tin sheets in the first place?

These disadvantages force the poor to pay a high price – very much higher than you and I pay – to save cash. This high price is expressed in two ways – high levels of risk and low, or even negative, interest rates. All round the world the poor entrust their savings to people and institutions that are less than fully reliable. 'Money guards' like relatives, employers, and shopkeepers hold vast sums of the poor's cash – and sometimes cheat them. Tens of thousands of informal savings clubs of all kinds spring up daily round the world, and too many of them are inefficiently or fraudulently run. Yet poor people persevere with these high-risk methods, for lack of better alternatives. Most vulnerable are the poorest – those most likely to be illiterate and powerless.

A good safe place to save money can be expensive. Deposit collectors – people whose job it is to collect and store savings from their poor clients – do the same job as a savings bank, but most charge for the service, rather than pay interest. In West Africa it is common for deposit collectors to collect savings on a daily basis, and to charge one day's savings per month.

CHART 3: SAVING DOWN WITH AN URBAN MONEYLENDER



Saving down

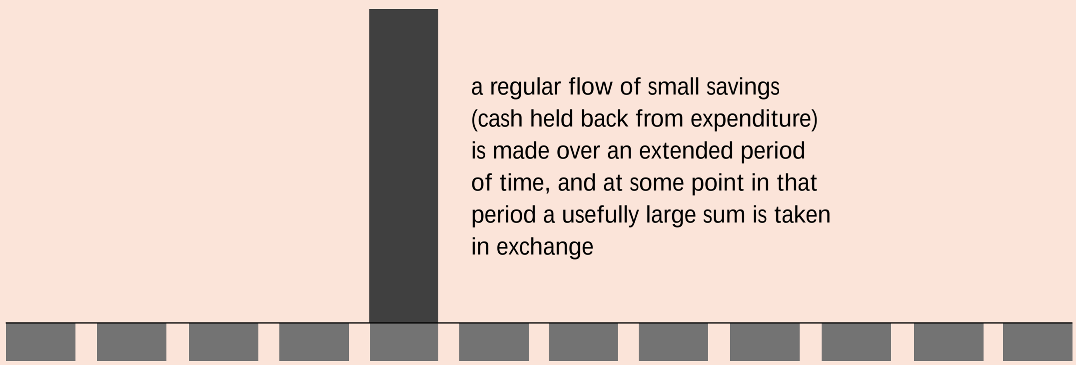
Not surprisingly, when a marriage contract for the daughter is suddenly proposed, or illness strikes, or the opportunity to buy a cheap rickshaw unexpectedly occurs, few poor households have got enough cash saved *up* to manage the required outlay. They may then try to tap future income – by saving *down*. To do that, they need to find someone or some institution willing to give them a cash advance against part of their future income. They often start with friends or neighbours who may be in a position (by having some funds saved *up*) to make them a loan. Such loans may be offered without interest if there is an assumption that the borrowing household will reciprocate the favour on some other occasion. With or without interest, the loans will be repaid by withholding a part of future income. Some lenders will be happy to get their money back in small installments, and in that case the borrower can repay as and when they can keep cash back from everyday expenditure. Many loans in the informal world, however, are repaid in a single 'balloon' repayment. In that case the borrower has got to find a way to save *up* the full amount of the loan – by definition difficult for households that resorted to saving *down* precisely because saving *up* was so hard in the first place.

The costs of using a moneylender are usually greater than a deposit collector, but it's not hard to see why. The moneylender, unlike the deposit collector, has to provide the capital for the lump sum in the first place. He also bears the risk of the contract not being honoured, whereas in the case of the deposit collector it is the client who takes that risk. Finally, the moneylender has to acquire the information that will enable him to decide how much he can risk advancing to his client, while the deposit collector simply returns whatever the client managed to save, and the client has to try to find out whether the deposit collector has a safe pair of hands.

Savings as the basis of all financial services

The fact that deposit collectors and urban moneylenders offer fundamentally similar, though mirror-imaged, services is not just a matter of aesthetic interest. It drives home the point that the money deposited with the

CHART 4: SAVING THROUGH IN A ROSCA



deposit collector and the money repaid to the moneylender come from exactly the same source: *cash held back from regular day-to-day expenditure by an act of will*. This is a pretty good definition of savings, and savings is exactly what these deposits and repayments are.

Deposit taking and lending are alternative ways of managing savings. Both transform a series of savings into a lump sum large enough to pay for the daughter's wedding, or bury grandfather or buy a rickshaw. A good definition of financial services for the poor is that they are '*money management services that help the poor turn their savings into usefully large lump sums*'.

This definition puts saving at the centre of financial services, rather than seeing it as a somewhat overlooked alternative to loans.

Saving through

This may become clearer as we investigate 'saving through'. To illustrate saving through, we turn to a service the poor can and often do set up for themselves – savings clubs. One particular kind of savings club is known as the ROSCA, for *rotating savings and credit association*. In such a club, members agree to meet on a periodic basis, say weekly, for as many times as there are members, say twelve, as in Chart 4. At every meeting everyone brings along a fixed sum of money, say $1. On each occasion one of the twelve members walks away with all $12 contributed that day. After twelve meetings everyone has put in twelve lots of $1 and come away with one usefully large lump sum of $12. The order in which the lump sum is taken can be decided by agreement, by chance (drawing lots), or by auction.

Because there are usually no charges involved, the simple function of this device stands out clearly: it turns a series of savings into a lump sum – some of the savings are made before the lump sum arrives, and some after (unless you are the first or last taker). Perhaps more importantly, 'saving through' features in some kinds of insurance, such as health and property insurance. We can see this in the simple case of vehicle insurance. When you insure your car, you make a series of regular small savings – perhaps annually or monthly – in the form of 'premium' payments. When you crash your car into a lamppost, the insurance company pays out a usefully large amount[2] – large enough to repair the car, with luck – after which you go on paying your premiums until the next need for such a sum arises.

Conclusion: Defining good microfinance products

Turning savings into usefully large lump sums is what financial services do, for no matter what use, over no matter what time-scale, in no matter what value, and in any one or any mix of three major strategies for effecting the swap: saving up, saving down and saving through.

The first requirement of a good financial service product, therefore, is that it *makes it easy to deposit the savings* (remembering that 'savings' can take the form of loan re-payments or insurance premium payments as well as 'savings' as generally understood). Easy deposit systems are those that are close-at-hand, regular, frequent, quick, safe, flexible and affordable. An ideal would be a neighbourhood-based collector who calls every day without fail and can accept deposits on the spot with a minimum of paperwork but with complete assurance that the de-posit will be properly credited to the client's account.

The second requirement of a good financial service product is that it *makes it easy to take out the lump sum* (again remembering that accessing the lump sum may take the form of a savings withdrawal, or a loan, or an in-surance pay-out, depending on the strategy being employed). Such a system would have unambiguously clear rules, so that accessing the lump sum would be as mechanical as extracting cash from an ATM with a debit card. It should also be close at hand, available at convenient hours, and unencumbered with complex paperwork or waiting time.

The third requirement is to accept a wide range of *values* of deposits. Since poor people have fluctuating amounts of cash available to save, it makes sense to accept, wherever possible, *any* value of deposit (in-cluding tiny sums). However, there are some circumstances in which fixed-value deposits make sense, both from the point of view of the user and the institution, because they promote discipline. In that case, the deposits should be small (so that very poor people can reach them) but capable of being deposited in *multiples*, so that those able to afford more than the minimum can do so. For example, in the marriage funds of South India, users pay a fixed sum each week, which must be a multiple of ten rupees (about 20 cents US). In many ROSCAs, better-off members can have several 'names' in the scheme, enabling them to deposit and take out larger sums.

The fourth requirement is to offer a wide range of *time scales* for the savings-to-lump-sum swap. Like anyone else, poor people need to be able to finance tomorrow's gro-ceries as well as next year's school fees and next century's retirement costs. For longer-term swaps some users may express a prefer-ence for *illiquidity*. That is, they may prefer to protect the savings from the temptation to withdraw and use them until a certain period of time has elapsed or until a certain event has occurred. This preference needs to be recognised and accommodated.

The fifth requirement is to offer a full range of *swap strategies*. People need to be able to draw on both previous and future savings, so they need to save up, save down and save through. Without this, they are unlikely to be able to maximise their savings potential.

For example, if they are offered only loans (savings-down facilities) they may be unable to exploit their capacity to make occasional low-value savings, especially if the loan has a fixed or infrequent repayment schedule.

The five key requirements I have listed are all matters of product design. Other sets of requirements – those that have to do with the institutions that are to deliver such products, and with the legal, regulatory and economic environment in which such institutions can flourish – will be important to the microfinancial era of the twenty-first century. But until we are clear about the kind of products we want to deliver, and why, our specifications for the design and support of sustainable MFIs will be premature.

[1] From Matin, I., D. Hulme and S. Rutherford. 1999. *Financial Services for the Poor and the Poorest: Deepening Understanding to Improve Provision*. Finance and Development Programme Working Paper Series, Institute of Development Policy Management, University of Manchester, UK. Available on-line at: http://www.man.ac.uk/idpm/idpm_dp.htm#F_DWP

[2] This article does not distinguish between arrangements (such as ROSCAs) where pooled savings are returned to their savings in proportion to each individual's contribution, and other arrangements (found in many forms of insurance) where pooled savings are distributed unequally between savers, according to the losses they suffer. A brief discussion of the two can be found in Stuart Rutherford, *The Poor and Their Money* (Oxford University Press, India, 2000). An earlier version appeared as a Working Paper from the Institute for Development Policy and Management, University of Manchester, in 1999.

This Focus Note was written by Stuart Rutherford of SafeSave.

Publication Manager: Tiphaine Crenn; Production: Valerie Chisholm; EarthWise Printing, Gaithersburg, MD (301) 340-0690.

Printed on recycled paper