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FINANCIAL SERVICES FOR THE POOR AND POOREST: Deepening Understanding to Improve Provision

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Summary

In the last fifteen years, we have made significant advances in both the understanding of the needs of the poor for financial services and in how to provide them. This has been accompanied by a change in our image of the poor. Previously, we saw the poor as small or marginal (male) farmers needing subsidised agricultural credit. As the 'microfinance' revolution spread, our image changed, and we came to see the poor as (largely female) micro-entrepreneurs with no collateral to pledge but with a business world to conquer with the help of microcredit. Now a new understanding is emerging: the poor are diverse group of vulnerable households with complex livelihoods requiring a full set of microfinancial services.

Such financial services help the poor maintain and improve their livelihoods, not merely by giving them access to credit to start or run a business, but also by offering them savings and insurance services that help them maintain and improve their human and social capital throughout their lives.

This paper reviews the achievements of the 'microfinance revolution' at the end of the twentieth century, through reference to the now extensive literature. It finds that there are many opportunities to improve and innovate. To illustrate this finding, the paper concentrates on examining what we need to know to design and deliver better financial products to the poor, especially the poorest. It argues that financial services for the poor are essentially a matter of helping the poor turn their savings into sums large enough to satisfy a wide range of business, consumption, personal, social and asset-building needs. The range of such 'swaps' needs to be wide enough to cater for short, medium and long-term needs, and they need to be delivered in ways which are convenient, appropriate, safe and affordable.

Providing poor people with effective financial services helps them deal with vulnerability and can thereby help reduce poverty. However, the relationship is driven by complex livelihood imperatives and is not simple. Microfinance is not a magic sky-hook that reaches down to pluck the poor out of poverty. It can, however, be a strategically vital platform that the poor can use to raise their own prospects for an escape from poverty.

This paper aims to assist in the design and construction of such platforms.

1 Introduction: Points of Departure

This paper is written on the premise that despite important recent advances in providing financial services to the poor, there are still many opportunities to improve practice. In particular we maintain that a better understanding of the financial service preferences and behaviour of the poor and poorest is important for expanding the scope of microfinance initiatives. This is crucial in order to address emerging concerns about microfinance and the poor and poorest (Morduch, 1998; Matin, 1998; Matin and Sinha, 1998; Rahman, 1998; Ito, 1998; Zaman, 1998; Gulli, 1998).

Our understanding of the role offinancial services, and of the ways of providing them to those not-served by conventional financial systems, has passed through its ,intellectual adolescence. After an initial wave of faith that state-mediated and subsidised credit expansion could massively reduce poverty, countered by a second wave during the 1980s of belief that state withdrawal would suffice, there is growing evidence of a 'new wave' of microfinance experiences that have been more successful (Lipton, et. al., 1997, Rogaly et al., 1997). This 'new wave', sometimes known as the 'microfinance movement', has generated considerable enthusiasm among academics, donors and development practitioners of diverse intellectual persuasion (Montagnon, 1998; Dichter, 1997). This is reflected in the figure that the microfinance industry at last count had extended around US$ 7 billion in loans to more than 13 million individuals around the world (World Bank, 1996).

The logic underpinning much of the recent innovation in microfinance starts from a set of beliefs about the financial service needs of the poor. The focus has been mostly on the design and institutionalisation of a microcredit 'template' – a delivery model that is believed to best answer those needs. Millions of poor households around the world now benefit from this model. However, more useful and varied financial products can be developed if a fuller understanding of the existing money-managing efforts of the poor informs practice. This paper attempts to begin that task.

Debates about finance and poverty-reduction have been shaped by changing conceptualisations of who the poor are and the nature of poverty. During the subsidised agricultural-credit era[1](1950s to 1970s), the poor were seen as **small or marginal farmers**, usually male, whose poverty could be overcome by credit-induced increases in productivity. From 1980 to 1995 they were seen as mostly female **micro-entrepreneurs** with no assets to pledge (but a world to conquer with microcredit financed investment that would raise their incomes). Recently, they have become a diverse group of **vulnerable households with complex livelihoods** and varied needs. From such a perspective, microfinance is seen as a mechanism that can reduce vulnerability (i.e. a sudden drop in income, consumption or assets) and/or reduce income poverty. We are now entering the **'microfinancial services era'.**

This paper is structured as follows. The first section does two things. It draws from the theoretical and empirical literature on the ways financial markets work when markets are missing and/or imperfect. Such a perspective highlights the interconnectedness of savings, credit and insurance - the three main elements of

financial services. Second, it provides a 'financial service anatomy' through which various money-managing efforts of the poor may be understood. Besides being a useful organising structure, such an exercise helps us to see the relationship between informal financial services and the more recent initiatives to deliver microfinancial services.

The second section discusses contemporary knowledge of pro-poor financial service provision in terms of a three-by-three matrix in which one axis comprises the financial service components (the classical three: savings, credit and insurance) and the other axis comprises the providers (the informal, the formal, and 'new wave' of semi-formal providers). Various issues are addressed here: the concerns with existing approaches, possible ways forward, and questions that need to be examined and assessed to push forward our understanding of better service provision for the poor and poorest.

The third section concludes with a summary of the arguments.

2 *The Poor and Financial Services*

2.1 The Economic Environment of the Poor: the Savings, Credit and Insurance Nexus

The economic environment of the poor has two features that have particular significance in shaping their use of financial services. The first is that they operate in a mini-economy in which production, consumption, trade and exchange, saving, borrowing and income-earning occur in very small amounts. The effect of this is that transaction costs tend to be high as the 'unit' of transaction is generally minuscule. This has important implications for the use of formal sector institutions where the charging of any standardised administrative cost will commonly make transactions unattractive to the poor.

The second characteristic is that there are high levels of insecurity and risk. These arise because flows of income and expenditure commonly do not coincide, because of household-specific factors (loss of earnings because of sickness, urgent medical expenses, premature death, theft, insecure conditions of employment, difficulties of contract enforcement), and because of broader environmental factors (natural hazards, harvest failure due to drought or flooding, national economic crisis). The co-variant nature of the risks associated with this latter group are particularly problematic as they weaken the capacity of community-based social security networks to provide support.

These characteristics have a number of consequences.

(i) They limit the interactions of poor people with formal sector institutions.

(ii) They foster strategies of risk-spreading by the poor: these encourage diversification of economic activities and the development of financial

relationships with networks of individuals, groups and agencies.

(iii) They lead to the use of savings and credit mechanisms by the poor as substitutes for insurance (Platteau and Abraham, 1984; Alderman and Paxson, 1992; Fafchamps, 1992) so that savings, credit and insurance have to be treated in a unified way.

Demand for financial services from poor households calls for short and long term credit lines for financing inputs and investments in both physical and human capital, and for provision of savings opportunities with different rewards and maturities. In general, the poorer the household the greater the need to use savings and credit as insurance substitutes.Thus the contributionof financial services to coping with risks (the 'protective' role of financial services) becomes more important than the expected return of the financial service alone (the 'promotional' role of financial services)[2].

2.2 The Money Management of the Poor: Towards A Typology[3]

Historically (and contemporarily, as well) the provision of financial services to the poor has often been seen as means to achieve some other 'greater' end. Such ambitions have included rescuing people from the exploitation of moneylenders, rehabilitation in the wake of natural disasters, promotion of co-operation among villagers, teaching people the virtues of thrift, poverty alleviation, the adoption of HYV technologies or empowerment. McGregor (1991) rightly points out that when colonial governments introduced rural credit projects, their intentions were often more moral and didactic than financial. Recently, Zeller (1993) argues that the past focus of agricultural economics on the farm rather than on the household, may have lead to a narrow definition of financial services for the poor as inputs for financing production rather than broadly defined financing for all aspects of household investment, including maintenance and formation of human capital and off-farm income generation activities. But despite convincing arguments supporting a broader agenda which considers financial services to the poor as an important issue in its own right, this emerging consensus is often not translated into practice. A number of misconceptions still shape much external intervention in the financial markets of the poor.

In order to get to grips with the ways in which financial services for the poor are provided and might be innovated upon, it is useful to construct a simplified typology of such provision, drawing from both informal and more formal experiences.

One of the most prevalent misconceptions about the poor is that they do not and/or cannot save. This perception is so pervasive that it demands elaboration as it is difficult to get an understanding of the money management efforts of the poor without confronting it. As we shall see later, the need and ability of the poor to save lies at the heart of innovative microcredit products.

Two images underlie the view that the poor do not save. One construes the poor as 'wasteful , immoral and irrational'. This is seen as a cause of their misery and also helps to 'explain' their failure to better their lot[4]. While we recognise (and have

witnessed) the problems that can arise from alcoholism and gambling our experience is that the vast majority of poor people are actively seeking to improve their personal and household circumstances. Consequently, we do not pursue this image of the poor as feckless. The second image holds that the poor cannot save because: " The poor spend all their income and still don't get enough to eat, so how can they save?". Paradoxically, it is precisely because of such survival uncertainties that the poor need to and do save, though in ways that are not self-evident, at least according to the conventional understanding of savings as income surplus after consumption. Such an image, as we shall see below, has two consequences: (a) it gives rise to the widespread view that the poor in general cannot save, and (b)it over-emphasises the promotional role of financial services as credit for investment. These lead to a lack of research into the financial service preferences of the poor and the actual ways they engage in money management, and result in the design of products that are either ill-suited to their needs and/or excludes them.

People (and not just the poor) may save money as it goes *out* (keeping a few coins back from the housekeeping money) as well as when it comes *in* (deducting savings at source from wages or other income). Even the poorest have to spend money to buy basic items like food and clothing, and each time they do so there is the opportunity to save something, however tiny. Many poor housewives try to save in this way, even if their working husbands fail to save anything from their income[5]. That they sometimes succeed is shown by their habit of lending each other small amounts of money (as well as small amounts of rice or kerosene or salt). This 'reciprocal lending' is very common and makes up the bulk of financial transactions for many poor people (Matin and Sinha, 1998; Dreze, 1997). Such arrangements depend primarily on the poor's capacity and willingness to save.

Given the interconnectedness of the roles of savings, credit and insurance (discussed above) the motivation behind savings can be expected to be diverse. These motivations can be viewed as the need for large lump-sums[6] of money that people (including the poor frequently) need for a variety of reasons. We can categorise these needs into three main groups.

Life-cycle needs: In South Asia, the dowry system makes marrying daughters an expensive matter. In parts of Africa, burying deceased parents is very costly. These are just two examples of 'life-cycle' events for which the poor need to amass relatively large lump sums. Other such events include childbirth, education, home-building, widowhood and old-age generally, and the desire to bequeath a lump sum to heirs. There are also recurrent festivals like Eid, Christmas, or Diwali. In each case the poor need to be able to access sums of money which are much bigger than the amounts of cash which are normally found in the household. Many of these needs can be anticipated, even if their exact date is unknown. The awareness that such outlays are looming on the horizon is of great anxiety for many poor people.

Emergencies: Emergencies that create a sudden and unanticipated need for a large sum of money come in two forms - personal and impersonal. Personal emergencies include sickness or injury, the death of a bread-winner, the loss of employment, and theft. Impersonal ones include events such as war, floods, fires and cyclones, and - for slum dwellers - the bulldozing of their homes by the authorities. Each creates a

sudden need for more cash than can normally be found at home. Finding a way to insure themselves against such events could help millions of poor people.

Opportunities: As well as *needs* for accessing large sums of cash, there can be *opportunities* when such access is important. There may be opportunities to invest in an existing or new business, or to buy land or other productive assets. The lives of some poor people can be transformed if they can afford to pay a bribe to get a permanent job (often in government service). One opportunity– the setting up of a new business or expanding an existing one - has recently attracted a lot of attention from the aid industry and from the new generation of banks that work with the poor. But business investment is in fact just one of many needs and opportunities that require the poor to access lump sums of cash at short notice.

How do the poor get access to the lump sums they so often need? Apart from gifts or charity - which cannot be relied on - there are only three common methods. The first is to sell assets they already hold (or expect to hold); the second is to take a loan by mortgaging (or 'pawning') those assets. The third is to turn their many small savings into larger lump sums.

The first method - the sale of assets - is usually a straightforward matter that does not ordinarily require any 'financial services'. However, poor people sometimes sell, in advance, assets that they do not currently have but expect to hold in the future. The most common example is the advance sale of crops. These 'advances' are a form of financing, since the buyer provides, in effect, a loan secured against the yet-to-be harvested crop. The advance may be spent on financing the farming costs required to provide that crop. But they may equally be used on any of the other needs and opportunities identified earlier.

The second method - mortgage and pawn - enables poor people to convert assets into cash *and back again*. It is the chance (not always realised) to regain the asset that distinguishes this second method from the first. As with the straightforward sale of assets, such services require the user to have a *stock* of wealth in the form of an asset of some sort. They allow the user to exploit their ownership of this stock of wealth by transforming it temporarily into cash. The most common examples are the pawn shop in urban areas and mortgaging land in the countryside.

Whereas these first two methods require that the users have assets, the third method enables poor people to convert their small savings into lump sums. This requires the users to have a *flow* of savings, however small or irregular. It allows them to exploit their capacity to make savings through a variety of mechanisms by which these savings can be transformed into lump sums. The three main mechanisms are:

- **Savings deposit**, which allow a lump sum to be enjoyed in future in exchange for a series of savings made now
- **Loans** which allow a lump sum to be enjoyed now in exchange for a series of savings to be made in the future (in the form of repayment instalments), and
- **Insurance**, which allows a lump sum to be enjoyed at some unspecified future time in exchange for a series of savings made both now and in the future

The problematic that needs to be addressed in order to provide each of these services is different. For savings services, the concerns are about the costs and legality of deposit mobilisation and about deposit protection. For credit and insurance services, the issues are about how to address adverse selection and moral hazard problems while minimising client transaction costs.

Thinking about financial services for the poor as a matter of providing ways of turning small amounts of savings into larger useful lump sums - a 'turning mickles into muckles[7] perspective - helps us to understand the wide variety of informal arrangements that the poor themselves innovate and use. The nature of the financial service used varies, depending on local knowledge, history, context and need, but the essence of such arrangements is similar: turning small amounts of savings into usefully large lump sums.

Interestingly, the current microcredit focus on loans that are repaid in small, regular instalments is a good example of such a perspective, since such loans are in many ways an 'advance against future savings' contract between the borrower and the lender. This is yet another example of the interconnectedness of saving and credit.

2.3 Conclusion

In this first section we drew attention to the facts that the economic transactions of the poor occur in very small amounts, and that they occur in an environment characterised by high levels of insecurity and risk. A result of the first, the poor enjoy limited access to formal financial service providers. As a result of the second, the poor develop strategies which emphasise the diversification of economic activity and the development of informal networks of financial relationships. In these relationships, the distinction between savings, credit and insurance breaks down, with credit often pressed into service as a substitute for insurance. The difficulties associated with managing such strategies are likely to be more acute for the poorest households.

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We also provided a simple typology of financial service from the user's perspective, in which the principal role of all three kinds of financial service is to build usefully large lump sums out of the pool's capacity to save. This is useful framework for looking at financial service innovations in various sectors

The upshot of the arguments of this section is that the design of financial service for the poorer households would need to pay attention to the protective aspect of financial service provision, in addition to the conventional emphasis on its promotional role. Poor households throughout the world face twin disadvantages. The first is difficulty in generating regular income while the second is vulnerability to economic, political and physical downturns. Harder still, the two disadvantages reinforce each other: poverty is a source of vulnerability and repeated exposure to downturns reinforces poverty.

Financial services in their broadest sense can play an important role in enabling poor

households cope with these twin disadvantages. For financial services to play such a role, however, we need to take the issue of vulnerability as seriously as poverty and refocus financial service innovations on that issue. To do that, we need a better understanding of when, how and why poor and very poor households manage to convert their capacity to save into usefully large sums of cash. We can start by looking at what is already in place.

3 The Providers and Their Provision

3.1 An Overview

This section examines the various providers of financial services to the poor and discusses the nature of their provision. The providers are categorised as informal providers, formal providers and semi-formal microfinance institutions (MFIs). The provisions are classified as savings, credit and insurance. For each of the cells in this three by three matrix, certain questions are addressed. These are:

- what do we know of the existing approaches?,
- what are the main concerns with these approaches?,
- what are the possible ways forward? and
- what questions need examination to encourange innovations?

It is important to clarify a few definitions. The conventional provider categories of informal and formal has been complicated by the recent entry of the semi-formal sector of the microfinance institutions (MFIs). The rationale behind the entry of this sector has ostensibly been the desire to address the twin failures of the market and the state, the bite of which is particularly acute for the poor. Further complexity has been added recently because several semi-formal providers have formally registered themselves as banks (BancoSolIn Bolivia , BRAC Bank in Bangladesh, etc).

In the context of financial services, there has been little explicit attempt to define the underlying characteristics based on which the distinction between different providers may be made[7]. The traditional distinction has been between institutional and non-institutional finance, implicitly encompassing both the nature of the providers and of the provisions. For instance, ‘institutional credit’ referred to legally-recognised banks as providers and to loans that are relatively large and are based on collateral and explicit contract. The informal sector was loosely viewed as non-institutional sources of credit, such as moneylenders and traders. Such a distinction however ignored other types of financial service that the poor themselves made as a part of their wider money management efforts, including savinds clubs such as RoSCAs rotating savings and credit associations and ASCrAs accumulating savings andcredit associations).

For the purpose of this paper, we shall refer to formal providers as those who are subject to banking laws of the country of operation[8], provide conventional retail facilities to customers and engage in diversified financial intermediation. Semi-formal providers are MFIs that are mostly registered NGOs or banks with a special charter (such as the Grameen Bank). The informal sector captures the residual providers - money lenders, traders, RoSCAs, ASCrAs, deposit-takers and non-bank pawnbrokers.

We acknowledge that this categorisation does not take into account the dynamics by which informal providers become semi-formal (such as where managed RoSCAs are registered as Chit Funds in India) and semi-formal become formal (such as BancoSol and Kenya's K-REP,two 'MFIs'that have chosen to register as formal banks). Within this framework, it could also be difficult to classify NGO-sponsored self-help groups, such as those in India, who are largely autonomous of the sponsoring NGO in their operations. Again, 'reverse' dynamics are also observed where formal financial institutions create microfinance windows like the BRI Unit Desas in Indonesia[9], or where the formal banks in Sri Lanka offer pawn shop services on a large scale. Such dynamics are important research areas, especially with respect to their implications for designing the right kinds of network for pro-poor financial structures. For instance, an interesting hypothesis could be that semi-formal providers are better able to do pro-poor financial innovation but that mass outreach requires some degree of formalisation.

Despite these limitations our formal/semi-formal/informal classification does succeed in capturing a wide gamut of providers and wherever qualification is necessary, it will be done. For the purpose of historic continuity[10], we discuss the providers in the following order: informal, formal and finally semi-formal.

3.2 The Informal Providers and Their Provisions

Unlike the semi-formal (microfinance) and formal providers, the informal providers do not constitute a neat category. More importantly, the distinction between informal *providers* and their *users* is often fuzzy since they may constitute the same group. This often results in a relatively localised scale of financial intermediation. In constructing a typology of financial service provision drawing primarily from the informal sector experiences, Rutherford (1998) refers to such intermediation as 'basic personal financial intermediation'. The conventional image of the informal provider is of the moneylender[11]. However, the range of informal providers and their provision is in fact far more diverse[12]. The fuzziness of the savings-credit-insurance nexus is most evident in the informal financial service provisions.

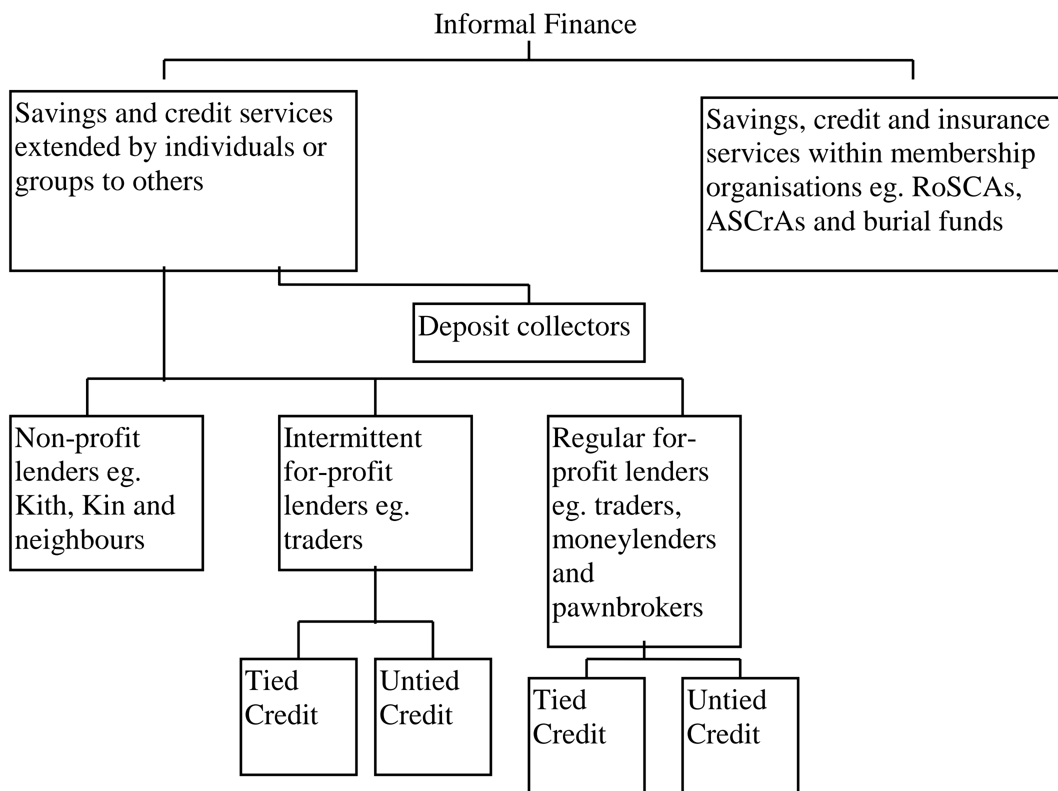
For a variety of reasons, our knowledge of informal financial service providers is relatively sketchy. These providers do not usually operate out of offices, they maintain few records and more importantly, many such arrangements are time-bound[13]. In some countries, such as Indonesia, such services are illegal - though quite common. As the loans extended tend to be relatively small, financing mainly consumption smoothening and working capital needs, informal finance is not very visible, despite its ubiquity (Ghate 1988). Moreover, the sensitivity that attaches to financial transactions, on the part of both borrowers and lenders, makes it a particularly difficult subject for empirical research. The sheer diversity of informal arrangements and the heterogeneity of the providers frustrate generalisation.

The main providers of informal financial credit services are illustrated in Figure 1. According to this schema, a distinction is made between five broad categories: (i) lending by individuals on a non-profit (and often reciprocal) basis; (ii) direct but

intermittent lending by individuals with a temporary surplus; (iii) lending by individuals specialised in lending, whether on the basis of their own funds or intermediated funds; (iv) individuals who collect deposits or 'guard' money; and (v) group finance.

A preliminary distinction which is more important in informal than formal finance is between credit extended by individuals to other entities and credit extended within mutually organised groups. A second distinction among informal lenders who lend to other entities, can be made between regular and intermittent lenders. The latter extend credit intermittently, although not necessarily infrequently, whenever they have a temporary surplus of funds. More often than not, such lenders become borrowers, when the need arises. Such role reversals form the basis of informal insurance networks that have been examined seriously by researchers (Morduch, 1997; Fafchams, 1995; Udry, 1994). Regular lenders, on the other hand, remain net lenders over a period of time.

Figure 1: Major Types of Informal Finance



Source: Adapted from Ghate (1988:24)

Among regular lenders, a major distinction arises between those who 'tie' lending to other market transactions, and those who extend 'untied' credit. A distinction that cuts across both tying and non-tying lenders is that between lending out of lenders' own funds (also referred to as 'direct financing') and lending based on funds borrowed as deposits when the lender acts as a financial intermediary. Intermittent lenders by definition rely on one or the other of the two sources, or sometimes on both, apart from on-lending borrowed funds from the formal sector. In group finance, intermediation can be thought of as taking place between members of the group.

Importantly, many of the transactions, which on the surface appear as credit, are on a deeper analysis, very closely linked to savings and insurance. Udry (1994), based on his study of credit transactions in Nigeria, has described much of such transactions as 'insurance substitutes', Fafchams (1995) refers to them as 'quasi-credit' and Rutherford (1999) as 'advances against future savings'. Several researchers also point out that such fuzzy financial transactions are more important for the poor[14] (Matin and Sinha, 1998; Morduch, 1997). Most intermittent lending (which is often reciprocal) and mutual group finance falls under this category.

Credit

The credit function of informal finance has received the most widespread attention. These services are extended by intermittent or regular lenders, though as discussed above, much intermittent lending is motivated by reciprocal arrangements and serves as a substitute for insurance[15]. Moreover, loans from such intermittent sources tend to account for an important share of the volume of informal finance and an even higher share of the number of loans, since such loans are relatively (and often absolutely) small. Lund (1996) provides empirical evidence that informal loan exchange in the rural Philippines is in fact used by households to pool risks.

However, informal credit is also important as a source of initial working capital for micro enterprises[16]. Intermittent and sometimes reciprocal lending for businesses also takes place between households and can help to smooth out the short-term cash flow problems and also to ease longer-term credit constraints. This is important in financial markets for the small enterprises of the non-poor. The size of this market in India is estimated to be equivalent to 13 to 25 percent of total bank credit to industry (Ghate,1988:25). Wholesalers and other firms in the textile and foodgrain distributive trades also actively borrow from each other, seeking short-term accommodation (Murshid, 1990).

Getting access to a useful lump sum through building mutual savings is most evident in informal group finance schemes. In such arrangements, groups of individuals pool their savings and lend primarily to each other or to persons outside the group. The two most common types are referred to as RoSCAs and ASCrAs. In the former, the equal periodic savings of every member are pooled and given to each member in turn: there are therefore as many as such poolings as there are members and the cycle comes automatically to an end when each member has taken her 'prize'. In an ASCrA by contrast, the pooled savings of the members may accumulate until such time as one or more members are willing to take them on loan. The device is therefore not time-bound in the same was as ROsCAm though many groups limit the life of their ASCrA

in order to ensure a satisfactory outcome the saved capital is returned to the members and interest earned on the loans can be distributed. The widespread use of such mutual finance 'templates' across time and space has generated a lot of interest and careful study.[17] These arrangements have been shown, in the extensive field literature, to exist in developing and developed countries in both rural and urban areas, among both females and males and among all classes including the poor[18].

The basis and the gains to members that such arrangements offer is predicated on the difference in preferences (in terms of current and future consumption) that might exist among the participants at any particular point in time. Besley et. al. (1992) argues that RoSCAs are predominantly means of acquiring indivisible consumer durables. As such, RoSCAs are often classified under informal credit (Besley, 1995). However, in a recent article, Calomiris and Rajaraman (1997) argue that the insurance motive[19] also plays an important role, especially in bidding RoSCAs[20]. The continuing prevalence (and rise) of these arrangements have often intrigued researchers. Part of the reason could be simply due to the inability of the participants to access other formal sources, but recent research shows (Brink and Chavas, 1997) that these institutions are built on solid microeconomic foundation[21] - one of several reasons that explain their continued popularity throughout the world.

Savings

Credit extended by intermittent lenders and group finance arrangements like RoSCAs and ASCrAs are essentially hybrid financial products, incorporating savings mobilisation and insurance functions. This becomes an even more important finding given the fact that the poor households tend to use these forms of financial services to a greater extent that the non-poor. The building up of small amounts of savings and innovatively intermediating it across a network (see Rutherford, 1998, for ingenious examples) is the basis of the informal financial services that the poor predominantly use.

The savings contribution of the informal sector is often discussed in the context of deposit mobilisation. However, when savings are viewed as deferred consumption, it is seen that the informal sector provides opportunities for saving both through direct lending and intermediation. A large part of informal credit is from friends, relatives and neighbours deferring current consumption to lend to others directly. In fact the bulk of rural credit consists of direct finance, with lenders using their own funds built up over a period of time.

The type of informal finance that makes the greatest contribution to additive savings (that is savings that would not have been mobilised anyway by the formal sector in the absence of the informal) is mutual finance – group-based or reciprocal financial services of one kind or another, including savings cclubs. The major attractions of such arrangements as a means of savings are: (i) Reciprocity, or the in-built provision of borrowing at short notice, especially for the bidding varieties of ROSCAS. This serves as a kind of access to a liquidity-guaranteeing function which is especially important to business. (ii) Being able to save in small instalments, which is particularly attractive to the poor. (iii) The provision of a disciplined environment in which to save, once the initial decision to join a club has been made. (iv) Convenience

and absence of formalities, and (v) Meeting illiquidity preferences by permitting savings to be hidden away from the demands of friends and relatives.

Savings and Credit: Informal Financial Intermediation

It has been asserted by some that – outside the mutual devices such as RoSCAs and ASCrAs - intermediation I soften either absent or very localised in the case of informal finance. Binswanger et. al. (1985) observes that the traditional moneylender relies on his own funds and does not accept deposits. He gives three reasons for this. First, the seasonality and synchronic timing of agriculture means that if depositors and borrowers are both engaged in cultivation, depositors will want to withdraw deposits exactly when borrowers want to borrow - at the beginning of the production season. Similarly, depositors will want to make deposits exactly when borrowers will want to make repayments - after harvest. Second, the covariance of yield risk in agriculture leads to covariance of default and to covariance of income between depositors and borrowers. After a bad harvest a depositor may want to withdraw deposits to cushion shortfall, exactly when borrowers are least in a position to repay. Unless the moneylender has a very high level of reserves, he may not be able to repay depositors[22]. Third, since the information gap between a depositor and a lender both engaged in the same occupation is likely to be smaller than would be the case were they engaged in different occupations, the possibility of direct lending places a limit on the difference between borrowing and lending rates the moneylender can charge. Since he must have a high reserve ratio if he accepts deposits, and only the lent-out part of his funds earn interest, he is not in a position to offer depositors a good enough return to prevent them from lending to borrowers directly[23]. Yet another reason is the limited number of borrowers that the moneylender can possess information on. This limits the size of his market to a small number of borrowers, to whom he can usually cater with his own funds.

Despite such arguments, the volume of intermediation in some rural areas by informal institutions has been reported to be high. This is especially in areas with diversified agriculture and a well developed non-agricultural sector. For example, the volume of intermediation is reported to be high in Kerala (Ghate,1988). It is conducted by large number of finance companies and trusts that often have several partners and employ staff to appraise loans. They take advantage of diversification of Kerala's agriculture, with its large variety of commercial crops which reduces the severity of seasonality and covariance of risk and income. Moreover, the importance of deposits from non-agricultural sources, such as remittances from abroad, greatly increases the possibilities of intermediation by increasing the heterogeneity of depositors and borrowers. In some cases informal clubs have evolved into credit unions or village banks (Box 1).

Box 1: Credit Unions and Village Banks

Most informally-run savings and loan clubs, such as ROSCAs and ASCrAs, run for a fixed duration (as in a ROSCA) or for a period of a few years or less (as in most ASCrAs). There are good reasons for this, which have to do with the difficulties that low-income groups have in maintaining books, avoiding disputes and fraud, storing excess cash in their often insecure environments, and escaping the notice of more powerful predators. ROSCAs and ASCrAs can be said to have adopted a strategy of 'impermanence and re-iteration' to reach millions of people, as opposed to the strategy of 'permanence and growth' adopted by the conventional banking industry and now being widely recommended to MFIs.

Small informally run savings and loan clubs at village or slum level that *do* try to become permanent institutions have a hard time and fail more often than not. One exception is the Credit Union (or Thrift and Credit Co-operative). A Credit Union is essentially an ASCrA that has chosen to adopt principles that have been worked out by the Co-operative movement over the last 130 years since its early days in Western Europe. These principles are designed to counter the difficulties mentioned in the previous paragraph. They include, essentially, some kind of affiliation to a supervisory body (or 'apex' institution) that can sort out disputes, audit the books, offer a home for excess cash, provide loan insurance (sales of insurance are often a way of securing income for the supervisory body), intermediate resources between its member Unions, and represent its members' interests to government and others. Traditionally used by middle-income rather than low-income groups, Credit Unions have recently begun to seek ways of increasing their membership among the poor.

The term 'Village Banks' has been used in several experiments, but the best known is the system devised by John Hatch and others in Latin America two decades ago. The system involves using NGOs to introduce a high level of regularity and discipline into what are basically ASCrAs. Groups of villagers are invited to form a 'Bank'. The sponsoring NGO provides resources that allow the members to take a series of nine successive loans that rise in value by a fixed amount. All members borrow and repay at the same time, usually in weekly instalments (see the box on the Grameen Bank) for sixteen weeks for each loan. Meanwhile, they are coached by their sponsoring NGO in business skills, and make savings which also rise in value each cycle so that by the time the nine 'external loan' cycles are complete the members' 'Bank' holds enough resources to continue indefinitely as a locally-owned autonomous financial institution. In practice this has rarely happened – for the reasons laid out in the first paragraph of this box – and by the mid 1990s many sponsoring NGOs had given up the ideal of promoting village-level self-help institutions. Instead, they have become permanent providers of financial services to the member-clients of the Village Banks they set up.

In Bangladesh, it has been found that commission agents financing paddy and jute marketing accept deposits from friends and relatives on a profit sharing basis and sometimes also borrow from moneylenders (Murshid, 1990). In this case, the seasonality of agriculture works in favour of deposit taking - deposits from farmers are most likely to be forthcoming when traders need funds for crop purchases. Harriss

(1981) also found that paddy traders in South India accept small deposits, which farmers make primarily for safekeeping[24].

The examples in this section so far are all from Asia. In many countries of Africa, above all in West Africa, itinerant deposit collectors collect savings from their customers and charge a fee for the service. They may also lend the proceeds back to their customers Box 2 describes an operator from Nigeria.

Box 2: An Itinerant Deposit Collector in Nigeria

Gemini News reported in 1995 that one consequence of Nigeria's current political difficulties is a drop in public confidence in formal banks. This has allowed an old tradition to flourish again -*alajos*, or peripatetic deposit takes. Idowu Alakpere uses a bicycle to go door-to-door round his outer suburb of Lagos where he has 500 customers who save about 10 or 15 naira cash with him (about 50 to 75 cents US) on each daily visit. Customers withdraw whenever they like, and Idowu charges them one day's savings pr month, which he deducts from the withdrawal. Since deposits are made evenly over the month, the negative interest rate for one-month deposits is 1/15, or 6.6% a month, an APR of 80%. some alajos, including Idowu, store the cash in a reliable bank, others use it to make loans. The Gemini reporter found many local people telling her that they trusted those alajos more than banks. When it was pointed out that some alajos are dishonest, they retorted that so are many banks.

There are itinerant deposit takers in Asia (see Rutherford 1998 for an example from Vijayawada in southern India) but their prevalence is low compared to Africa. One reason suggested to explain this is that in Asia it is more often the case that the poor turn their savings into lump sums through money lenders who offer to let them repay in small regular installments.

Insurance

The insurance role of informal finance has already been discussed above[25]. It has been pointed out that extension of credit more often than not serves as insurance substitutes. However most empirical studies haveshown that the scale and effectiveness of most informal insurance are narrow. A substantial number of households, especially the most poor, appear ill-equipped to handle even small scale, localised risks (Alderman and Paxson, 1994; Morduch, 1995)[26]. Most informal insurance arrangements work on the basis of self-enforcement, as, for example, when slum shopkeepers set up a fund to spent in the case of a fire or a bull-dozing. It tends to operate best when participants have a cushion from poverty. Thus theory suggests that such informal arrangements may be more effective for slightly better-off amongst the poor (Coate and Ravallion, 1993). More importantly, many of these mechanisms are costly. In risk prone rural India, for example, households may sacrifice as much as 25% of average income to reduce exposure to shocks. Third, informal insurance mechanisms appear to be particularly fragile when needed most – for poor people during widespread covariate and repeated shocks.

Nevertheless, some specific risks appear to be well-covered by informal insurance devices in some localities. Buriesl or funeral funds were found by Rutherford and Arora(1996) to be working well in the slums of the southern Indian city of Cochin, and reaching the very poor in greater numbers than most other informal schemes. There are reports of similar devices in southern and western Africa. Related schemes such as marriage funds - where parents save small sums regularly in order to enjoy a substantial sum when their child marries - are also common in southern India and elsewhere.

Typically, the choice for policy makers looking at insurance for low-income groups has been between three imperfect options: fostering government-provided safety nets, private insurance markets or existing informal insurance mechanisms. The choice may be a false one, however. The most promising policy option may be a fourth option (Morduch, 1997): the promotion of new market-based institutions that substitute for both failed insurance markets and failed informal insurance mechanisms. An important and promising example of this fourth option would be fostering easier, more flexible ways to save (and possibly borrow) in small amounts. The idea is to help develop markets that span the failed markets but which themselves are not as prone to failure.

To carry our understanding of the limitations and possibilities of informal financial arrangements forward we would need information on the extent of consumption volatility and the major insurance mechanisms used by households. The absence of institutions needs to be assessed and reasons researched. A related research area should focus on the economics of household savings. Why are households unable to save enough to protect themselves against insurable downturns? Can savings-focussed innovations make a dent? Can informal arrangements like RoSCAs and ASCrAs be built upon? Is it possible to increase savings mobilisation without broader financial reform?

3.3 The Formal Providers

There is a plethora of studies evidencing the failure of the formal financial sector in serving the poor. The existence of capital market imperfections in the rural areas of developing countries has engaged the attention of economists, social scientists and policy makers for decades. (Griffin, 1979; Ladman and Adams, 1978; Lipton, 1976; Ruttan, 1986; Braverman and Guasch, 1986; Eswaran and Kotwal, 1986). An important feature of this market is that access to credit is far easier for some groups than for others. Following the green revolution and a greater need for credit to small farmers to facilitate their adoption of technology, the question of small farmers' effective access to institutional credit received considerable attention. In many parts of the world subsidised agricultural credit was viewed as a key strategy for promoting economic growth and poverty reduction.

The empirical record suggests that these efforts have seldom benefited poorer farmers or poorer people (Gonzalez Vega, 1981; Lele, 1981; Lipton, 1976; Rao, 1970, Egger, 1986). The reasons for this include urban biased credit allocation (Lipton, 1976), the poor's lack of suitable collateral (von Pischke, 1983; Rudra, 1982; Binswanger and

Sillers, 1983), the higher transaction cost faced by small borrowers (Aron, 1981; Timberg and Aiyar, 1984), interest rate restrictions faced by formal lenders (Gonzalez Vega, 1981) and finally patronage, arbitrariness and corrupt practices (Ladman and Tinnermeir, 1981; Adams and Vogel, 1985, Ghatak, 1977). In addition, high default rates prevented these interventions from becoming financially viable and most had to be abandoned after years of public financial support. The reasons for poor loan recovery, it was argued, are related to inappropriate design features leading to incentive problems and most importantly, politicisation that made borrowers view credit as political largesse (Lipton *et al.*, 1997).

Such failure had been at the heart of innovations that lead to the development of the tools of the 'new wave' of microfinance. Not surprisingly, these failures are often used as benchmarks against which the success of these new ideas is assessed. Interestingly, however, the formal financial sector has in general shied away from making use of the recent breakthroughs in financially serving the poor. Their approach to banking and financial service provision has remained by and large unaltered. The reasons for this are not clear: it could be scepticism about profitability (Montagnon, 1998), lack of pro-poor organisational values, or simply a market niche that has been shown to be better served by specialised microfinance institutions. One exception to the general state of affairs is the Bank Rakyat Indonesia (BRI) which manages to deliver conventional banking services to low income clients (Box 3). In addition, in many countries the post office run savings schemes that are widely used by low-income households (eg. Kenya, Malawi and Sri Lanka), and in some countries (eg. Sri Lanka and the Philippines) formal banks engage in pawnbroking.

Box 3: The Bank Rakyat Indonesia's Unit Desa Scheme

The Bank Rakyat Indonesia is notable for its success in delivering conventional banking services to low-income clients. By setting up small sub-branches – or 'units' – BRI is able to reach a mass rural clientele. It does not have an exclusive 'poverty' focus in the way that, for example, Grameen Bank does, but has developed products that have enabled it to work profitably with low-income as well as its more conventional bank clients. Foremost among these are its savings services which offer convenient banking hours, a friendly interface, unconstrained withdrawals, and a range of incentives including bonuses and raffles. Clients may also take loans with a range of convenient terms and repayment frequencies. Unlike the group-lending methodologies developed by Grameen and others (see the note on the Village Bank system) BRI acts as a conventional intermediary, borrowers are dealt with as individuals, and only a minority of its clients – including its low-income ones - are borrowers at any one time. Since the mid 1990s BRI's approach has been studied and elements of it tested in other countries.

However, while the formal financial sector has remained largely uninterested, there is an interesting trend whereby a few specialised microfinance institutions are increasingly resembling the formal sector in size and nature of funding sources, A study by World Bank (quoted in Montganon, 1998: 19) show that in contrast to the commercial banks whose 46% of funds come from deposits, the corresponding figure for NGOs is a meagre 7%. In the same study it has been pointed out that banks actually account for 78% of the total number of outstanding microloans whereas the voluntary organisations' share is only 9%. The remainder comes from credit unions (11%) and savings banks (2%). However, it should be noted that there are now several

MFIs like the BancoSol in Bolivia and the Grameen Bank which are formally categorised as banks in this study[27].

Admittedly, much less is known about the formal financial sector's involvement in providing financial services to the poor than about the semi-formal sector. This is increasingly becoming an important research area which is showing interesting trends as former specialised microfinance NGOs are transforming themselves into banks, looking to the private and formal banking sector for funds, and as private initiatives in providing certain financial services, especially insurance, is becoming more prevalent[28].

Box 4: Gono Bima Scheme of Bangledesh

Gono Bima (Popular Insurance' in a subsidiary of a formal private insurance company in Bangledesh, Delta Insurance. It markets a life insurance product that has been designed to reach the poor in large numbers, and has clearly benefited from the experience of MFIs like Grameen Bank. The product itself is simple. It is a ten-year contractual savings account with fixed monthly premium payments leading to a one-time limp sum pay out at maturity along with accumulated interest. The insurance element is provided by the guarantee that the death of the insured name at any time during the term will trigger a full pay-out as if the term had been completed.

Its delivery mechanism is equally simple. There are no medical examinations and application procedures are minimal. Gono Bima rents simple office accommodation in rural and urban centres staffed by field workers who collect the premium payments from customers arranged in groups in the villages and slums. The smallest monthly premium accepted is about twodollars. The office then re-lends the premium income to its customers in loans whose terms are similar to those of the Grameen Bank.

Started in 1994, the Gono Bima service had reached many villages by 1997, in which year its premium income topped four million dollars per year, and represented more than fifth of Delta's total premium income. At the end of 1997 there were more than half a million policy holders in the scheme

3.4 Microfinance: Providers and Promises[29]

The promise of alleviating poverty through banking (and predominantly credit) is an old idea with a chequered past. Cheap credit provision was a centrepiece of many countries' development strategies from the early 1950s through the 1980s, but these experiences were nearly all disasters --- repayment rates were often below 50%, costs of subsidies ballooned and much credit was diverted away from the intended recipients (Adams, Graham and von Pischke, 1984).

At the time that the Ohio State School was criticising conventional rural finance a set of unusual financial institutions in several corners of the world began to prosper and attract attention – especially in Bolivia, Bangladesh and Indonesia. These institutions,

united under the banner of 'microfinance'[30], share a commitment to serving clients that have been excluded from the formal banking sector. While they often claim to have 'poor' clients the socio-economic position of those they serve varies greatly.

In what ways are these new institutions different from their predecessors? First, many microfinance institutions (MFIs) are financially successful, boast repayment rates above 95%[31], and keep a watchful eye on subsidy levels and institutional efficiency. This vigilance is a direct response to past disasters, and is helped by keeping government involvement to a minimum. The second, often-cited source of change is a real innovation: the group-lending contract[32], which has been the subject of much interest to economic theorists[33]. A third source of change is the acceptance that what households need most is access to credit, not cheap credit.

But, as we discussed in the first section, credit is but one of the ways in which households can access useful large sums through exploiting their capacity to save. Thus the currently popular product (such as that offered by the Grameen Bank and copied by many other MFIs) which allows borrowers to repay the loan in small frequent manageable instalments represents the pivotal innovation (see Box 5 for a description of the Gramean Bank). Supported by quick access to larger repeat loans, this can to a large extent explain the widely touted success of these programmes. In a large study by Mosley and Hulme (1998), defining success in terms of arrears rate and subsidy dependence index (Yaron, 1991), they find that these two features - frequency of instalment and repayment incentive - correlate strongly with success. (Repayment incentives may include several devices including larger repeat loans, access to loans for other group members and 'cash-back' for clients who repay on time). It also correlates with savings facilities, but interestingly, not with the tendency to lend through the group-formation model.

Box 5: The Grameen Bank in Bangladesh

In Bangladesh the Grameen Bank has for the last twenty years been offering villagers loans which can be paid back in very small equal instalments at frequent intervals – once a week for a whole year. Grameen thus provides what are essentially 'advances against savings', since its clients (or 'members') can normally make these small weekly payments from their regular household cash flow. This frees clients to spend the advance in any way that suits their needs, including consumption-smoothing and managing emergencies as well as livelihood activities and small businesses. One result of this is that although Grameen has been widely presented as a service for 'entrepreneurs', in fact much of the borrowing is used for the full range of household financial needs. Clients usually take a new loan as soon as repayments are completed, giving the system – from the point of view of the client – a cash flow similar to that of the ubiquitously popular ROSCA. The service is extremely popular and has led to Grameen's product being replicated by hundreds of MFIs, big and small, all over Bangladesh and elsewhere. It is estimated that in 1999 some eight million clients are using this system in Bangladesh alone. Although Grameen started with clients of both sexes, by the 1990s almost all its borrowers were women.

The loans are delivered in the context of a weekly meeting held in the village (or slum) and attended by forty or fifty clients who live within walking distance. This 'centre' is further sub-divided into five-person cells whose members undertake to cross-guarantee each other's loans. Although this system of peer pressure - known sometimes as the 'solidarity group approach', or as 'social collateral' – has been much noticed by commentators, recent observers have concluded that its role in securing low arrears rates on loans may not be as significant as was first thought. It is more probable that the key elements in the success of the approach are the ability to repay in tiny instalments, the discipline offered by a regular weekly regime, the convenient 'doorstep' delivery, and the promise of a repeat loan.

The participation in such programmes, especially by the poor, and the flexible range of loan use (Matin and Sinha, 1998; Todd, 1996) which borrowers find useful, is thus made possible by the key feature of microfinance lending - tiny, often weekly, repayments[34]. Such a regime allows borrowers, if other options fail, to repay out of existing income[35], freeing the borrower to invest the loan in whatever use best fulfils their needs of the moment. This is not to deny that for some borrowers, usually the relatively better-off, these loans are directly invested in productive enterprises where the returns on additional investment is sometimes enough to service the regular repayments[36]. But even for this class of borrowers repayment by instalment remains attractive, giving them an option to maintain good repayment records even if investments fail.

Some MFIs have tried to monopolise their clients' financial service needs, and some even believe that after using their services for a spell clients will become 'self-reliant' and able to do without financial services altogether. Observation of the actual financial service preferences and behaviour of poor people tells a very different story. Where they are available, many poor people choose to use every service or device they can. For example, a visitor to a borrowing group set up by an MFI will often find that its clients have their fingers in several other financial pies. Typically they will also belong to ROSCAs, and sometimes to more than one ROSCA, using each ROSCA to satisfy a particular need with a particular term. One ROSCA to help pay

an annual tax burden, another to deal with school fees, and a third to refresh stock in a small business, is not uncommon. In Uganda there are even ROSCAs designed to finance hair-dos. Meanwhile, the MFI client may not have broken her relationship with her traditional moneylender or deposit collector, maintains her relationship with the set of relations and neighbours with whom she exchanges loans on a reciprocal basis (often charging interest), and stores some cash at home or in a savings account in a bank[37]. Where MFIs are thick on the ground – as in Bangladesh – multiple membership of MFIs is becoming common, despite efforts by the MFIs to discourage it.

4 *The Impact Pathways: Not One but Many*

In conceptual terms, one can distinguish between two types of strategies used by a household to smoothen effects of risk. The first is income smoothering - this is most often achieved by making conservative production or employment choices and diversifying economic activities. In this way, ouseholds take steps to protect themselves from adverse income shocks before they occur. Second, households can smoothen consumption by borrowing and saving, depleting and accumulating non-financial assets and employing formal and informal insurance mechnisms. These mechanisms take force after shocks occur and help insulate consumption patterns from income variability. In the absence of access to financial services, both these strategies are costly and can adversely affect the risk-coping mechnisms of the household in the long run, further exacerbating poverty. Based on this, the ways in which financial services impacts on the househld welfare and food security, can be grouped into three (Zeller et al, 1996). The first is income generation, which decreases the cost of income smoothering by allowing households to engage in more risky but also more profitable activities. The second and third impact pathways are related to decreasing the cost of consumption smoothering. Financial services can do this in two ways:- firstly through allowing households to hold and retain better combinations of assets and liabilities and secondly, through increasing liquidity for direct consumption smootering. These are further discussed below:

- **Pathway 1-- Via Income Generation:** This has been the traditional and mostly widely claimed rationale for credit intervention, evident both in the earlier (largely unsuccessful) variants and the present generation of microcredit institutions. The argument is that loans provide additional capital on a temporary basis that can be used to enhance the level of the household's productive physical capital. For farm households, in particular, the demand for financial services arises out of the requirements of the agricultural cycle. Borrowing may also allow the household to take advantage of potentially profitable investment opportunities that are too large to finance out of its own resources. Furthermore, easing capital constraints through credit can reduce the opportunity costs of capital-intensive assets relative to family labour, thus encouraging labour-saving technologies and raising relative to family productivity, a crucial factor for development (Delgado, 1995.

  A second indirect effect stems not fromborrowing per se, but from access to credit. This is expected to increase the household's risk bearing capacity. Just the knowledge that credit will be available to cushion consumption against an income

shortfall if a potentially profitable, but risky investment should turn out badly, can make the household more willing to adopt more risky technologies (Eswaran and Kotwal, 1990). Thus compared to a household that are not rationed in their credit demand by lenders, it is hypothesised that (controlling for other factors influencing resource use, such as wealth and education), credit-constrained households will have: (i) a lower intensity of modern input use. (ii) more diversification to minimise risk and (iii) less capital intensive income earning activities.

- **Pathway II - More Cost Efficient Assets and Liabilities:** Improved access to credit may make it possible for the household to smooth consumption at lower costs compared to traditional strategies. It is argued that improved access to financial services induces the following changes in the household's composition of assets and liabilities.

A decrease in the holding of assets with lower risk-adjusted returns, specially if they have access to less risky savings options.
- A reduction in the level of assets held for precautionary savings (Deaton, 1991).
- An increase in the level of assets held for speculative purposed.
- A decline in the level of credit obtained at high cost from informal sorces.

A decline in the level of assets sales at low prices.

- **Pathway III - Via Direct Use for Immediate Consumption Needs:** Households attempt to smooth their consumption by adjusting their disposable income> Informal systems of savings, self-help and insurance, as well as high-cost lending, appear to have comparative advantages for covering idiosyncratic shocks, but may not be an efficient institutional response to covariate risk. Moreover, access to the poorest to the informal arrangements, might be restricted. More formalised financial services can, on the one hand deepen access and on the other hand allow households to smoothen consumption in the face of covariate risk. Formal financial institutions can do this due to their diversified scale.

In summary, improved access to financial services either augments income generated by production process or reduces costs for smoothering consumption at sufficient levels. The latter two effects, (i.e smoothing disposable income generated by borrowing for consumption or by saving in highly liquid but less remunerative assets, including the accumulation of claims to neighbours and friends through reciprocal gift exchange), is expected to be relatively more important for households that face the risk of transitory or chronic food insecurity

The Depth-of-Outreach Failure: The Lessons

Such a nuanced perspective of financial service allows us to understand the difficulty that poorer households face in participating in and sustaining benefits from some of the current innovations[38]. It is possible to decipher two distinct responses to these concerns. The first comes from the 'poverty-focussed' quarter who argue that non-credit and more direct income generating interventions are required for the poorer for whom the 'poverty escape through credit' route is much too risky and inappropriate (see Hashemi, 1997; Greeley, 1997 for an elaboration of this view). The second response is from the 'scale-is-all' quarter, which argues that as long as a large enough

scale of outreach is reached, the concern with ‘depth of outreach’ (i.e. the proportion of poor in total membership and the depth of poverty of the poor reached)[39] is inconsequential.

In the first view, provision of financial services is seen as playing an instrumental role in poverty alleviation. However, as we argue in this paper, it might be worthwhile considering the importance of financial service provision to the poor as of intrinsic value, irrespective of its promise as a poverty-alleviating tool. Viewed from such a vantage point, the focus is placed on the design of suitable financial service products that the poor would find useful. This in turn warrants an understanding of financial behaviour and preferences of the poor. The second view, on the other hand, can lead to the unfortunate turning back of the achievements that have been made in the provision of finance to the poor. Ignoring the depth of outreach issues and concentrating solely on the scale of outreach might encourage exclusive upmarket product innovations[40] leading to further regression in the development of financial services for the poor. In this sense, both these views share the common assumption that financial service is not important for these excluded poorer households — a view that has been shown in this paper to be false. Much of the informal arrangements that the poor use reflect the importance that financial service has on their lives.

The issue of the current microfinance initiatives in failing to attract[41] the poorest of the poor is an important one for the purpose of this paper and for an understanding of the possibilities and limitations of the current innovations in general. At the outset, it is important to highlight that the measurement of any form of depth of outreach is fraught with methodological problems[42]. This is primarily because of lack of base line data on those that join these programmes. The other problem is the difficulty in factoring in the dropouts from these programmes into the analysis. Due to these problems, the evidence that is collected is of *current* poverty information on *current* participants.

The methodological problems that arise are two – first, current poverty status might not be the same as the poverty status of the participant at the time of joining and second, current participants might be a biased sample of all participants that ever joined. This is due to the possibility that dropout behaviour might not be random and independent of initial endowment. While the second methodological concern requires identification of dropouts, the lack of base line poverty data remains a problem even if we manage to identify dropouts - their current poverty status might also be different from their poverty status at the time of joining.

What is often used to measure the depth of outreach of a programme is poverty correlates that are relatively stable over time. Such poverty correlates have to be obviously context-specific, like land ownership which is widely used in the rural South Asian context (see Matin, 1998, Zaman, 1998). Participatory research tools could have potential value in this respect, but the concern is that often participants of such programmes have a fairly clear idea about institutional values and rhetoric, which could bias their responses. Instead participatory exercises can be potentially used to derive context-specific, stable poverty correlates and information on them. The next step is to compare the depth of outreach in the membership population with a wider population which can be at national or area level. The problem with this is that microfinance intervention can have wider affects on the non-participants and

again this might not be random.

Once it can be reasonably established that the poorer among the poor are relatively less likely to join these programmes, the next obvious step would be an inquiry into the reasons. Surprisingly, most of the time, the reasons are seen as so obvious that they are not given much serious thought[43]. Towards this end, it is useful first to examine if there is any discernible time pattern - it could be that the depth of outreach problem gets aggravated over time, as a number of studies suggest (Hulme et. al., 1996; Matin, 1998; Ito, 1998; Zaman, 1998). An examination of the possible explanations of such a time pattern would itself shed important light on the dynamics of the depth of outreach problem[44].

The depth of outreach problem of microfinance institutions can be discussed in terms of demand and supply forces. Most studies focus on the demand side forces leading to the conclusion that not all categories of the poor can make good use of the services. However, it must also be noted that such demand side constraints are underpinned by certain supply side factors like the nature of the service provision, terms of the contract etc. It could be argued that changes in these supply side features – through better product design and delivery methods - might alter demand in ways that create deeper outreach. This would warrant serious research into the financial behaviour and preferences of the poor, which as we argued above, can be very different from those of the non-poor. In general, in our framework outlined above, poorer households tend to use financial services more through pathway II – not so much through direct income generation, the much championed rationale for microcredit initiatives.

A Financial Service-Outreach Perspective

We propose a perspective that highlights the relationship between the nature of financial services being provided and the client set it attracts. It is possible to conceptualise the 'nature of financial service provision' rubric to include other wider supply factors like institutional values and the dynamics through which they are translated into practice[45]. However, for such a perspective to be useful, it would be important to treat the direct nature of the financial services as a menu of services with the terms of the contract as the core, while examining the ways changes in these core elements affect other supply factors[46]. The complete analysis would then examine the way this whole process in turn influences client outreach. This final relationship would have to be informed by a sound understanding of financial behaviour and preferences of the clients.

What seems to influence the depth of outreach in an important way is the content and the flexibility of the programme and its terms and conditions: the degree to which the products offered meets poor people's special needs by tailoring the characteristics of the products to them. The poorer strata of the population might be better reached if a broader range of financial services is provided. In Sri Lanka, for example, SANASA's poorest clients use savings services more than credit services (Hulme and Mosley, 1996) and small, high-cost emergency loans more than larger, lower cost investment loans.

One can think of three dimensions that need to be in place, to a greater or lesser extent, for poverty targeting to be effective. These are: (a) identifying/reaching the poor; (b) attracting the poor and (c) discouraging/excluding the non-poor. A recent study (CGAP, 1998) assessed the relative emphasis that existing MFIs place on each of these dimensions. The results show that the most emphasis is placed on identifying/reaching the poor and the least on attracting the poor, which lies at the heart of the financial service-outreach framework outlined above.

Lately, development researchers and practitioners have been discussing the relative importance of deposit services and loans, especially for the poorer clients (von Piscke and Adams, 1992; Gulli, 1998). The emphasis is shifting from microcredit-poverty alleviation equation to one that recognises the intrinsic importance of building sustainable financial systems that offer a wide-ranging menu of services comprising of microcredit, microsavings and insurance facilities. It is argued that provision of a wide range of financial services will not only better fulfil clients' needs, but also improve outreach-depth, and improve access to sources of funding.

Although traditionally the microfinance industry has placed greater importance on loan provision, opportunities of opening savings accounts and deposit services may be as important, specially, for the poor. As Wisniwski (1998: 1) argues, the advantages that deposit facilities show over informal savings is a good mix of accessibility to cash, security, return and divisibility. Additionally, the ability to mobilise savings can contribute crucially to the long term sustainability of the deposit-taking institution. Savings deposit and withdrawal behaviour can be a useful proxy for debt capacity, which can be used along with the traditional membership length proxy widely used[47]. However, regulatory framework issues pertaining to deposit protection needs to be addressed. Moreover, donor's provision of low cost loans and grants could also threaten organisational incentives for savings mobilisation.

Above all, mobilisation of the savings of the poor requires primarily an understanding of the nature of such savings, which as we argued in the first section, are tiny temporary surpluses that accrue to the household with high frequency and seasonality. Along with this, it is also important to understand the motivations behind savings of the poor - this we have argued to be driven by the need for useful lump sums which is used to meet a diverse set of needs. The design of products and mobilisation technologies need to be attentive to these issues (for an innovative programme mindful to these issues, see box 6 below). This should not come as a surprise to those who have followed the development of the current microcredit technologies and the innovations that were needed to serve non-collateralised, poor clients.

Box 6: SafeSave

SafeSave is a financial services provider which works in the poorer slums of Dhaka, the capital of Bangladesh. It started in late 1996 and is still a small organisation. In early 1999 it had a little less than 3,000 clients, was holding about 2.4 million taka of clients' savings (about 50,000 US dollars) and had about 3.7 million taka (about 75,000 US dollars) of loans outstanding.

Despite its small size, it is attracting attention because of its unique products. Financial services for poor people are viewed by SafeSave as a matter of helping the poor turn their capacity to save into usefully large lump sums. Its products are designed to enable very poor slum dwellers to do this as conveniently and as quickly and in as many ways as possible.

In essence, SafeSave offers its clients a full individual banking service on their doorstep. There is no group formation. Bank workers, called Collectors, visit each client every day six days a week. On each visit clients may save, or withdraw, or repay loans in any amount they choose including zero. They may also take loans on their doorstep in values based on their proven capacity to save and repay.

Given this flexibility, many clients transact very regularly, in volumes that exceed those of more conventional schemes for the poor. For example, clients tend to pay back loans much more quickly than in the Grameen Bank system (see Box 5 for details).

Loans are charged at an effective interest rate of about 2.25 per cent per month. Using cost cutting devices such as recruiting Collectors from among the slum dwellers themselves, a full computerisation, SafeSave is already covering its operational costs from its loan interest income and with growth, promises to become fully economically sustainable

Battle of Superiority: A Non-Starter

Evidence from various countries demonstrates that the demand for deposit services is high and that such services have benefits for both the institution and their clients. Some analysts argue that savings and credit facilities can serve the same purpose and the choice of one over the other is a part of the household's risk management and coping strategies. For instance, a small credit to cope with a crisis at a time when saved resources are inadequate does not necessarily make a household more vulnerable - it depends on the terms on which the credit is extended and the overall financial situation and debt burden of the household.

There is also an important difference between savings and credit - loans provide an opportunity of accelerating investments when the amount saved is inadequate (Gulli, 1998). People need a plan and a disciplined opportunity to save and they save slowly while they can borrow relatively quickly. For a poor tailor, the opportunity to buy a sewing machine today as opposed to after a year of saving might make a big difference.

What may make the difference, however, is the availability of all three types of financial services. Availability of financial services does not mean that all poor households need to be in debt or save at a certain point in time. However, all households, including the poor will benefit from the availability of financial services that allows them to save when they want, cope with a crisis and borrow to take advantage of good opportunities.

5 *Conclusion*

The last fifteen years have seen significant advances in both the understanding of the needs of the poor for financial services and of the provision of financial services for them. We now understand that:

- The poor need financial services that help them maintain and improve livelihoods. Innovations that address the constraints faced by the poor due to an imperfect financial market can allow them to take up direct income generation, increase productivity of existing enterprises, and also help smoothen consumption, invest in longer term human capital formation and cope with contingencies and life cycle needs.
- Both informal (including self-provision) and formal providers can help meet these needs.
- Understanding the existing financial service behaviour and preferences of the poor can be a good guide to product design and development by other agencies.
- Financial service innovations for the poor need to be dynamic, context-specific and adapt to the changing needs.
- Better-designed financial services can act as an important leverage. Providing poor people with effective financial services helps them deal with vulnerability and can thereby help reduce poverty. However, the relationship is driven by complex livelihood imperatives and is not simple. Therefore, it is not a panacea that converts the poor into the non-poor.

However, as we have shown in this paper, provision still lags behind theory - there remains a great need to narrow the gap and also deepen understanding. It has advanced in terms of recognising the need for products that meet the preferences and circumstances of poor people - access to ‘lump sums’, regular and small savings and repayments, appreciating the importance of incentives and commitment to sustainability. However, it remains weak on developing processes that rapidly identify high quality ‘new products’ and on mechanisms for increasing depth of outreach. The first ‘microfinance revolution’ has shown that the ‘poor are bankable’ – the second revolution is faced with the challenge of showing that it is possible to offer a set of financial services to the poor that meet their livelihood needs.

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Notes

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[1] Muhammad Yunus argued vigorously during the entrepreneurship era against the agriculture bias in earlier periods of pro-poor credit. He argued that most poor are landless and derive income from non-farm sources and that an agricultural-bias also leads to making women invisible (Yunus, 1984).
[2] See Dreze and Sen (1989 and 1991) using this distinction in the discussions of different forms of 'entitlement' and 'social security' and an application of the concept in microfinance concept by Hulme, et. al. (1996).
[3] Several paragraphs in this subsection are drawn from Rutherford (1999).
[4] With great sarcasm, Bouman (1990:155-54) writes, "[..] and the lucky few who produce a surplus, do they not indulge in wasteful consumption, squandering their money on wasteful consumption, social-religious expenses?" Significantly, Polly Hill (1982:216) speaks in this respect of the inheritance of 'the colonial obsession with debt'— an obsession which is particularly in tune with our times and seems reluctant to die.
[5] Gender differentiated credit repayment behaviour has received a lot of interest (see Khandker, 1998 for a gender differentiated impact argument and Morduch, 1998 disputing it). However, the gender difference in savings behaviour, especially of tiny amounts, most relevant for poorer households, is also widely acknowledged and supports popular impression. Folk tradition in Bangladesh is filled with adages that reflect such a view.
[6] 'Large' is a relative term. For poor people in low income countries this may mean sums of US$20 to US$500. For very poor people it may mean only a few dollars.
[7] This is in contrast to the large body of literature on the distinction between the formal and informal sectors of the economy, in general and various markets, like labour, in particular. See Johnson (1999) for a review of this problem.
[8] As microfinance institutions start collecting deposits from non-members, the issue of adherence to certain banking regulation will also become important. This is already a subject of considerable interest in Bangladesh (see Bangladesh Bank, 1998)
[9] However, question arises regarding the possibility of cross-subsidisation for such windows, especially when such cross-subsidisation is from (profitable) micro to more commercial (loss making) component. That this is the case in BKK/BRI in Indonesia has been argued in (, 1998). Another important related research area is examining the context (nature of the State, banking regulations and formal banking culture) which are more conducive to such formal-semi formal mix. For instance, Grameen Bank started off as an experimental window under a formal bank structure (then known as GBP: Grameen Bank Project), before getting a special banking license. The 'downgrading' idea did not work in Bangladesh, but did work in Indonesia.
10 This continuity itself might be 'disturbed' with the dynamics discussed.
[11] As Bouman (1990:154) points out, "One did not even speak of informal financial market, but only of 'informal lenders', with the emphasis on 'lending'."
[12] Ghate (19?:4-5) found the theme of 'informal credit market' to be very restricted for his research: "The subject matter of the research project was initially 'informal credit markets', but as the study proceeded it became clear that informal finance is much more inclusive" Bouman (1990:167) in a similar spirit writes that, "It is a fallacy to regard the informal financial market as the exclusive domain of the village moneylender… he forms only a small, often minor part of the protective network of mutual assistance that is chameleon-like and kaleidoscopic in nature (Hospes, 1989)."
[13] For an explanation of the widespread time-bound feature of many informal arrangements, see Rutherford (1998).
[14] It however must be pointed out that most empirical studies have shown sharp limits to these arrangements, especially as far as their access to the poorest group goes. A substantial number of households, specially the poorest of the poor, appear ill-equipped to handle even small-scale, localised risk that most of these arrangements are designed to cope with. The reasons and dynamics of such exclusion lies in broader socio-economic forces and have been examined in depth (Osmani, 1988; Platteau, 1992; Dreze and Sen, 1989).
[15] Udry (1994) in his work on Nigerian rural credit market finds that such transactions have implicit insurance contingencies --- such that the terms of repayment are conditional on the income realisations of borrowers and lenders.
[16] However, personal savings remain to be the most important source of start-up capital for rural non-farm activities (Khandker, 1998). It is as high as 50% even for Grameen Bank borrowers (table 4.9).
[17] (see Bouman, 1979; 1990; 1995 for an overview description; Miracle et.al., 1980 for an African review; Besley et. al., 1992; Brink, 1997; Calomiris and Rajaraman, 1997 for theoretical treatment; Rutherford, 1996 for an examination of similarity and diversity).

[18] The only systematic field survey with structure interviews covering about 900 respondents is that reported in Adams and Sahonero (1989) for Bolivia. Rutherford (in Wood and Sharif, eds) reports on about 100 RoSCAs and ASCrAs in Dhaka's slums. Other field reports range from less formal and much smaller surveys (eg., in Mexico by Cope and Kurtz, 1980), to the anthropological and anecdotal. Reviews of these are made in Greetz (1962), Ardner (1964), Anderson (1966), Bouman (1977) and Holst (1985). Female participation is often reported to be higher than male participation (Adams and Sahonero, 1989; Ardner, 1964; Geertz, 1962). The hallmark of RoSCAs is their accessibility to the poorest. Indeed Kurtz (1975: 55) sees poverty as a particular 'correlate of RoSCA participation'.
[19] However, it should be noted that RoSCAs are better able to insure against event uncertainty than against income uncertainty (non-idiosyncratic risk).
[20] One of the important differences between RoSCAs is in the variation of determining the sequence of fund receiver. This may be random (lottery RoSCAs), pre-determined and bidding. In each category, there are variations as well.
[21] Comparison is made between saving with interest, borrowing with interest and RoSCA participation in order to acquire an indivisible good.
[22] To the extent that farmers grow different crops with different cropping calendars, the effect of seasonality and synchronicity will be dampened somewhat. Moreover, if there is no perfect correlation between the risk associated with different crops, and if the farmer is diversified with respect to crops and if different farmers have different portfolio of crops, the covariance of income between depositors and borrowers will not be as high as in areas with less crop diversification.
[23] This argument can be challenged on the grounds that the poor are so keen to save that they are prepared to accept low interest rates and/or even pay for savings services. Binswanger et al (1985) do not consider the possibility of such imperfect markets for savings.
[24] References to the safekeeping motivation for depositing small amounts with 'moneyguards' are found more often in the African literature (see Aryeetey and Udry, 1997 for a good review). For an example from Indonesia, see Hospes, 1989 and for one from southern India, Rutherford.
[25] It should however be noted that implicit informal insurance arrangements encompass a much broader set. For an excellent discussion see, Morduch, 1997.
[26] For the initial optimism with informal insurance mechanisms, see Townsend (1994). For later more pessimistic findings, see Alderman and Paxson (1994); Chaudhuri and Ravallion (1996); Morduch (1991); Rosenzweig (1988) and Czukas, Fafchamps and Udry (1995).
[27] Which is strictly speaking the case. BancoSol started off as a NGO while the Grameen Bank has always enjoyed a special status as a bank. Debates over whether other NGOs like BRAC, ASA should also be granted similar special bank status and if so the regulations required, is a topical one in Bangladesh.
[28] For example the Gono Bima (People's Insurance) Scheme by Delta Life Insurance in Bangladesh.
[29] We borrow this phrase from Morduch (1998a).
[30] This term itself is new --- the earlier version, 'microcredit' is still widely used (as the microcredit Summit exemplifies), underpinning the belief that credit is the vital element for poverty alleviation. As we hope to show, such credit first vs. savings first dichotomy is false and is deterimmental to the real prospects that the innovations can have.
[31] Repayment rates, however, are not uniformly calculated and can be misleading: see the recent CGAP note by Rich Rosenberg (1998) for a good discussion.
[32] It should be pointed out at the outset that the group contract approach is far from universal (Chaves and Gonzalez-Vega, 1996) and the success of the model is mixed. Recent empirical (Matin, 1998; Jain, 1996) and theoretical (Morduch, 1998c; Diagne, 1998) works cast considerable doubt on its sustainability and applicability in varying contexts.
[33] Recent theoretical studies of the group based approach to microfinance include, Stiglitz, 1990; Varian, 1990; Varian, 1990; Besley and Coate, 1995; Banerjee, Besley and Guinnane, 1997; Madajewicz, 1998; Diagne, 1998; Wydick, 1998; Conning, 1997; Prescott, 1997; Sadoulet, 1997 and Morduch, 1998b.

[34] The argument would also imply that as instalment size gets bigger due to rapid credit deepening, participation by poor as new entrants might be adversely affected and repayment suffer. Evidence for both of these tendencies is found in Matin, 1998.
[35] One of the most prevalent reasons cited by poor non-participants of such programmes for not joining is the 'fear of not being able to *manage* weekly instalment' (Hashemi, 1997). See also Ito 1998.
[36] The debate around market saturation and declining returns as loans get larger has been aired for some time (see Osmani, 1988) but never seriously examined. In a recent paper, Montagnon (1998) argues

that at initial stages (and low loan size), it is possible to generate adequate return from investing loan money to manage repayment with interest, but not at later stages as both the business and loan size gets larger. This is because, initially most microenterprises are labour-intensive with few fixed assets. Thus credit extended can make huge difference to productivity which is passes through the business with enormous turn-over. However, as loan size gets larger, the turn-over slows down as more and more of the capital is used as fixed investment on which returns may be lower and slower to materialise. On the other hand, Rutherford et al (1995) argue, in a paper for the ADB, that loan terms which require the capital to be returned in weekly instalments within one year, and starting the week following receipt of the loan, require very high internal rates of return for the businesses in which the loan is invested and that in Bangladesh at least there is only a very narrow range of businesses that can tolerate such terms.

[37] Rutherford and Arora titled one of their reports for UK aid, *Almirahs Full of Passbooks*, after discovering very intense multiple-use of financial services in the slums of Cochin in Kerala. An *almirah* is a secure steel or timber cupboard found in most homes on the sub-continent.

[38] The finding that the poorest households tend to shy away from these programmes is well-documented (Hashemi, 1997; Rahman, 1997; Matin, 1998; Ito, 1998; Zaman, 1998; Rogaly, 1996; Rutherford, 1995; Navajas et. al., 1998). The concern that the poorer participants are less able to sustain benefits from these programmes and might drop-out disproportionately have also been evidenced in some studies.(see Zaman, 1998; Wright, 1998).

[39] In the poverty measurement literature, distinction is made between several poverty indices of a particular class of measures. The most common class of such measurement is the Foster Greer Thorbeck (1984) indices, popularly referred to as FGT indices. There are three measures within this class. The first, popularly known as the P_0 measure tells us about the incidence of poverty, or the head-count ratio which is the number of people below the poverty line as a proportion of a population. The P_1 measure tells us about the depth of poverty or the average shortfall in expenditure per head of a poor person from the poverty line. The P_2 measure captures the inequalities amongst the poor which P_1 measure does not. The P_2 measure allows for an expenditure improvement of a person far below the poverty line to be valued more than the same gain for a person just below the poverty line. The concern for microfinance programme outreach is that, it might score well in terms of P_0 measure, but not in terms of other FGT poverty measures.

[40] Moving upscale only in terms of quantity (loan size) while maintaining other elements of the contract unaltered has not been very successful (see Matin, 1998 for the Grameen Bank experience and Motagnon, 1998 for a more general discussion). This has been well-recognised and recent upscaling attempts involve radical changes in the nature of the contract, like the microleasing of Grameen Bank (see Dowla, 1998) or the MELA loans of BRAC (see Zaman, 1998).

[41] We prefer to use the word 'attract' rather than the more well-known 'reach' because our preferred term implies a client-driven, bottom-up perspective where the client decides to use the provision based on its usefulness.

[42] It is important to distinguish between measures of (depth of) outreach and the determinants of outreach. The former is discussed here. The determinants of outreach is a separate question and poses other types of econometric problems pertaining to self-selection bias. For a discussion, see Morduch,1998; Zeller, 1996.

[43] For instance, a recent study (Navajas et. al., 1998) finds that on balance, the poorest of the poor tend not to be attracted into programmes studied. In conclusion, the authors note (pp. 1), "While microcredit can help to improve the welfare of some poor households, it cannot do much for the poorest of the poor. *This is not a surprise*" (my emphasis). The study by Rahman (1997) is a notable exception.

[44] There are several explanations that have been put forth, like, institutional value drift (Hulme et. al., 1996) staff fatigue leading to leniency in membership selection (Zaman, 1998), rapid credit deepening policies (Matin, 1998), client learning (Ito, 1998).

[45] Several studies stress the importance of organisational commitment to working with the poor as a condition of actual outreach (Jain, 1996; Hulme and Mosley, 1996; Chavez and Gonzalez-Vega, 1996; Almeyda, 1996; Nelson et. al., 1996; Johnson and Rogaly, 1996; Mutua et. al., 1996).

[46] It is possible to think of ways in which the nature of service provision can influence staff incentives. For instance, several studies show how credit disbursement pressures lead staff to select better-off clients (Hulme and Mosley, 1996; Rahman, 1998; Matin, 1998). Such staff incentive can change if the service provision emphasises small savings mobilisation.

[47] Using of membership length as a proxy for debt capacity is not without problems. Several studies show how this is leading to default for some institutions (see Matin, 1998; Wiig,)