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FINANCIAL SERVICES AND THE POOR; report from a conference

by
James R. Finucane

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Mahaweli Enterprise Development (MED)

The development of the natural and human resources of the Mahaweli river basin is a high priority of the Government of Sri Lanka. The construction of physical infrastructure, the settlement of the land and the formation of the agricultural production base are largely completed. The challenge now is to build a diverse, dynamic economy capable of steadily raising Mahaweli family incomes. In meeting this challenge, the private sector - farmers, entrepreneurs, companies, community groups, non-governmental organizations - has an important role to play.

MED is a project of the Mahaweli Authority of Sri Lanka and the United States Agency for International Development. MED promotes investment and employment generation by the private sector in non-farm economic activities and contract outgrower programs producing diversified crops. MED does this by: (i) developing technical, marketing, financial and other services which assist self-employed individuals, microenterprises and companies to start and improve their businesses; (ii) developing entrepreneur associations and other participatory groups; and (iii) carrying out studies and analyses to improve the frameworks for development in the Mahaweli areas.

The Employment, Investment and Enterprise Development (EIED) Division of the Mahaweli Authority is the MED implementing agency. Technical consultancy is provided by a consortium led by the International Science and Technology Institute, Inc. (ISTI), and including Agroskills, Development Alternatives, Ernst and Young, High Value Horticulture and Sparks Commodities.

PREFACE

The attached is a report of a conference on Financial Services and the Poor held in September 1994.

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FINANCIAL SERVICES AND THE POOR
selected notes from a September, 1994 conference
with observations on issues relevant to
microenterprise program design in Sri Lanka

INTRODUCTION

At the end of September I attended a USAID supported conference held at the Brookings Institution in Washington on Financial Services and the Poor: U.S. and Developing Country Experience."

This report includes a selection of notes made during various of the conference sessions. A concluding section comments on some of the issues which, based on the conference discussions, are likely to arise in the context of possible USAID supported microenterprise activities in Sri Lanka. These notes were the basis for a presentation made to a group of USAID and EIED officials upon my return to Colombo.

Overview. Much of the conference dealt with the knowledge generated to date in the microenterprise finance field. Many of the presenters highlighted the importance of achieving the financial sustainability of financial organizations. Several commented on the results of their studies aimed at identifying the "industry standards" which may be emerging in a number of organizational and management areas from the experiences of some existing programs which are achieving sustainability and serving large numbers of poor people. At the same time, however, it seemed clear that much remains to be done to identify ways to provide financial services to the poor in a fashion which, while being sustainable at the level of the financial organization, is developmentally effective in improving the situations of the poor.

A strong theme which emerged, in my view, was that microenterprise program opportunities for achieving both financial organization sustainability and poverty alleviation will be strongly influenced by contextual factors, and that enterprise and social intermediation, as well as financial intermediation, may be required. However, it may well be that these different forms of intermediation can most effectively and efficiently be carried out by separate organizations.

USAID's Microenterprise Approach

At various points during the conference the current USAID approach to microenterprise finance was presented.[1] A broad overview was put forward by Carole Lancaster, a senior representative of USAID:

USAID's economic growth objective means:

(i) strengthening markets (policy and regulatory frameworks) and

(ii) increasing access to markets (more opportunities for the poor).

Progress toward both of these can be achieved in part through USAID's microenterprise initiative.

The key challenges for the microenterprise initiative programs are viewed as being to achieve outreach and sustainability. As for the impact of the programs, USAID will do research on impact on families and enterprises.

Financial programs will be part of USAID's microenterprise initiative. In the financial programs, the intention is to focus not simply on the number of loans, but rather on leveraging and on the more strategic objective.

Learning in the microenterprise development field has been a matter of "successive approximations", but the bottom line on microenterprise learning to date is that it can be done.

(Ms Lancaster noted also that USAID is changing its systems - management, personnel, information, procurement. New ones will be in place in one year which will allow one to push a button and get the necessary information. AID will become one of the more streamlined government agencies using information technology. Convinced that USAID will survive, although the strategic objectives may change, which should not be unexpected as the world is changing.)

[1]Official, comprehensive explanations of USAID's microenterprise initiative are, of course, available.

Background to USAID's Microenterprise Finance Program Approach

The following draws from the comments of several persons, including Robert Christen, Cressida McKean, Maria Otero, Elisabeth Rhyne and Bob Vogel, who at different times during the conference put forward the thinking behind the USAID microenterprise approach. The main thrust of their presentations follow along the lines of work reported in various reports of GEMINI (USAID's centrally funded microenterprise research program; the reports are available from DAI) and in a draft report by IMCC[2] of a recent USAID supported study of eleven relatively successful microenterprise finance programs. USAID was interested in the study as it was starting to put increased funds into microenterprise programs without having a solid idea of best practices or industry standards.

USAID's thinking on microenterprise finance programs is that:

- the main issue is outreach, particularly reaching poor people who have not been reached with financial services before.

- financial sustainability of financial organizations is necessary to achieve outreach.

- there is no trade off between serving the poor and financial sustainability if programs are done on large scale.

- achieving sufficient scale however requires a different type of NGO organization. Scaling up requires leverage which requires using other people's money, which requires deposit taking. It requires an NGO to transform itself into a financial organization, which is very difficult. Once an NGO becomes a financial organization, taking deposits, it becomes regulated, its ownership nature changes and it must seek to become profitable, at which point it is perhaps no longer an NGO (seemed to be Otero's point, giving the example of Bolivia's BancoSol).

- there are few experiences of NGOs transforming themselves into financial organizations.

- NGOs can be analysed in terms of how developed they are in terms of scale and financial sustainability; few are well along in either scale or sustainability.

- the policy framework is not critical for successful microenterprise finance programs (seemed to be Vogel's point).

- good microenterprise finance organization are often characterized by:

[2]The draft report of the study, which was distributed at the conference, was written by Robert Christen, Elisabeth Rhyne and Robert Vogel, with Cressida McKean as the assessment manager for CDIE. IMCC is at 2101 Wilson Blvd., Suite 900, Arlington, Virgina 22201.

(i) standardized retail units,

(ii) limited menu of services,

(iii) high productivity (several comparative measures - administrative costs as percentage of loans, number of borrowers per staff member, average loan size, average salary as percentage of GDP per capita) were proposed as possible "industry standards"),

(iv) staff training which focuses on mission, targets and procedures (not necessarily motivational, but creating potential for change),

(v) information system focusing on a few key indicators,

(vi) leadership (there has as yet been little experience with change of leadership in the eleven organizations studied,

(vii) effective real rates of interest covering costs and reasonable profit,

(viii) low levels of delinquency,

(iii) productivity culture (including low cost operating methodology, decentralized units, good MIS, performance based indicators, appropriate infrastructure), and

(iv) good liquidity management.

Donors considering microenterprise finance programs should:

- insist that financial organizations commit to financial sustainability and the donor must see this as sine qua non,

- insist that NGOs get their credit methodology right, and

- at a minimum, not support activities which retard growth in scale and sustainability.

- focus design and evaluation efforts on two levels - client outreach and organizational financial sustainability. (A GEMINI report[1] by Rhyne on evaluation of microenterprise finance programs presents this approach in some detail; this could be read in conjunction

[1]This is among a number of GEMINI reports which have been edited and compiled in *The New World of Microenterprise Finance*, eds. Maria Otero and Elisabeth Rhyne (West Hartford, Conn.: Kumarian, 1994).

with the chapter on "measuring the results" in Von Pishke's on finance at the frontier[4] and an article on successful fural finance institutions by Yaron.[5]

Additional Ideas Presented on Microenterprise Finance Programs

Presentations, and comments from the floor, were made on a wide range of microenterprise finance programs. Some of the more provocative points made are paraphrased below.

Gonzalez-Vega, of Ohio State and well known in the field of rural finance, on financial services for the poor

The main concern is poverty. Important requirements are to raise the access of the poor to assets, increase the productivity of their assets, including human capital, and create employment.

A focus on the financial system is appropriate, as it is the brain of the economy (Stiglitz). However, should not ask financial organizations to do other than financial functions (e.g., risk diversification, intertemporal movement of funds) otherwise the result is usually "failed interventions".

Producers need savings services (to diversify risk, get higher returns, make intertemporal savings) more than credit services.

The most critical factor is viable organizations. A frequent difficulty in achieving the financial sustainability of financial organizations serving microenterprises in rural areas is often the high fixed costs of maintaining many bank branches with many small heterogeneous and widely dispersed clients. As a model, BRI, with 12m depositors and 2m borrowers, is better than Grameen. One important aspect of BRI is that it serves individual borrowers, which is a less costly methodology.

Credit doesn't make up for bad policies or bad roads.

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[4]J.D. Von Pischke, *Finance at the Frontier* (Washington, D.C.: Economic Development Institute of the World Bank, 1991).

[5]Jacob Yaron, "What Makes Rural Finance Institutions Successful?," *The World Bank Research Observer*, vol. 9 (January 1994), pp. 49-70.

Robinson, of Harvard Institute for International Development and formerly associated with rural finance programs in Indonsia, on BRI's unit desa system

BRI's success required a paradigm shift from being a credit delivery organization to being a viable institution, which has depended in a major way on deposit mobilization. BRI, which is self-financing from its deposit base, provides credit (2 million borrowers) for the working poor, not for the destitute. Savings (12 million depositors) is perhaps its most important service.

Why was there lack of credit before BRI developed its unit desa program? Savings were underemphasized (interest rates also were controlled). Microfinance was considered unimportant for the economy, unprofitable for banks, and not needed by poor. Academic analyses of the failure of market forces to provide sufficient microfinance services emphasized issues of asymetric information, adverse selection and moral hazard.

Now that BRI has developed the market, there is increasing interest by other banks in Indonesia in providing small credits in rural areas.

Hubbard, who recently completed an assignment as a coordinator of donor activities for Grameen Bank, on Grameen

Grameen is not self-financing. Over 1989-93 it received $85m in donor grants. Its replicability depends on grant funds.

The model requires forced savings, which BRI does not.

Grameen is engaged in social intermediation as well as financial intermediation.

Carroll, of Georgre Washington University, on NGOs

Good NGO's are professional, enabling (i.e., focusing on developing capacities of membership organizations and linking the poor with mainstream institutions), reorienting public services. When NGOs are significant it is because their effects are catalytic rather than just additive.

There are no pure NGOs. NGOs are hybrids - quasi public services or social businesses. Some NGOs are surrogates for the state in that they are substitute providers of public good services. One should not put cooperatives, credit unions, and other membership organizations (which are key parts of true civil society) in NGO category.

NGOs haven't made much dent in providing credit, but have broken myths.

NGOs do three types of intermediation - financial, enterprise and social.

One issue is always transaction costs. One should separate costs of doing business and costs of capacity building. The social utility of latter may be greater.

Zander, a rural credit specialist, on IFAD approach to microenterprise finance

A microenterprise finance lending strategy should begin at household level.

Impacts should be measured at the household level.

Programs should avoid credit strategies for overindebted households.

The poor do not need separate financial institutions.

Individual lending is more effective and efficient than group based, although group formation is useful.

NGOs should not be used as financial vehicles.

IFAD does not consider credit unions as NGOs.

Cuevas, of Ohio State, on formal and informal finance

Whether NGOs can scale up to banks depends on how regulatory questions are answered.

Microenterprises rely on supplier and customer credit.

In informal finance there is usually no control over the final use of the funds. Informal finance assists to stablilize household consumption.

As formal markets integrate, the scope for informal finance declines.

Adams, of Ohio State, a well known authority on rural finance, on microenterprise finance

A number of conventional wisdoms have long been discredited, namely: that the poor (i) need low interest rates, (ii) are too poor to save, (iii) can not afford services, (iv) must be targeted in special credit programs.

In USAID's current microenterprise finance approach one sees a shift from programs emphasizing production to those emphasizing altruism, especially through NGOs.

Why did the former production based programs fail? The causes included: (i) hostile economic environment, (ii) repressive macro financial policies, (iii) hostile political environment in centrally planned economies, (iv) concessionary lines of credit which distorted markets, (v) ignoring institutional sustainability issues, (vi) using the financial system to dispense grants and subsidies leading to rent seeking, and (vii) political infections. For these reasons, it seems that USAID in most places has given up on formal financial systems.

However, in most places the environment now is hospitable to production type programs through the financial system.

As for NGOs, their strengths are in being grass roots, altruistic and a fad now. However, there are limitations in most NGO approaches - high costs, lack economies of scale, lack prudential regulation, subsidy dependent, faulty loan screening, loan recovery problems, principal agent problems, poor risk management, lack broad network, ultra altruistic NGOs with soft lending procedures undermine the work of others. NGOs generally can not meet financial system needs (e.g., diversifying risks, participating in the payments system). Lending to poor people and handling their deposits is expensive.

Deposit mobilization is the main way to reach the poor.

AID should go back to strengthening formal financial sector institutions, looking at BRI as a model because of scale, potential and sustainability. The requirements are deposits and discipline, not donor funds; donors moving money is dangerous. A concern is that it may not be possible now to build political support for going back to formal sector and building sustainable formal sector institutions.

Schmidt, of the University of Frankfort and a consultant to the Interamerican Development Bank, on IDB's approach to microenterprise finance

For the IDB a major study of NGO microenterprise programs in Latin America was carried out. It was much wider than the USAID study, which only looked at possible successes. Latin American experience with NGO microenterprise finance is largely urban.

Donors are in error in preferring group lending rather than individual lending and integrated assistance packages rather than credit only packages; in encouraging NGOs to consider savings as their main source of funds; in not intervening sufficiently or making firmer commitments when dealing with partner organizations. These preferences undermine institution building, which is the main requirement of microenterprise finance programs.

He criticizes group based lending, preferring individual based lending using non conventional cash flow and character based creditworthiness basis rather than asset and document based approach. While it is difficult to compare costs of the two approaches because of different contexts, after a few years of experience, organizations emphasizing non-traditional individual lending are more efficient than group based ones. This is because within the organization more learning and cost reduction occurs when using an individual approach and thus more dynamic effects of scale. Group lending, on the other hand, externalizes many costs. The borrowers have higher costs. The focus of donors on groups is a romantic issue.

What is the role of deposit taking in development of a financial organization which is clearly target oriented? Must distinguish between (i) service to depositors and (ii) method of funding loans; and between (a) inter- and (b) intra-sector full service banks. However, not all target oriented lenders must raise deposits or raise deposits from their borrowers. Deposit mobilization is expensive and may impede growth in lending. Intra-sectoral savings orientation is not viable.

What institutions to work with? Any type given failure of many. There is good potential for working with banks, "downgrading" their services to reach the poor. The donor subsidies for these institutions, private or state one, should be for institution building, although now it may be politically incorrect. One can also "upgrade" NGOs to be banks. In dealing with the NGOs, donors should see themselves as owners and strongly flex both carrots and sticks. The same should also, of course, to interventions with other institutions.

Conclusion is that finance programs targeted on the poor require institution building (upwards or downwards), which in turn requires strong interventions (carrots and sticks, the ownership perspective) and a long term commitment.

Lessons include don't do much group lending and don't do deposit mobilization with weak institutions.

Von Pishke, currently with KMPG Peat Marwick and a well known authority on rural finance, on small enterprise finance

The financial performance of micro-lending organizations is very poor or at least unknown. Few are profitable using general accounting principles. The cases we hear about are the very best. Outside of 20-25 NGOs, there is very little good data is available on NGO financial performance. Improving performance will require major improvements in financial reporting and analysis and reporting.

The emphasis on financial sustainability of microenterprise financial organizations in USAID's approach and for development finance institutions generally in Baron's work at World Bank are positive steps.

Savings is the most should be called the "missing 7/8ths" or rural finance.

A key question is whether a lender strikes a viable balance balance outreach and sustainability? The issue is lender "constancy" - the possibility of abandoning wholly or partially the original target group through "subtle migration" to more creditworthy clientele or to clients or products which are less costly to the institution striving for financial sustainability or more rent-seeking opportunities.

Yaron, of the World Bank and a financial analyst of development finance institutions, on subsidy dependency

Presents his "subsidy dependency index" as a key measure of the financial sustainability of a development finance institution.

Most measures of return on equity and return on assets are not useful in analyzing DFIs as they are not profit maximizing institutions, rather they are established to resolve market failures. As most DFIs are subsidized, profit is a residual of subsidies and the level of equity capital doesn't determine their borrowing or lending capacity.

Of the microfinance programs studied, only BRI had a negative subsidy index.

He is not confident that a composite index can be developed for measuring access equivalent to the SDI for measuring financial sustainability.

Seems to argue against trying to measure impact as no one can say, for instance, what is economic value of extension services to farmers. However, we can measure its economic cost and identify whether there are changes (e.g., in technology) as a result of the extension (i.e., whether it is effective). Then we can ask whether it is important to provide free or at a subsidized cost and whether there are other ways to provide it?

Bennett, of the World Bank and a researcher on "participation", on social and financial intermediation

Raises concern about need to measure access and impact data at reasonable cost.

Discusses social intermediation in Nepal programs. All provided good non-financial services but have significant loan losses.

Social intermediation is needed to serve poor people who are beyond the frontier of ordinary financial intermediation. Usually this requires separate organizations which either link poor people in groups to financial services of the formal financial system or to parallel financial institutions (e.g., ROSCAs or Grameen, which is a bank-NGO hybrid).

Interested in increasing participation and thus in group based approaches. But sees dangers in combining business and equity approaches in single organization. Apparently has not found evidence that group based financial intermediation pays off financially.

The suggestion seems to be that in preparing a microfinance program, one should take a systems approach, looking the full range of organizations providing relevant social, enterprise and financial intermediation and seek a contextually appropriate design solution.

(Among group based programs in South Asia, her paper refers to Sanasa as one of the strongest financial performers and one which had one of the best information systems.)

Chavez, of the Interamerican Development Bank, on finance programs for the poor

Financial services for the poor need to be the right services, using the appropriate technology, combined with effective organizational incentives and operating in a conducive policy environment.

The main design problem in microenterprise finance programs is the agency problem - designing correct incentives for managers of financial intermediaries. BRI does this, resolving agency problem with appropriate incentives for managers (efficiency wages and fixed salary being only portion of total emoluments, the balance being performance based).

Poor people's businesses are mainly family businesses. They keep simple records and make production and consumption decisions simultaneously. Enterprise budgets are of little use in determining loan repayments as the main budget basis is the household. Banking based on written records for this group is inherently ineffective. Rather, microenterprise lending technology must be based on information flows that are inexpensive, only dealing with relevant information. Information on a borrower's family and habits is a sunk cost, comes from living close, no opportunity cost. Screening should look at ability to repay and value of the hostage. Monitoring should only be done if it can affect repayment. Interest rates should be carefully, set, as if they are too high they may result in adverse selection, and if they are too low they may be a signal that the organization won't survive, which may reduce repayment rates (game theory's terminal period dilemma).

Microenterprise Finance in the US

Several presentations were made on financial services for the poor in the US. They mainly dealt with the Community Reinvestment Act, which is intended to require that banks reinvest a portion of locally mobilized resources in their community, and community development credit unions as examples of credit unions serving poor people. A separate presentation dealt with modern financial technology.

Fishbein, Barr - CRA

The CRA provides for targeted credits. In some cases, CRA lending also includes subsidized credits (e.g., with city government buying down interest rates from 10% to 3% on housing loans for low income families). The CRA program appears to be quite flexible (e.g., in setting the area to be considered the community), although this means that it is never specifically clear what a "CRA loan" is while, at the same time, the reporting requirements seem onerous. In one interesting case, a foundation program provides $500 loans to individuals, closely monitors the repayments, and, if performance is satisfactory, links the persons to mainstream banks for subsequent financing via with "regular" loans, presumably categorized as "CRA loans".

Mayer, author, among many publications, of *The Bankers*

There is no evidence that CRA lending is not profitable.

In poor or declining areas, economic decline leads to less credit and vicious circle.

There is a need to support the poor more with education while doing other things with credit.

The banks' relationships with CRA clients are mutually educative.

Interest rates are more important to banks for long term than for short term loans.

Kimenyi, of University of Connecticut and authority on US poverty

The main concern is poverty in the US. It is characterized by the collapse of families and other institutions, drugs, crime and the failure of the labor market. These features tend to make the nature of US poverty different from that in many developing countries.

Anti-poverty programs in US succeed in providing a safety net, but not in getting people off welfare

US welfare policies don't encourage families and don't encourage cooperation or family based businesses. They force poor to sell assets.

A viable approach would be one which assists the poor to increase their ownership of assets.

O'Connor on modern banking technology

With telecommunications, computers and information technology, the ways of banking are rapidly changing - e.g., ATMs, payment cards, cash cards, smart cards. Examples of possible implications include turned around cash register at McDonalds (customers punch in their order directly) and food stamps and aid for dependent children being issued via cash cards.

(One interesting point is that the number of bank branches is seen as declining. The fixed costs of maintaining them are high, and most services can now be provided without the individuals physically visiting a branch office. In Sri Lanka, with a literate population, a wide spread of banking services and a projected dramatic increases in the density of telephone communications, one can anticipate a relatively early move to introduce many aspects of these modern banking technologies.)

Issues and Observations

Why microenterprise programs? They are pursued for a variety of objectives (e.g., reduce poverty through employment creation and basic needs production, increase political stability, empower poor people, increase competitive pressures in the economy) and views on the design and evaluation of the programs ultimately depend on one's objectives. In general, the reported weaknesses of many current programs are familiar ones - e.g., little coverage, ineffective, inefficient, not serving the poor. However, out of some 20 years of efforts in this field, there are important successes and lessons.

A widespread consensus has developed on many points in the field of microenterprise finance programs, particularly on the need to measure and track subsidies and, further, to seek the financial sustainability of financial organizations. There is also a concensus on many of the modalities and organizational attributes required for success in financial organizations (full cost recovery interest rates, low unit costs, good information systems, proper organizational incentives, staff training, good liquidity management, etc.) which address issues such as asymmetric information, adverse selection and principal-agent concerns. Approaches have been developed for rigorously measuring subsidy dependence and for designing and evaluating minimalist credit programs which make small loans.

Further, there is concensus that regarding financial services for the poor we are still very much in a learning mode and that program design should avoid one size fits all solutions, that NGOs should not all be viewed as the same, that problems and their solutions will be very contextual. Thus the call to believe in the purpose, rather than the program.

Amidst the concensus, it is clear that critical issues remain unresolved and that new ones are emerging and old ones re-emerging. The following essays some of the issues which can be anticipated in the design of USAID microenterprise programs in Sri Lanka.

Microfinance or microfinance for the poor? For USAID's microenterprise initiative finance programs, the minimalist approach with an institutional development twist is in fashion, that is, develop financially sustainable organizations which provide microfinance services to the greatest number of poor people at the lowest unit cost. However, there remains a concern that minimalist programs, in striving for organizational financial viability through a no-frills strategy for making small loans (and sometimes raising deposts), may not reach or continue to reach the very poor (e.g., BRI reportedly does not reach the very poor and BRI and BancoSol may be experiencing loan size creep). In examining this concern about the degree of "constancy" in reaching the microenterprises of poor people, the most common proxy indicators for the number served are the number and average value of the small loans made. Although relatively simple in terms of data collection, these are inadequate proxies for measuring the outreach to the poor and, as is well recognized, fuller client-based information on other indicators is required. Certainly one indicator to be considered would be the number of employees, particularly the number of non-family employees. (For instance, according to one report,[6] BRI's unit desa borrowers averaged 5.6 employees after taking Kupedes loans, with 3.3 of these employees being hired workers; for comparison, in the rural dry zone Mahaweli areas, 97% of the enterprises have five or fewer employees and 69% of the units have no non-family employees.[7]) For domestic NGOs in the US, a frequent recommendation is that they seek detailed information on their client markets to be able to serve them better and, also, to be able to report effectively to their stakeholders on whether the intended target clients are in fact being reached. It is also one of the recommendations in the USAID microenterprise initiative approach. This is a "who are we serving" issue; it is likely to gain in strength along with the emphasis on organizational level financial sustainability. Addressing it successfully in developing a microenterprise program will require clarification about purposes and strategies (e.g., is the concern to provide financial services to microenterprises, the poor, or microenterprise of the poor, or is is to provide microfinancial services in poor areas, and so on), prior to determining the appropriate indicators and key data level to monitor (e.g., financial organization, enterprise, family household).

Improving the situations of the poor. A second, very familiar issue likely to emerge more strongly is whether minimalist microenterprise finance programs assist the poor to improve their lives. On the credit side, a core minimalist premise is that "credit is self-evaluating, it either comes back or it doesn't", and the good organizations are the ones that get it back. In the extreme minimalist approach, short-term microcredits are provided without accompanying training or other assistance. In fact, training in these programs would be directed exclusively at staff rather than clients. However, microenterprise finance in many instances is replacing informal financial mechanisms, a main purpose of which is consumption smoothing, which are increasingly viewed as effective and efficient. The poor, if in fact it is "the poor" who are being reached, in these replacement cases at the "frontier", may not experience any notable change in circumstances, but rather remain poor having merely shifted their source of finance. Without accompanying credit with human resource development and enterprise (business planning, marketing, technology assistance) and, many argue, social (empowerment, social mobilization) intermediation, it may not be possible to increase the opportunities available to the poor. Minimalist credit programs may provide a social safety net (in US program terms, welfare) but may not stimulate economic development (moving people off welfare). That is to say, the debate between minimalist and integrated programs is not settled, with many suggesting that, in its impacts on the poor, credit is not self-evaluating, and continuing to stress that to reach the very poor effectively an array of selected complementary interventions may be necessary. Interestingly, the more integrated approach seems to be followed in the more innovative US domestic programs concerned with disadvantaged communities, the inner cities, remote rural areas, and getting people off welfare. A general case can be made for the minimalist programs in that by extending the frontier of formal finance they are achieving a greater integration of

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[6]James Bromgard and Kenneth Angell, "Developing Financial Services for Microenterprises: An Evaluation of USAID Assistance to the BRI Unit Desa System in Indonesia," Gemini technical report No. 6, 1990.

[7]James Finucane, "Microenterprises in the Dry Zone: Structure and Dynamics of Non-Farm Enterprises and Employment in Mahaweli Areas," MED report, September, 1994.

markets with all the economic benefits which theory teaches accrue to such integration. Also, much anecdotal information on the improvements in the lives of individual clients of microcredit programs can be marshalled. However, the case of Sri Lanka, in which the outreach of formal and quasi-formal (usually cooperative) financial organizations has been already extended to a remarkable degree in response to both market forces and public policy interventions, without much donor support, and yet poverty in rural areas remains widespread, suggests that the issue is whether further minimalist-type frontier extension efforts are warranted. It would seem rather that other interventions will be required to enable the poor, the vast majority of whom are currently being served by at least one formal or quasi-formal financial organization, to improve their situations, including through better utilization of financial services. Meanwhile, on the financial intermediation side, efforts will be required to shore up and strengthen the financial viability of those organizations which are now reaching the poor to ensure the continued availability of their services. In design and evaluation, this concern as to whether minimalist programs improve the situations of the poor is reflected in the classic concerns about "benefits" - how to measure and attribute them and, in the language of US domestic programs, whether to focus on results (e.g., numbers of borrowers and depositors and the average size of loans) (the US lobbying group which pushed the USAID's microenterprise "initiative" called itself Results, Inc.) or impacts (e.g., changes at enterprise or family household level). While earlier, subsidized and targeted credit programs did not serve the poor (the Adams, Graham and von Pischke volume was entitled "undermining rural development with cheap credit"),[8] it remains largely unproven that the minimalist programs will be more effective.

Scaling up NGOs to become financial organizations. One of USAID/Washington's particular interest's seems to be the potential of scaling up NGOs to be finance institutions. The rationale argument for such scaling up is that expansion would take advantage of economies of scale and scope which would make for the financial viability of organizations serving the poor. However, there is much skepticism on this point given the paucity of empirical successes of NGOs as financial organizations. The interest in scaling up NGOs seems to have emerged from several sources. One is the lack of success with earlier subsidized, targeted credit programs through banks and development finance institutions in serving small farmers and small entrepreneurs and their harmful effects on the financial system. However, the reasons for these failures have been identified and corrected in many countries at the policy and organizational levels and, many argue, the environment is now hospitable to working again in many countries with formal financial institutions to provide services to the poor. Secondly, the interest in scaling up NGOs is based largely on the Latin American experience with NGO operated urban microenterprise programs and their lack of success in "graduating" their clients to mainstream financial institutions. It may be that in many instances there was a generally hostile formal environment for microenterprises which established barriers to graduation; however, it is also clear that many programs in their design and implementation did not encourage graduation, which in any event would have required the better clients to leave the programs, thus perhaps weakening the programs drive to financial sustainability. One sees a similar dynamic in incubator programs

[8]Dale W. Adams, Douglas Graham and J.D. Von Pischke, eds., *Undermining Rural Development with Cheap Credit*, (Boulder, Colorado: Westview, 1984).

in the US; unless the state or other organization has a firm policy on each participant leaving the subsidized incubator after a stipulated number of years, the incubator operators attempt to retain the better businesses and replace the weaker ones. NGOs that have scaled up and become (perhaps) financially viable (BancoSol) seem no longer to be NGOs. Grameen Bank is not financially viable as a bank. Once NGOs stop being grassroots oriented, that is once they scale up to be the national programs that some are suggesting is a useful objective, they risk weakening their competitive advantage (over the state) in providing certain public good type services. There is also the burning issue of prudential regulation once an NGO stops depending on donors or commercial banks but rather takes deposits and starts using "other people's money" (Vogel). NGOs are institutional mechanisms to address market and governmental failures and to generate and provide information. However, they do not participate in payments system and do not diversify risk, two key functions of financial system. Many NGOs are small and first generation leadership driven, and there has not been much experience with transitions to new leadership of successful, minimalist finance type NGOs. Finally, in Sri Lanka, with the wide extension of formal financial intermediation which has been achieved, the question would be whether further development of financial (rather than enterprise or social) intermediation through NGOs would be catalytic and enabling, or merely additive.

Financial organization alternatives to scaling up NGOs. The alternatives to scaling up NGOs remain to link or graduate clients upwards (i.e., make clients of an extension service or an NGO into clients of financial institutions, which in turn are dependent on local deposits over wide area and many sectors), to establish parallel "targeted" financial organizations, or to downgrade the services of the formal financial institutions. In Sri Lanka, much can be learned (which may be of much interest to those developing programs in other countries) from the on-going efforts to strengthen the linkages between enterprise, social and financial intermediation and, secondly, from the efforts of the many existing financial institutions to reach the poor. These two approaches can also be strengthened. As for the other option (establishing parallel financial organizations), it does not immediately appear as a needed approach.

The current political incorrectness of working with state and private banks. There is some concern that it is not very politically acceptable (in the US) for USAID microenterprise programs to work with state and private banks. The concern is somewhat surprising as it is the program of a state bank (BRI) which represents perhaps the best performing microfinance institutional model to date and USAID's long-term technical assistance support contributed to its development. The existence of this political correctness concern emerges not so much from documents (the USAID microenterprise initiative formally is very inclusive in this regard) but rather from the comments of participants during the conference. Part of the background would seem to be that certain NGOs, including those associated with the minimalist approach, were instrumental in generating political support in Congress for USAID's microenterprise initiative and that in some amorphous way continued strong political support for USAID may require some adherence to NGO-based, minimalist strategies as the main approach of the initiative. On the other hand, success in the field will clearly require adopting a very contextual approach adopted to local institutional and cultural contexts. In Sri Lanka, where state and quasi-state financial institutions, rather than NGOs, provide rather massive access to savings and credit services but financial sustainability is weak, this may be an important issue. For instance, the People's Bank and Bank of Ceylon, both state banks, have extensive rural branch networks and other schemes for serving the poor. The regional rural development banks set up under the Central Bank, have extensive network and are applying innovative approaches. The cooperative rural banks alone, with more than 1,000 branches, 3.8 million depositors, and 0.8 million borrowers, already have achieved more outreach than BRI in Indonesia or Grameen in Bangladesh, and perhaps four times more than Sanasa in Sri Lanka. They are under the multipurpose cooperatives (quasi-state institutions?) and bank with People's Bank (a state bank). Would it be politically correct for USAID to work with them, to improve the sustainability of their services which have already been "downgraded" to reach the poor, given also that development towards full financial sustainability requires a long term commitment? If savings are the main financial service for the poor, see next issue, what role should NGOs, which are not deposit takers, play? There are also other financial services which microenterprises require, such as the payments system, which may be equally important as credit and which the formal financial system is usually strongly positioned to perform.

Savings - a service to the poor or a tool for achieving the financial viability of microenterprise finance programs? The old debates over credit first or deposits first, over whether credit or savings services were more needed by the poor, seem to have been passed over. Now it is accepted that savings is a key, perhaps the key, formal financial service to be provided to the poor. If the challenge is to make the poor creditworthy, deposit mobilization is the key. However, there is no consensus on the role savings should play in a microenterprise finance program. Grameen requires savings by its borrowers; BRI does not. NGOs do not take deposits; if they do, they would need to be regulated. One aspect is whether to view deposit taking as a service or, alternatively, as an instrument to achieve financial viability and leverage. An increase in deposits is sometimes not an increase in savings, but part of the process of monetization (with the benefits and risk thereof) and a shift in the type of savings instruments used.

How important is the policy framework for the success of microenterprise finance programs?. For a few, the importance which has been ascribed to the policy framework as a pre-condition to successful microenterprise finance programs has been overdone. They now suggest that it is possible to have successful microenterprise financial programs in the midst of a not very conducive policy environment. I am not certain that I captured this part of the discussion correctly. Certainly it was surprising to hear that policy is not so important. I suppose that a case could be made - e.g., as formal finance institutions extend the frontiers into formerly informal finance territory, they will adopt approaches which compete with, perhaps even mimic, informal finance approaches. And as informal finance uses measures which succeed in most policy contexts, adopting even to hyperinflation, one can posit that the frontier expanding microfinance programs will do the same. Secondly, policy contexts are always shifting, responding to changes in leaders, ideas, technology, governments, the external environment, etc. Successful financial institutions learn how to weather ups and downs in the policy environment and presumably successful microenterprise financial institutions will become similarly adept. Nonetheless, it seems to me, that starting and building a strong microenterprise financial organization under adverse policy conditions would not be an attractive programming opportunity, given that it would be such a problematic task and that there are currently many opportunities in which the policy environment is conducive.

Should microenterprise programs focus on individuals, households or enterprises? USAID's approach to microenterprise finance appears to focus sharply on individuals (often by gender) and enterprises (by size), although it was mentioned that impacts at family levels would be a subject of research. This seems to be a departure in emphasis from earlier or alternative approaches. Early approaches to small farmer credit and the non-farm informal sector included a focus on households. Von Pischke argues in calculating the amount of senior claims which a borrower will meet before making loan repayments, lenders at the "frontier" must consider the cash flow of a borrower's household, not simply the enterprise. Studies of informal finance have stressed the household unit and the role of family based businesses. Studies of risk spreading in rural societies have focused on the role played by extended family networks. Studies of peasant farms have stressed the notion of "labor farm" and of the family head being both head of the family and head of the family's multiple farm and non-farm enterprises, making decisions on (rational) criteria far removed from a simple one of profit maximizing. Students of poverty in the US stress the breakdown of family institutions as one of its distinguishing features. In Sri Lanka, self-employment and microenterprises are predominantly operated by the poor on a family basis; in the dry zone, there is often a direct, two way relationship between the continued intactness of the family farm unit and the survival of the non-farm enterprise units operated by family members. As microenterprise activities become more targeted (in the sense of sharper marketing research and segmentation), incorporating family institutions perspectives into their design and evaluation is likely to emerge as an issue critical to the success of many of the enterprises as well as of the programs themselves in terms of poverty alleviation and economic growth objectives. This will be an issue certainly in the rural areas in the dry zone, where non-farm microenterprises are usually not the primary enterprise of multiple enterprise farm families. The contextual factors seem to suggest that in terms of lending methodologies, what may be necessary, to achieve either or both financial sustainability and services for the poor, is a focus which includes the training of attention on households and families. For instance, this might entail "family character based" appraisals as rural informal finance often does in gauging ability and willingness to repay, rather than appraisals based on collateral and enterprise financial characteristics, as do formal finance, and on individual character, as do many of the better microenterprise finance programs. Certainly in rural areas, as formal and quasi-formal financial frontiers are extended, it may be very useful to include, along with analyses of interest rates, unit costs and loan sizes, a good dose of Polanyi and institutional economics. In Sri Lanka, with the wide spread of financial institutions and with overindebtedness reportedly a problem for many rural families, a household perspective would seem to be strongly warranted on the basis, at a minimum, of the "do no harm" argument.

Negative impacts of high interest rates charged by organizations targeting the poor while seeking financial sustainability. A third issue in cases in which there is little competition and the minimalist credit programs charge high interest rates to cover their (too high) costs, is whether donor support for such programs may not be imposing the costs of monopoly on the poor. There is also a concern that too high rates will lead to adverse selection, skewing lending toward higher risk borrowers and thus causing higher financial losses for the organizations.

Lack of priority accorded to financial services for the poor. Following the conference on financial services for the poor was a conference on sequencing financial sector development. In the discussions on financial sector development, a concern was to prioritize actions to develop and improve the functioning of the financial system. Other than somewhat indirectly in a presentation by Gonzalez-Vega, extending the frontier of formal finance to serve more clients, including microenterprises and the poor, was not raised as one of the many matters to be attended to on a priority basis.

Annex I

Financial Services and the Poor: U.S. and Developing Country Experiences

The Brookings Institution
1775 Massachusetts Avenue, N.W.
Washington, D.C.
September 28-30, 1994

Sponsored by the United States Agency for International Development
Through the Financial Sector Development Project (FSDP II)

AGENDA

Wednesday
September 28, 1994

8:00 a.m.	Registration and Continental Breakfast
9:00 a.m. Auditorium The Brookings Institution 1775 Massachusetts Avenue, N.W.	**Introductory Session and Welcome** ❖ *Bruce K. MacLaury, President, The Brookings Institution* ❖ *Russell D. Anderson, Director, Emerging Markets, USAID* ❖ *Darwin Johnson, Managing Partner, The Policy Economics Group, KPMG Peat Marwick*
9:20 a.m.	**Do Financial Institutions Have a Role in Assisting the Poor?** ❖ *Claudio Gonzalez-Vega, Ohio State University*
10:10 a.m. Main Lounge	Coffee Break
10:30 a.m.	**Panel: Large Financial Institutions and the Poor** ❖ *David O'Connor, Chairman, Internet, Inc.* ❖ *Marguerite Robinson, Harvard Institute for International Development (HIID)* ❖ *Joan Hubbard, Consultant, Canadian International Development Agency (CIDA)*
	Discussion Period
12:15 p.m. Room 105	Luncheon

Wednesday
September 28, 1994 - continued

1:30 p.m. Auditorium	**Panel: U.S. Experience in Directing Credit to the Poor Under CRA** ❖ *Allen J. Fishbein, General Counsel, Center for Community Change, Washington, D.C.* ❖ *Kate Barr, Senior Vice President, Riverside National Bank, Minneapolis* ❖ *Martin Mayer, Guest Scholar, The Brookings Institution* Discussion Period
3:15 p.m. Main Lounge	Coffee Break
3:45 p.m.	**Panel: Small Scale Providers of Financial Services to the Poor: The Role of Non-Governmental Organizations (NGOs)** ❖ *Thomas Carroll, George Washington University* ❖ *Maria Otero, Associate Director, ACCION* Discussion Period
5:00 p.m.	Recess

Thursday
September 29, 1994

8:00 a.m.	Continental Breakfast
9:00 a.m. Auditorium	**Panel: Serving the Poor Through Credit Unions** ❖ *Carol Aranjo, President, National Confederation of Community Development Credit Unions* ❖ *David Richardson, World Council of Credit Unions* Discussion Period
10:00 a.m. Main Lounge	Coffee Break
10:15 a.m.	**Panel: Donors' Perspectives on Financial Services for the Poor** ❖ *Lynn Bennett, The World Bank* ❖ *Mark Flaming, Inter-American Development Bank* ❖ *Rauno M. Zander, IFAD* ❖ *Elisabeth Rhyne, Director, Office of Microenterprise Development, USAID*
12:00 noon Room 105 and Main Lounge	**Luncheon**
1:00 p.m.	**Financial Services for the Poor and the AID Mandate** ❖ *Carol Lancaster, Deputy Administrator, USAID*
2:00 p.m.	**Panel: Informal Financial Services and the Poor** Chair: *Akhter Ahmed, International Food Policy Research Institute* ❖ *Otto Hospes, Agricultural University, The Netherlands* ❖ *Carlos Cuevas, Inter-American Development Bank* ❖ *Robert C. Vogel, IMCC* Discussion Period
3:30 p.m. Main Lounge	Coffee Break

Thursday
September 29, 1994 - continued

3:50 p.m. Auditorium	**Panel: Strategies and Guidelines for Donors** ❖ *Philip D. Berlin, Consultant; The World Bank (Retired)* ❖ *Matthew Gamser, Director, GEMINI, Development Alternatives, Inc.* ❖ *Dale W Adams, Ohio State University* ❖ *Reinhard H. Schmidt, University of Frankfurt and IPC* Discussion Period
5:30 p.m.	Reception
6:00 p.m.	Recess

Friday
September 30, 1994 - continued

1:30 p.m.	**Institutional Choice and Program Design** ❖ *Lynn Bennett, The World Bank and J.D. Von Pischke, The Policy Economics Group, KPMG Peat Marwick* ❖ *Forrest Cookson, Nathan Associates* ❖ *Jeffrey Poyo, Inter-American Development Bank* ❖ *Rodrigo Chaves, Ohio State University*
	Discussion Period
3:30 p.m. Main Lounge	Coffee Break
3:50 p.m. Auditorium	**Essentials for Sustainable Financial Services for the Poor** ❖ *Robert Christen*
4:45 p.m.	**Closing Remarks** ❖ *Bruce L.R. Smith, The Brookings Institution*
5:00 p.m.	Adjournment

MED/EIED PUBLICATIONS AVAILABLE

Local Market for Pickled Products (December 1990)

Non Farm Small Scale Enterprise Credit on Selected Mahaweli Systems, Geoffrey Peters and M.W. Panditha (December 1990)

Crop Profiles - Spices, Herbs and Aromatics, L. Denzil Phillips (July 1991)

Study of the Tourism Development in the Uda Walawe (July 1991)

Potential for Silver Skin Onions in the Mahaweli, Walter Nueberg (August 1991)

Nursery Development of Papaya and Mango, Papaya Growers' Guide and Technical Notes for Business Plan for Mixed Fruit Cultivation Investment, Ben Hatfield (November 1991)

Dehydrated Fruit Processing Opportunities and Trends in Sri Lanka, Wanchai Somchit, (November 1991)

An Evaluation of the Entrepreneur Development Programmes, Dr. Susan Exo and Hina Shah, (December 1991)

Aromatics PIP Interim Report on Trials Establishment, Dr Thomas Davies (December 1991)

Agro-Business Financing Review, Dennis De Santis (December 1991)

Integrated Fruit Drying, juicing, Pulping project - Prep Feasibility Study, Michael Smedley, Ben Hatfield and Wanchai Somchit (December 1991)

Cold Chain Requirements for Uda Walawe, Fredrick E. Henry (March 1992)

Field Manual for Processing Tomatoes, Peter Florance (March 1992)

Processing Tomato Trials in Mahaweli System H, Peter Florance (March 1992)

Processing Tomato Trials in Mahaweli System C, Peter Florance (March 1992)

Dried Fruit Processing in the Mahaweli, Dr. Kamal Hyder (September 1992)

Feasibility Study on Commercial Potential of Snake Venoms in Mahaweli Systems. Anslem de Silva, (January 1993)

Census of Mahaweli Enterprises and Employment (January 1993)

Most publications are priced at Rs.100/-. The publications are available at the MED Office at 8th Floor, Unity Plaza, Colombo 4. (inquiries, Ph. 508682-4)

An EIED publication entitled - "Information Available for the Mahaweli Investor", is also available at the MED Office.