

**Focus Note No. 5, December 1996**

## **Financial Sustainability, Targeting the Poorest, and Income Impact: Are There Trade-offs for Micro-finance Institutions?**

Can micro-finance institutions (MFIs) achieve financial sustainability and reach the poorest of the poor? What are the tradeoffs in pursuing these two goals simultaneously? These are among the key questions addressed by David Hulme and Paul Mosley in their recent book, *Finance Against Poverty* (London: Routledge, 1996). The findings of this book has sparked a lot of discussion among micro-finance specialists. The objective of this Note is to bring these findings to a wider readership. It is not a review of the book and should not be considered as such.

Professors Hulme and Mosley examined 13 MFIs in seven countries, all poverty-reducing in intention and all using slightly different combinations of design features. The purpose of the study was to understand the influence of the institutions' design, management and policy environments on financial sustainability and on various measures of impact, including poverty. The authors compared the change in each impact variable over the period 1989-1993 in a random sample of 150 borrowers with the change in that variable in a control group of 150 non-borrowers whose incomes, asset holdings, and access to infrastructure were similar to the borrower group's. This Note describes the results of their study.

### **Financial Sustainability and Best Practice**

Table 1 ([link to table](#)) shows both financial performance and poverty impact results of the MFIs studied. The institutions with high financial sustainability (Group A) have lower arrears rates and subsidy dependence indices than those with lower sustainability (Group B). Moreover, financial sustainability appears to correlate with recognized "best practice" design features such as higher interest rates, the availability of voluntary savings facilities, the frequency of loan collection, and the existence of material incentives to borrowers and lending staff to maximize repayment.

### **Financial Sustainability and Poverty Reduction**

The relationship between financial sustainability and poverty reduction is more ambiguous. Group A institutions, taken as a whole, produce more income impact than Group B institutions. However, the proportion of clients under the poverty line ranges dramatically from 7 percent at BRI (Group A) and Malawi Saca 9 (Group B) to the "vast majority" in the Bangladesh organizations (Group A). Group A institutions do not target poorer clients than Group B institutions.

Figure 1 provides more insight into the relationship between financial sustainability and poverty reduction. Three conclusions can be drawn from Figure 1:

For each of the five institutions for which data exist, program impact increases, at a decreasing rate, with client income. In other words, borrower households above or on the poverty line experience a higher average income impact than households below the poverty line, in comparison to income changes encountered by a control group. For the very poor, loan impacts are, on average, small or negative in comparison to the control group, although there are some important exceptions to this rule which deserve further study<sup>1</sup>. The impact curves for Group A institutions lie consistently above the curves for Group B institutions, suggesting that it may be possible to increase average program impact by adopting best practice features that increase financial sustainability.

Table 1: Overview of 13 Micro-finance Institutions

									Average increase in borrower income as % of control group	
	Number of borrowers (1991)	Real interest rates (%) (1992)	Subsidy dependence index	6-month arrears rate (1992)	Voluntary savings	Frequency of loan collection <sup>1</sup>	Incentives to repay <sup>2</sup>	Proportion of borrowers below poverty line (%)	Whole Sample	Individuals Below Poverty line only
<b>GROUP A</b>										
Bolivia BancoSol	51,000	45	135	0.6	Y	M	1	29	270	101
Indonesia BRI unit desa	1,800,000	6	9	3.0	Y	W	2	7	544	112
Indonesia BKK	499,000	60	32	2.1	Y	W	2	38	216	110
Indonesia KURK	158,000	60	35	13.7	Y	W	2	29		
Bangladesh Grameen Bank	1,050,000	15	142	4.5	N	W	1	vast majority	131	126
Bangladesh BRAC	598,000	11	199	3.0	N	W	1	vast majority	143	134
Bangladesh TRDEP	25,000		199	0.0	N	W	1	vast majority	138	133
Sri Lanka PTCCs	702,000	11	226	4.0	Y	M	1	52	157	123
Kenya KREP Juhudi	2,400	9	217	8.9	Y	W	1		133	103
<b>Average Group A</b>	<b>542,822</b>	<b>27.1</b>	<b>132.7</b>	<b>4.4</b>					<b>216.5</b>	<b>117.8</b>
<b>GROUP B</b>										
India RRBs	12,000,000	3.0	133	42.0	Y	A	0	44	202	133
Kenya KIE-ISP	1,700	-1.0	267	20.2	N	M	0	0	125	

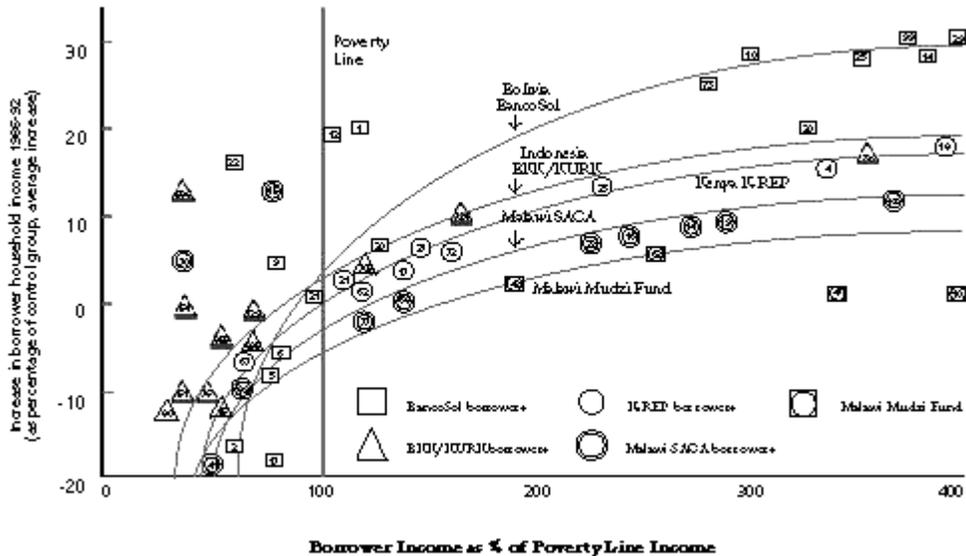
Malawi Mudzi Fund	223	8.0	1884	43.4	N	W	1	vast majority	117	101
Malawi SACA	400,062	7.0	398	27.8	N	A	0	7	175	103
<b>Average Group B</b>	<b>3,100,496</b>	<b>4.3</b>	<b>670.5</b>	<b>33.4</b>					<b>154.8</b>	<b>112.3</b>

\*Year prior to survey

<sup>1</sup>*Repayment Intervals*: M= monthly, W= weekly, A= annually

<sup>2</sup>*Incentives to repay*: 0= none, 1= larger repeat loans only available if repayment performance satisfactory, 2= as 1, plus staff pay and borrower interest rates related to repayment performance.

**Figure 1: Loan Impact in Relation to Borrower Income: Within-Scheme Data**



Note: Only a few specimen data points are indicated. Full data arrays are available from the authors upon request.

**Why Do Less Poor Borrowers Receive More Income Impact? -- Protection vs. Promotion**

The authors maintain that higher-income borrowers experience a greater income impact because clients above the poverty line are willing to take risks and invest in technology for "promotional" activities more likely to increase income flows. Very poor borrowers, on the other hand, tend to take out small, subsistence-protecting loans and seldom invest in new technology, fixed capital, or hiring of labor (Table 2). These loans do not tend to produce dramatic changes in borrower income and in some cases can even lower income possibilities by plunging the borrower deeper into debt.

**Table 2: Five Borrowers Samples**  
Loan use per \$100 borrowed by income category (1993)

Loan Use	Household Income category	
	Less than 80% of Poverty Line	Higher than 80% of Poverty Line
Consumption	69	14
Purchase of Working Capital	15	30
Hiring of Labor Outside the Household	5	12
Purchase of Fixed Capital not Embodying New Technology	10	32
Purchase of Fixed Capital Embodying New Technology	6	12
Average Loan Size	59	143

Despite the overall tendency of better-off clients to enjoy larger income impacts from microcredit, some borrowers below the poverty line achieved substantial increases in income from their loans. Preliminary analysis of the "outliers" indicates that these particular poor clients borrowed for relatively low-risk capital investments such as small irrigation, high-yielding seeds in

rained areas, and new carpet-weaving looms.

### **Why do Financially Sustainable Institutions Produce Better Income Impact?**

The impact curves in Figure 1 for the three Group A institutions (BancoSol, BKK and K-REP) lie above those for the institutions with worse financial performance, suggesting that institutions adopting micro-finance "best practice" features can achieve more impact. The authors put forth a number of possible explanations for how these features enable clients with the potential to generate higher rates of return to self-select themselves into a program:

1. The higher interest rates charged by financially sustainable institutions screen out borrowers whose projects have relatively low rates of return;
2. Financially sustainable institutions tend to operate voluntary or compulsory savings schemes, and willingness to save screens out the same borrowers as 1) and provides borrowing households with a limited degree of insurance should projects not yield the expected level of return;
3. The provision of banking services close to the customers' place of business or residence lowers transactions costs to borrowers, thus raising their rate of return; and
4. The fact that loan instalments are collected regularly tends to deter borrowers with low rates of return.

### **Assessing the Trade-off**

What are the implications of Hulme and Mosley's findings for MFIs? First, MFIs are likely to produce a higher average income impact by focusing their lending on borrowers just above the poverty line who demand "promotional" loans. Second, appropriate institutional reforms to bring the micro-finance institution in line with accepted best practice design features (cost-recovery interest rates, savings and insurance facilities, intensive collection of loan instalments and incentives to repay) may make it possible to increase poverty impact and increase financial viability at the same time.

In addition to adopting best practice design features, the researchers suggest two other recommendations for MFIs interested in deepening their outreach to very poor people. First, a financial product tailored to the requirements of the poor will increase their successful uptake of financial services. These products include appropriate savings facilities and small emergency loans for consumption. Second, MFIs could charge higher interest rates on smaller loans, thus altering the incentive system that systematically works against relatively high-cost smaller loans.

This note draws from the book by David Hulme and Paul Mosley, *Finance Against Poverty* (London: Routledge, 1996). It was prepared by Paul Mosley, Professor of Economics, University of Reading and Brigit Helms, Rural Development Specialist, CGAP Secretariat.

<sup>1</sup>These exceptions are represented as "outliers" in Figure 1, to the left of the poverty line and above the impact curves.