

Ensuring Impact

**Reaching the Poorest while Building Financially Self-Sufficient
Institutions, and Showing Improvement in the Lives of the
Poorest Women and their Families**

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INTRODUCTION: Eradicating Poverty

A) Overview

This paper is about microfinance and its contribution to the eradication of poverty for millions of the world's poorest people. It also recognises that microfinance is not a panacea and that expectations should not be built up so high that it is bound to fail. Microfinance is reaching and impacting on millions of poor people, predominantly women, but the boundaries of who microfinance can reach, and in what ways, have still to be explored. Many millions more can benefit. It is not the poverty level of potential clients that determines access and impact, but the design of the services provided. Not all people need microfinance, but most groups can benefit.

The Millennium Development Goals, arising from the United Nations Millennium Summit, set a critical challenge of halving absolute poverty in the world by 2015.¹ Governments and donors around the world responded with plans to work towards the realisation of these goals. Given the success of the microfinance industry in reducing the poverty of millions of people, it is surprising that there has not been a greater focus on microfinance in the Millennium Development strategies developed by donors². In this paper I present evidence of the important contribution of microfinance to the eradication of poverty, particularly through the empowerment of poor people to choose when and how to access other development services such as health and education, and reduction in vulnerability. Donors should be investing in poverty-focused microfinance as a key element in their strategies to achieve their Millennium commitments.

As the Microcredit Summit campaign passes its half-way point, it moves on from promoting the goal of sustainable microfinance that results in significant positive change in the lives of the poorest women, to reviewing the evidence of its efforts and concluding that these objectives are more than worthy aims - they are being achieved by organisations around the world.

Defining poverty: A note on terminology

There are a number of definitions of the concept of poverty and how this should be measured. Sebstad and Cohen (2000) separate those living above and below the poverty line – poor and non-poor. The category of poor are further divided into *destitute* (bottom 10% below the poverty-line), *extreme poor* (those in the bottom 10 to 50 percentile of households below the poverty line), and *moderate poor* (the top 50% of households living below the poverty line). A further category of *vulnerable non-poor* is also recognised.

In this paper I look broadly at poverty, but I focus particularly on those people living below half the national poverty line or living on less than US\$1 per day. This group, which includes the extreme poor and destitute, is defined by the Microcredit Summit as the *poorest* and by the Consultative Group to Assist the Poorest (CGAP) as *very poor*. I use both terms, choosing the term *poorest* to emphasise the need not to automatically exclude anyone from microfinance - even the poorest person.

B) Goals and Structure of the Paper

This paper draws on a range of literature and experience. Two case-studies illustrate and support the ideas and arguments presented, but the paper is based on wider influences and learning from the larger microfinance field. My aim is to frame key questions, to explore and challenge conventional wisdom, and perhaps most importantly to suggest practical and promising ways forward. Given the scale of this

task it is not possible to discuss many issues in as much detail as might be desired, nor to present the supporting evidence in full. Three core pieces of work have been used to support this paper, and readers are referred to these for more detailed evidence and discussion -

- Two case-studies prepared by Alice Walter analyse the available data on the case-study organisations SHARE and CRECER.³ These include for each organisation, a poverty assessment, an impact assessment and a rating. No primary research was conducted for this paper. The case-studies provide clear evidence for performance in poverty outreach, impact and financial performance, as well as some details of how each organisation has succeeded in achieving these goals, and in balancing the different priorities and challenges that necessarily face a poverty-focused microfinance institution (MFI).
- A comprehensive literature review of microfinance and poverty reduction was prepared by Morduch and Haley in November 2001. This provides compelling evidence for the impact of microfinance on six out of seven of the Millennium goals to halve absolute poverty, through its impact on income poverty and vulnerability, and to a lesser degree through impacts on health, nutrition and schooling. The review concludes there is strong evidence that microfinance can be effective for a broad group of clients, including the very poor or poorest. It also concludes that financial performance of poverty-targeted MFIs can be comparable to those that do not reach the poorest.
- A study by the AIMS⁴ project prepared for the World Development Report 2000/2001 looks at microfinance, risk management and poverty (Sebstad and Cohen, 2000). It examines non-income dimensions of poverty, focusing on the impacts of microfinance on risk, vulnerability and assets, in helping to protect against risk ahead of time, and managing losses following a shock or economic stress event. This analysis provides great insight into the mechanisms by which the services offered by MFIs relate to poor people's lives. It is important both in broadening the scope of the consideration of impacts beyond income poverty, and in terms of the implications on the design and delivery of microfinance services.

This paper is divided into three parts:

- **Part One: Evidence for Sustainable Microfinance for the Poorest**

The paper examines the evidence for sustainable microfinance reaching and impacting on very poor people, particularly women. It examines the challenges and limitations for the realisation of these goals. Evidence from two case-studies is cited to demonstrate that microfinance can reach very poor women (Section 2.0), that it can have a significant impact on their poverty levels (Section 3.0), and that it can be delivered by sustainable organisations (Section 4.0).

- **Part Two: Design and Delivery of Microfinance for the Poorest**

This part is a wide-ranging discussion on critical operational issues which determine the effectiveness of microfinance for the poorest. Section 5.0 looks at both the deliberate and inadvertent mechanisms that act to exclude the poorest, and suggests ways in which these can be overcome. Section 6.0 discusses how the effectiveness of microfinance in supporting income growth and reducing vulnerability can be improved, as an active and managed strategy. Central to this is to create a 'culture of impact and poverty' within MFIs.

- **Part Three: Implications for the Microfinance Industry**

This part draws conclusions and presents practical suggestions for practitioners and policy-makers. What should the industry realistically be striving for? How can information about performance and achievement of goals be collected and used? What role can donors and policy makers play in re-aligning the industry towards a greater focus on achieving positive impacts for very poor people?

C) The Success of the Microfinance Movement to Date⁵

The microfinance movement was founded on the belief that microfinance can be a powerful tool in combating poverty. The realisation of the Microcredit Summit Campaign's target of reaching 100 million of the world's poorest families with microcredit and other financial services offers a significant contribution to the Millennium Development goals.

To date, a successful microfinance industry has been built that is effective in reaching millions of poor people, in providing them with financial services and in reducing their poverty. Strong and replicable models of microfinance have been developed and adapted throughout the world, and implemented by increasingly professionalised and commercialised organisations. To achieve these goals practitioners have had to make many compromises and trade-offs. The imperative to develop viable and sustainable institutions has placed great pressure on organisational productivity and efficiency, but this has had to be balanced against social objectives. The goal of combating poverty in the most effective way has also necessarily been compromised, as it is clear that MFIs seeking to become financially sustainable cannot spend the time and resources with clients that more holistic development organisations might. Nevertheless, the achievements in terms of financial performance and impact on poverty have been impressive.

In this paper I take the position that microfinance has been too cautious and that the compromise has been too much on the side of financial and institutional performance, and not enough on the possibilities for maximising poverty impact and client performance. The microfinance industry has demonstrated what can be achieved; it has not demonstrated what cannot be achieved. The fact that most MFIs do not reach large numbers of very poor people does not mean that they cannot reach them, or that very poor people cannot benefit. It is now time to innovate and design microfinance services that maintain the high standards of financial performance, but which set new standards in poverty impact. There are costs and benefits in working with very poor clients, and the challenge is to push the frontiers of microfinance so that it better serves its developmental goals.

Microfinance has tended to exclude those that cannot use the 'one-size-fits-all' services provided. The services that have been developed tend to meet the needs of a particular segment of the client market, and have led to the exclusion of those that cannot use or pay for these services. Increasingly it is being recognised that the poor are not an homogenous group and that products and their delivery need to be better tailored to the needs of different groups of clients. Organisations need to be more flexible and to provide services that are appropriate for a range of client markets, not just the 'middle poor'. In doing so they expand the scope of their market. Services that are better tailored to the needs of clients, lead to better performance and sustainability amongst clients, which in turn will lead to higher performance and sustainability for the MFI. This is a time of opportunity, and a time for a renewed commitment to developing services that reach a much greater range of clients, including the very poor.

"Like many other development tools [microfinance] has insufficiently penetrated the poorer strata of society. The poorest form the vast majority of those without access to primary health care and basic education; similarly, they are the majority of those without access to microfinance." (Morduch and Haley, 2001, p.1)

A symbolic milestone has been reached in the recent announcement of *Grameen II* (Yunus, 2002). This new approach of the Grameen Bank learns lessons from 25 years of practice, and recognises that the previous model incorporated a number of elements that limited the ability of many potential clients to benefit, particularly the poorest sections of the community. Grameen II emphasises the need to focus on the poorest in order to be able to serve their needs. Central to the new model is increased flexibility of products to allow for loans and savings services to fit better with client livelihoods and experience.

D) The Case-study Organisations

CRECER, Bolivia (Village Banking model with *Credit with Education*)⁶

CRECER provides integrated financial and educational services to very poor women and their families in the rural and marginal urban areas of Bolivia, in order to support their autonomous actions to improve their health, nutrition and family income. Two thirds of the population live below the national poverty line in Bolivia. As of December 2001, CRECER had 30,989 total members in approximately 1,700 village banks, in 5 of Bolivia's 9 departments.

CRECER's methodology follows the village bank model, with self-selected solidarity groups of five to eight women forming village banks of 15 to 30. Loans are made to the village bank and then distributed to members. Loan sizes are small (starting at Bs.500/US\$71), and are made at an interest rate of 3.5% per month flat. No collateral is required, instead clients undertake to jointly guarantee each other. Local CRECER staff, called promoters, visit each village bank for their weekly or bi-weekly meeting, at which the members make repayments of interest and principal in equal instalments over four to six months. These meetings are mandatory, and include an educational component in healthcare, nutrition, self-esteem and management of small businesses.

Loan use is registered for statistical purposes, but is the free choice of each member and CRECER does not carry out loan use checks or income generating capacity checks. Clients must maintain 10% to 15% of the loan amount on deposit, which can be withdrawn at the end of each cycle. No interest is paid on savings, but dividends from the internal account are paid based on a member's savings and external loan. Each village bank has an internal account, from which borrowers can also take loans, at a slightly higher interest rate, simultaneously to the program loan. The size and term of these loans is decided by the women themselves, but internal loans must be repaid before a program loan cycle can end.

SHARE, India (Grameen model)

SHARE Microfin Limited (SHARE)⁷ provides financial services to poor women in the state of Andhra Pradesh, India, for viable productive income-generating enterprises, to help them reduce their poverty and improve their quality of life. Thirty-five per cent of the population live below the national poverty line in India.⁸ As of March 2002, was working in 13 districts with 109,484 active clients in 21,897 centres.

SHARE implements a Grameen methodology, lending to poor women through groups of seven to eight which come together into centres of 35 to 40 members. SHARE's average loan size is approximately US\$85 and the interest rate is 20% per annum for loans repayable over 50 weeks. Screening of clients takes place through a means-based client profile format, and pre-lending training is followed by a Group Recognition Test to ensure that members have understood the program's rules and regulations. Various loan products are accessible to members.

Table 1. SHARE loan products

TYPE OF LOANS	DURATION	ELIGIBILITY
General Loan	One year (50 weeks)	From first year
Seasonal Loan	One Year (25-50 weeks)	From second year
Sanitary Loans	One Year (50 weeks)	From second year
Housing Loans	Four Years (200 weeks)	From third year
Supplementary Loans	Six months (25 weeks)	From first year after six months
Small Enterprise Loans	Two Years (100 weeks)	From first year

Savings, which were compulsory until 1999, are now voluntary, with members pledging to try to save a fixed amount per week into an offshoot savings cooperative. SHARE has access to a proportion of these savings, and interest is paid according to amount and term. SHARE has a culture of strict credit discipline and close supervision, emphasising the productive use of loans, and visiting clients to check their loan use. It focuses on financial services, and does not provide many client support services.

The following tables give basic information about each of the case-study MFIs with respect to their poverty outreach, impact and financial performance.

Table 2: Reaching the Poorest.

	CRECER	SHARE
% clients living at or below US\$1/day	41%	72.5%
% clients living below national poverty line	73%	60%
% of entering clients poorest third	38.6%	58%
% of entering clients middle third	39.6%	38.5%
% of entering clients least poor third	21.8%	3.5%
% of clients women	99	100
Poverty focus: Design, Geography, Targeting, Screening, Motivation, Culture of organisation	D, G, M, C	D, T, M, C
Average loan size	US\$128	US\$85

Table 3: Impact.

	CRECER	SHARE
% all clients experience reduction in economic poverty	66%	76%
% very poor clients experience reduction in economic poverty	Not available	89%
% client experiencing increase in savings	86%	84%
Drop-out rate for very poor	Not available	Lower than overall rate
Overall drop-out rate	Not available	17%

Table 4: Financial Performance – FY2001 (*March 2002)

	CRECER	SHARE
Date of establishment	1990 (as MFI)	1990 (SHARE Microfin Ltd from 1992)
Rating	Investment grade	Investment grade
No. clients	30,989	*109,484
No. of staff	139	*688
Staff productivity (clients per loan officer)	223	343
Portfolio at risk (>30 days)	0.26%	*Nil
Outstanding loan portfolio (US\$)	3,979,737	*6,280,076
Operational self-sufficiency	102%	*105%
Financial self-sufficiency	100%	*100%
Cost per unit of money lent	0.17	0.07
Return on avg performing assets	1%	30%
Administrative efficiency	39%	25%
Financial cost ratio ⁹	4.65%	7.9%

PART ONE: Evidence for sustainable microfinance for the poorest

1.0 Introduction: Banking the Unbankable

The microcredit¹⁰ movement started with the vision that ‘the poor are bankable’. Conventional wisdom - as expressed by the formal banking sector and many in the donor community - told us that poor people (let alone the poorest) could not use credit, and even if they could, the costs of providing credit to them would be prohibitively high. Therefore it would be foolhardy to try, as poor people were bound to fail to use the credit well and would be bad risks.

Some years on we have witnessed a revolution. Millions of poor people now have access to credit and other financial services, and there is no doubt that these services can be delivered in a financially sustainable way, and that they are effectively used. The conviction and innovation of the industry has proved the sceptics wrong.

Now, ironically, we hear the former ‘conventional wisdom’ being repeated in terms of the poorest – ie. that they are unbankable. Very poor people cannot use credit, and even if they could, the costs of providing credit to them would be prohibitively high. Therefore it would be foolhardy to try, as very poor people are bound to fail to use the credit well and would be bad risks.

There is a lack of progress in reaching the poorest, which is leading many to conclude that microfinance cannot reach the very poor or is not an appropriate intervention for most very poor people. For example, the UK’s Department for International Development (DfID), despite a mandate to working with the poorest, seems to demonstrate a lack of commitment to the use of microcredit in its poverty reduction strategy.

“International microfinance experience indicates that microcredit is not a suitable tool to assist the chronically poor. Instead, savings can assist them to ride out crises by strengthening their economic security. In Russia, MFIs are currently not able to mobilise savings, thus, this option for assisting the poorest, DfID’s primary target group, is currently not an option.” (Maximising the Outreach of Microfinance in Russia. Research and Impact Assessment; Terms of Reference for FORA. DfID, 2001)

Like the conventional wisdom of the bankers, this message is based on perceptions rather than evidence. There is no evidence to say that *in general* the poorest are unbankable. The ‘failures’ of MFIs to reach very poor clients result not from failure of the very poor to benefit from microfinance, but from failures to design programs to meet their needs.

This paper is written with the conviction, based on evidence from two case-study MFIs and experience from many more, that the poorest are bankable. The limiting factor is not the potential of very poor clients, but the ability of microfinance organisations to deliver the right services, in a manner that is cost-effective, and can lead to sustainable organisations and sustainable long-term changes in clients’ lives. The microfinance industry needs to rise to this challenge rather than concluding that ‘because the poorest are not being reached, this means they cannot be reached’.

Part one of this paper examines this challenge in three parts:

- Section 2.0 focuses on the practical challenge of identifying large numbers of very poor clients.

- Section 3.0 looks at the role of microfinance in poverty alleviation and how effective microfinance can be in reducing poverty, and whether very poor clients generally benefit from participating.
- Section 4.0 examines the issue of financial self-sufficiency and whether a poverty focus is compatible with this aim.

2.0 The Challenge of Reaching the Poorest

2.1 Can MFIs reach very poor clients?

Microfinance does serve very poor clients, although in general they do not participate in large numbers (Morduch and Haley, 2001; Sebstad and Cohen, 2000). Although very poor people are present in most programs, the majority of clients are from the moderately poor and vulnerable non-poor categories, ie. those just below and above the poverty line. Evidence from poverty assessments conducted by the Consultative Group to Assist the Poorest (CGAP)¹¹ on a number of MFIs indicates that although all those surveyed were reaching some very poor clients (defined as those in the bottom third of the population), few were reaching large numbers from this group. Most MFIs were biased towards less-poor clients, or at best reflected the general population distribution.

The CGAP experience demonstrates that MFIs do not automatically reach large numbers of very poor clients by using conventional design features, such as small loan sizes. It is striking that of the organisations assessed, the four that have analysed and designed their programs to focus on the needs of the very poor are the only ones with significant depth of poverty outreach¹². Those that use active poverty targeting are especially effective in biasing their outreach towards the poor and very poor.

Two examples, the Small Enterprise Foundation (SEF) in South Africa and Caisses Feminines in Madagascar are particularly interesting. Both organisations have two programs, the first designed along the lines of conventional non-poverty focused wisdom, the second designed with the needs of the very poor explicitly in mind and with active poverty targeting. There is a remarkable contrast between the poverty profiles of these two programs, with both poverty-focused programs significantly biased towards the poor and very poor, and the non-targeted program biased towards the middle poor and non-poor. Figure one presents the results from a poverty assessment of SEF. The graphs demonstrate a huge gap in poverty outreach between TCP, which predominantly reaches the poorest people and has very few clients in the least poor third, and MCP which predominantly reaches clients from the least poor group and has few clients from amongst the poorest third.



Figure 1: Comparing poverty-focused (TCP) and mainstream microfinance programs (MCP) of the Small Enterprise Foundation, South Africa. (Source: van de Ruit et al.)

2.2 Reaching the Poorest: Evidence from the Case-studies

SHARE and CRECER work with the poorest clients by international, national and local definitions:

- By *international standards* 72.5% of SHARE and 41% of CRECER clients are living in *absolute* poverty, as defined by living below US\$1/ day (purchasing power parity).
- By *national standards* 60% of SHARE and 73% of CRECER clients live below their national poverty line.
- By *local standards* SHARE and CRECER reach the poorest people in the communities in which they operate. 58% of SHARE clients and 38.6% of CRECER clients are amongst the poorest third of people in their communities.
- SHARE and CRECER achieve very high *depth of outreach*. 32.5% of SHARE and 19.8% of CRECER clients are amongst the *poorest 20%* in their own communities.

2.2.1 Absolute or relative poverty?

Poverty outreach can be seen both in absolute and relative terms. Three levels can be defined:

- Those people who are very poor compared to their neighbours. The CGAP poverty assessment looks at the poverty level of *in-coming* clients and divides the population in an MFI's operational area into thirds, and defines the bottom-third as very poor, the middle as poor, and the top third as non-poor. This definition does not take into account the relative poverty of the MFI's operational areas compared to the rest of the country.
- Using a national definition of poverty, the poorest are defined as those people living at below half the national poverty line. This definition allows for accurate comparisons within a country, but does not capture how poor the country is on an international comparison.
- Internationally *absolute poverty* (the poorest) is defined as those living at or below US\$1/day per person (adjusted for the purchasing power of the local currency).

These definitions are important, since if we are to ask whether MFIs reach very poor clients, we need to understand how this is defined. In a poor country, such as Bangladesh, the majority of clients reached by MFIs are living below the international US\$/day absolute poverty line. However, this does not mean that they necessarily include large numbers of the poorest clients relative to national poverty. In a richer country national where the poverty line is higher in terms of US\$ levels, an MFI may be very successful in reaching some of the poorest people in terms of their local context, but this would not be reflected in US\$/day poverty definitions.

2.2.2 Poverty outreach compared to operational area and nationally

CRECER and SHARE are effective in reaching very poor clients relative to the national poverty-line and relative to the population in their operational areas. The CGAP poverty assessments and other poverty research demonstrates that they are reaching significant numbers of very poor clients, and are biased towards poorer clients when compared to the general population within the areas in which they work. Both organisations reach large numbers of clients from the poorest 20% of the communities in which they operate (SHARE – 32.5%; CRECER – 19.8%). Both organisations are working with large numbers of people below their countries national poverty line (SHARE – 60%; CRECER – 73%).

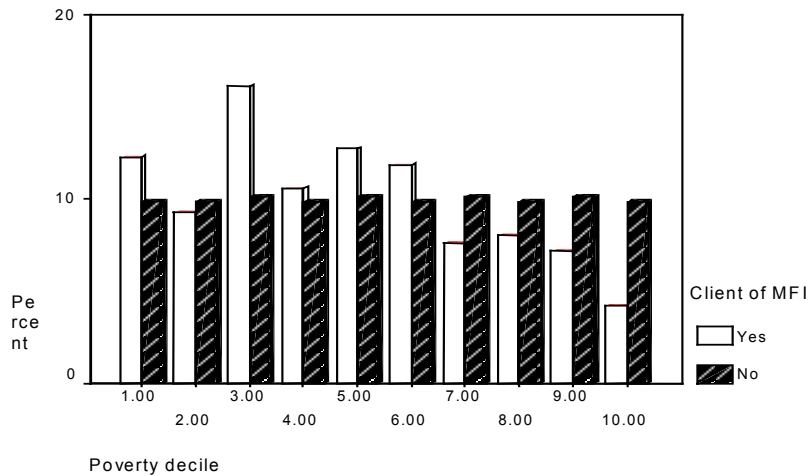


Figure 2: Poverty Outreach of CRECER

Figure two shows the profile of *incoming* CRECER clients compared to non-clients in CRECER’s operational areas. It demonstrates that CRECER has both an overall poverty-bias, and is effective at reaching the poorest. Whilst CRECER includes clients from the full range of poverty levels, it is striking that it reaches down to the poorest 10% of people in the communities in which it works, and is biased towards the very poor and moderately poor. Poverty indicators demonstrate that incoming CRECER clients are significantly worse-off than non-clients in terms of education levels, asset value, per person expenditure on clothes and shoes, and housing. CRECER uses geographic targeting, using a number of UNDP benchmark measures and indices and national statistics to identify the poorer Departments in the country. The CGAP poverty assessment found that “CRECER operations are consistently located in those more deprived areas, and in those *Departamentos* with the lowest Vulnerable Social Index.” (Jimenez, 2002, p13). Approximately 70-75% of CRECER clients live below the national poverty line. The national data combined, with the data on relative poverty outreach in CRECER’s operational areas confirm that CRECER is effective at targeting the poorest people in Bolivia.

CRECER has made a practical decision to work in both peri-urban and rural areas, even though rural areas are poorer, so as to allow for cross-subsidisation of more costly rural areas by more profitable peri-urban areas. Comparison of the poverty assessment results between these two areas demonstrates that CRECER reaches *relatively* poorer people in the peri-urban areas, although these clients in terms of *absolute* poverty are less-poor than those in the rural areas.

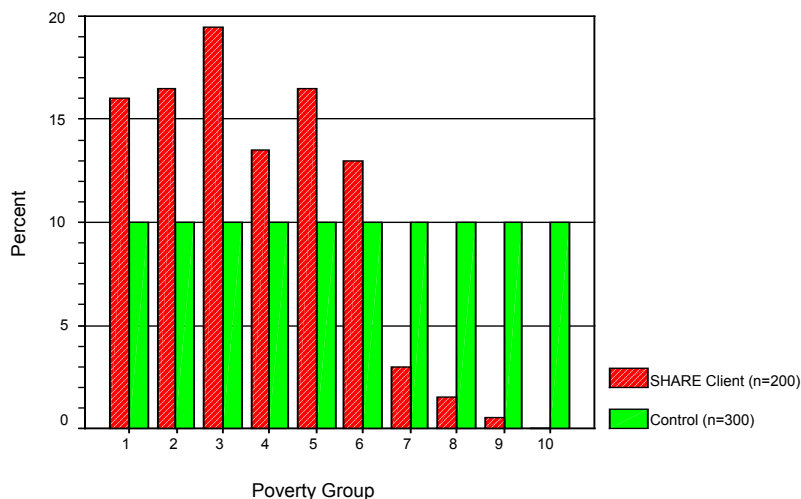


Figure 3: SHARE Poverty Assessment, breakdown of poverty levels by client group. (Source: CGAP analysis of poverty assessment data)

Figure three shows the same figures for SHARE. In this case there is a very strong pro-poor bias, with very few clients from the upper 40% of poverty levels, and high numbers of very poor clients right down to the poorest decile. Incoming SHARE clients display greater levels of poverty than non-clients in indicator-by-indicator comparisons relating to food security, quality of housing and asset ownership, consuming less meals, fewer luxury foods, owning less land, and living in poorer quality housing with less household goods. Only characteristics such as literacy rates and educational attainment are similar for both groups. SHARE clearly achieves significant outreach towards the very poor and moderately poor, with little inclusion of its non-target groups. Although SHARE is extremely effective at reaching the poorest people in its operational area it is notable that SHARE does not use geographic targeting to the same extent as CRECER. SHARE works in one of the poorer regions of India (the fifth poorest State), but does not implement a detailed process of identifying the poorest areas in which to work. This may explain the lower percentage of clients reached living below the national poverty line compared to CRECER.

2.2.3 Poverty outreach compared to national indicators

CRECER and SHARE reach large numbers of clients living in absolute poverty as defined by the international US\$ per day comparison (72.5% of SHARE and 41% of CRECER clients). These figures reflect the greater level of poverty overall in India compared to Bolivia. Thus whilst CRECER reaches a greater proportion of very poor clients according to national poverty line estimates, in terms of international comparisons, SHARE's proportion is much greater.

3.0 Impact: What Role for Microfinance in Poverty Eradication?

The previous section demonstrates that MFIs can bring very poor clients into their programs. But to achieve significant impact on poverty, inclusion is a necessary but insufficient goal. High levels of client drop-out, and the push to give larger loans to more successful clients, suggest that very often the poorest clients enter programs that are not designed specifically to meet their needs. In some cases this may not matter and very poor clients may succeed or fail in similar numbers to other participants. However, inappropriate services can result in very poor clients experiencing difficulties and not benefiting as much as other clients, or even experiencing negative impacts.

3.1 The case for poverty-focused microfinance

3.1.1 Why a market-based approach is inadequate

Many people in the microfinance industry adopt the 'financial systems approach' – ie. they see the primary goal of MFIs as developing strong institutions that can sustainably meet the needs of the market they choose to serve. They argue that the main test of success should be client demand for the service. If clients continue to take loans and deposit savings, then the market is demonstrating that there is value in the services being offered. Steps to limit access - through eligibility criteria or targeting - raise the cost of operations and distort the market. Instead microfinance can offer appropriate market-based approaches to deliver the right services to the right people. They argue that the increased costs incurred by poverty-focused MFIs undermine their financial performance, and result in services that are

inappropriate to the market needs. The very poor should be recipients of government or donor-funded development services, not microcredit.

These arguments have some logic, but viewed through a social rather than banking lens they break down. For a poverty alleviation objective, we need to look at how best to provide financial services to both poor and very poor clients in a sustainable way. Market-led approaches tend to serve the most profitable markets first. Thus the more easily accessible urban and peri-urban areas will be selected before the more remote rural areas; clients with previous business experience will be selected before those without experience; less-poor clients who can take relatively large loans will be selected before very poor clients who need very small loans.

It is not good enough to wait for the market to serve the poor and very poor. There is a strong case for poverty-focused microfinance that actively seeks to work with poor and very poor clients, that seeks to understand their needs and design services specifically for them, and which monitors and assesses the success of the programs in meeting these needs and reducing poverty. This is not to say that all microfinance should be implemented in this way, since there is clearly a strong case for achieving poverty reduction through working with the moderately poor and vulnerable non-poor (Sebstad and Cohen, 2000). But where poverty reduction is a key objective, design and monitoring of program outreach and impact should be central.

“Most MFIs have far to go in finding ways of reaching extremely poor households. Too often this is excused in statements such as ‘the very poor can only be benefited through welfare’ or that ‘program sustainability is incompatible with the inclusion of the very poor’. This possibly belies a lack of understanding of the dynamics of poverty and the opportunities that exist for the provision of financial services to the extremely poor. To date there has been inadequate exploration of financial products and low-cost service delivery mechanisms that would allow MFIs to include extremely poor households without compromising their sustainability objectives.” (Hickson, 2001, p67)

3.1.2 Is the impact of microfinance dependent on level of poverty?

From a developmental perspective many people view microfinance as inadequate on its own to combat poverty. Particularly prevalent is the view that *credit* is not an appropriate service for the poorest. Much of the work looking at risk and vulnerability points to the important role of savings and other financial services for the livelihoods of the very poor (Rutherford, 1999; Sebstad and Cohen, 2000; Wright, 1999). This work does not negate the role of credit, but redresses the past over-emphasis on credit. Unfortunately, it is often cited to support arguments that credit is inappropriate for the very poor, or that the needs of the very poor are separate from mainstream microcredit.

Robinson (2001, p21), for example, argues that savings are better able to reach poorer people than credit, and that the extreme poor, whom she defines as the majority of those below the poverty line, need subsidised poverty alleviation programs, not financial services (see Figure 5).

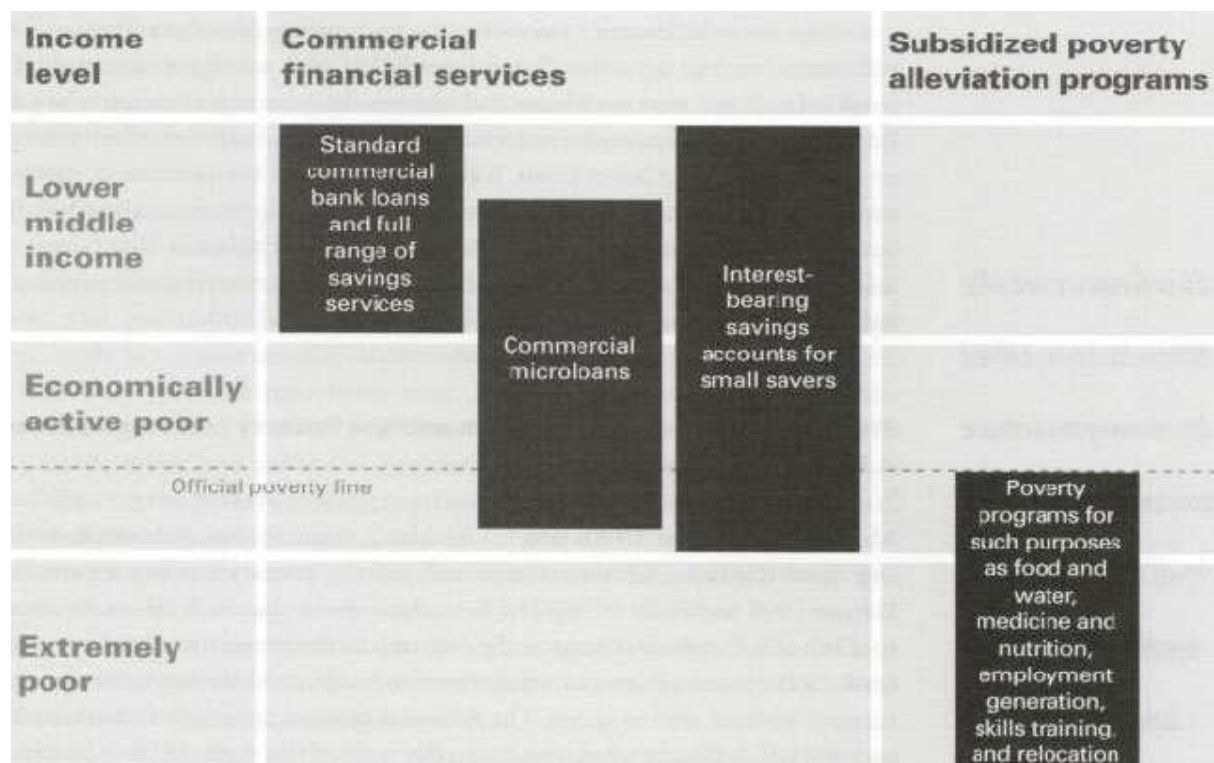


Figure 5: Poverty tool-kit (Reproduced from Robinson, 2001, p21)

In this paper I argue against this perspective and demonstrate that millions of people living below the poverty line and indeed below half the poverty line can and do effectively use credit, savings and other financial services. Both CRECER and SHARE, for example, are working with large numbers of clients in Robinson’s ‘extremely poor’ category. I take the position that the full range of financial services may or may not be appropriate for different people at different times. Poverty level is not a determinant of this, but does create a challenge for MFIs to deliver appropriate services. Working with the very poor is difficult, but there are a number of ‘frontiers’ in poverty-focused microfinance which need to be explored, and old models adapted or new ones developed. The challenge then is to systematically look at what is appropriate in what contexts, rather than to accept what is becoming a status quo created by ‘accepted wisdom’.

3.2 Understanding poverty and its relationship to financial services

To understand poverty holistically, it is important to move beyond economic and include the fulfilment of basic needs (food, shelter, clothing, health, education, and psychological well-being), the means to achieve welfare in the present and future, social capital and empowerment, and vulnerability to risk.

In order to understand the role that microfinance can play in reducing poverty, it is important to understand conceptually the mechanisms by which financial services can affect poor peoples’ lives. Poor people live in a high risk and changeable environment. They need to be able to take advantage of opportunities that lead to improving income or economic status, to protect themselves against the risks of crises or shocks, and to cope with these when they arise¹³. Poverty reduction then is in part a process of increasing income and economic stability, which lead to improved fulfilment of basic needs and access to services. The empowerment of women can facilitate control over resources which allows for this improved access. It is also about developing a range of assets that will reduce household vulnerability to physical, economic and social shocks. Sebstad and Cohen (2000, p12) define these assets as: financial (income size, regularity and security, savings, loans or gifts), human (skills and knowledge, ability to labour, good health, self-esteem, bargaining power, autonomy, and control over

decisions), physical (housing, land, productive and non-productive possessions etc) and social (networks, group membership, relations of trust, access to wider institutions of society, and freedom from violence).

Most MFIs work with poor clients and there is ample evidence to show that overwhelmingly the impacts of microfinance are positive, particularly through increasing income, reducing risk and vulnerability, and empowering women (Morduch and Haley, 2002). However, it is important to be realistic about the changes that can be brought about by financial services *alone*. By itself, microfinance cannot eliminate poverty, or transform social relations and the structural causes of poverty. If we are to push the frontiers of the effectiveness of microfinance then we need to explore and innovate and find where the limitations are in each context.

Financial services can contribute by helping stabilise, diversify, smooth and increase incomes. Rutherford (2000) outlines how the biggest financial need for people (poor or otherwise) is to assemble 'lump sums' of money that can be used to cope with opportunities or demands. "Despite their small incomes, the poor are faced, surprisingly often, with expenditure needs which are large in relation to the sums of money that are immediately available to them." (Rutherford, quoted in Ani, 2001, p2). These lump sums can be acquired either through credit or saving. Understanding why lump sums are needed by poor people provides an understanding of how financial services may be useful and what impacts (positive and negative) these may have on poor people's lives.

There are four areas where the need for lump sums may create hardship or problems and where a poor person's livelihood may be strengthened by credit, savings or other financial services-

- **Opportunities:** Poor people need lump sums in order to invest in opportunities - economic or social. Money may be invested as working capital or as productive assets for an income-generating activity. Other opportunities may not be related to economic returns.
- **Consumption:** There is often a difference between people's consumption patterns and their income. Household consumption patterns, for example, may require regular small purchases or occasional large ones, for example for clothes, buying food in bulk or housing; income may be evenly spread through the year, or may be erratic. In both cases money may not be available when it is needed and this may lead to inefficient management of household finances.
- **Life Cycle needs:** All people have major predictable occurrences throughout their lives, such as birth, marriage, death, school fees, retirement etc. These all require relatively large sums of money.
- **Crises and Emergencies:** Unpredictable events such as illness, death, accident, fire, weather, crime are common for all people, and more common for the very poor, who are also more vulnerable to their negative impacts.

3.3 Impact on poverty: evidence from the case-studies¹⁴ and literature

It is clear that both CRECER and SHARE achieve significant positive impacts on the lives of the majority of their clients. Impact assessments were conducted with each of the case-study MFIs. A range of approaches were used which were able to produce credible results describing the range and extent of impacts experienced by the MFI clients.

The complexity of poverty means that the impacts measured in the assessments depend to a large extent on how each organisation has conceptualised poverty, its operational design, and the choice of what was measured. Since each organisation has different objectives, each impact assessment is different. Therefore it is not easy simply to compare the results, but still there are clear/common impacts on poverty¹⁵. These are summarised below:

- **SHARE is achieving remarkable levels of impact on the incomes, well-being and business skills of large numbers of very poor clients.** SHARE is a minimalist organisation and aims to reduce poverty by providing financial and support services to poor women. Although SHARE does not focus much attention on social development, clients do increase their business skills and autonomy of decision making. But social activism is not part of SHARE’s objectives, and community level empowerment is not taking place.
- **CRECER achieves positive impact on both economic and social poverty, of a cross-section of clients, including a large proportion of the very poor.** CRECER has a much broader and more explicit social objective than SHARE. Its methodology is based on the assumption that improved nutritional status of children and household food security requires first improvement in women’s economic capacity, empowerment and knowledge and practice.

3.3.1 Impact on Current Economic Status

A) Microfinance impacts directly and significantly on economic poverty (Morduch and Haley, 2001). Credit invested in an income-generating enterprise as working capital or for productive assets leads to establishment of a new enterprise or growth of an existing one. Profit from the enterprise provides increased income, and a general strengthening of income sources.

The extent to which income increases occur varies considerably between organisations and between clients, since they are primarily related to the investment of credit in an income-generating activity. The AIMS longitudinal studies, for example, found that increases in household income were driven largely by increases in microenterprise revenues. Clients from programs that did not focus specifically on microenterprise development therefore experienced little or no net income gains (Snodgrass and Sebstad, 2002).

Both CRECER and SHARE provide credit for enterprise development, and reported income increases for a majority of their clients. The primary source of income increase was through investment of loans into income-generating enterprises.

- **SHARE achieves an unambiguous positive impact on the economic poverty of its clients.** SHARE uses a composite “poverty index” in its impact assessment study. This combines a number of proxy variables for income (sources of income, productive assets, quality of housing) and an independent variable, the household dependency ratio. The poverty index demonstrates that **76% of SHARE’s mature clients¹⁶ have experienced significant reduction in their economic poverty, and half are no longer poor.**

Table 5: Economic Poverty Reduction at SHARE

Poverty Status	Upon joining (%) N = 125	March 2001 (%) N =125
Very Poor	64	7.2
Moderately Poor	36	56.8
No longer Poor	0	36
Totals	100%	100%

CRECER clients achieve significant increases in income. Increased income was reported by 66% of clients, but only 1% reported large increases. Participants most commonly attributed this improvement to the expansion of their income-generating activity, reduced input costs as a result of buying in bulk or with cash, or the new activities or products made possible by access to credit and selling in new markets.

B) Microfinance leads to stabilisation of income and expenditure smoothing

The establishment of a reliable and regular income can create significant impacts in terms of ability to access food, health care, education and other services, and reduce the negative effects of debt-cycles. Similar economic benefits are gained from consumption smoothing, where savings or credit allows for small regular payments to be made, rather than cash having to be found for a larger lump sum. Again this can help with avoiding indebtedness and/or enabling day-to-day payments to be made, for example by avoiding the need to sell assets, cut back on expenditure such as education or take usurious loans from money-lenders. These impacts are particularly important for very poor clients who may be less able to respond to opportunities to invest in and expand a microenterprise.

The impact assessments of both CRECER and SHARE reported significant changes in terms of the major income sources of clients, and consumption smoothing benefits.

- ***SHARE clients experienced a very large change in main income sources*** from “lower-end” occupations, such as temporary labourer work, where wages are low and paid by the day and work is irregular, to self-employment in small business activities (72% new clients, compared to 9% mature clients). Participation in the program also led to diversification of income sources and to an increase in the number of income earners.
- ***CRECER clients experienced benefits through household consumption smoothing.*** 30% of clients declared using at least part of their last loan (as opposed to profit) on food or other household necessities. Particularly important was the bulk-buying of food.

C) Microfinance leads to increased physical asset accumulation

A key impact of microfinance is to help clients accumulate or retain physical assets (Sebstad and Cohen, 2000). Assets are increased either through direct loan use, as a benefit of income smoothing, or through the use of profits generated through the investment of a loan. Clients can also protect existing assets, for example through the investment in vaccinations for livestock, or by using savings or credit to cope with shocks when they occur. Poor households invest in physical assets for three main reasons:

- household assets which primarily contribute to quality of life, and may also provide security and possible income in the case of future need;
- household assets which are primarily held as savings-in-kind such as livestock;
- productive assets which are used to generate income, such as land/houses for rent or equipment for a business.

CRECER and SHARE both report asset accumulation as an important benefit for their clients.

- ***SHARE: The strongest impact on poverty status was increased asset ownership.*** The majority (59%) of mature clients were classified as non-poor in terms of productive asset ownership with assets worth over RS10,000 (US\$200), whereas 81% of new clients rank as “very poor” with assets worth less than Rs5000 (US\$100). Mature clients are also more likely to live in bigger houses made of more permanent materials than new clients. Using a housing index that classifies poverty in terms of housing size, materials and condition, 40% of new clients compared with 23% of mature clients are classified as “very poor”, whilst 33% of mature clients compared to 6% of new clients are classified as “non-poor”.
- ***CRECER:*** Clients' diversified loan-use strategies suggest the program allowed participants to augment household assets. 41% experienced increase, chiefly in the purchase of animals.

3.3.2 Impact on Basic Needs and Capabilities

Key to the impact of microfinance on poverty is the enabling effect of economic improvements. Increased income and economic security can give clients access to improvements in many aspects of their well-being and basic-needs. Morduch and Haley (2002) link improvements in income and empowerment generated through microfinance to improvements in education, health care, family planning, nutrition, water and sanitation, coping with HIV/AIDS and shelter. These are often not direct impacts and may result from the combination of microfinance with other services, or be context

specific. However, there is convincing documented evidence for impacts in all of these areas. These indirect benefits are not automatic since they depend on the availability of services and commodities, the knowledge to prioritise these expenditures, and the power to make appropriate decisions for expenditure. One of the motivations for focusing on women rather than men is the evidence that economic improvements experienced and controlled by women will lead to greater improvements in overall household well-being, particularly when they are accompanied by increased empowerment of women. Microfinance allows households to improve their 'human capital' which allows for improvements in their capabilities to maintain and raise their standard of living in the present and in the future (Snodgrass and Sebstad, 2002, p68).

Clients of both CRECER and SHARE have experienced positive changes in fulfilment of basic needs. The impacts seem greater in CRECER, where there is an explicit education component that encourages clients to use their economic gains to improve their nutrition and use of health services.

- ***SHARE clients experience are more likely to attend higher quality private clinics.*** Household members of mature clients were more likely to go to a private, higher-quality clinic than those of new clients (84% vs. 69%). Improved access is primarily a result of increased savings and therefore availability of ready cash to pay for unexpected needs. Participation in the program did not reveal any change in behaviour regarding children's education.
- ***CRECER clients are better able to cope with periods of food stress than non-clients.*** They can purchase foods in bulk using CRECER loans, internal village bank loans or savings. However, there is no evidence of impact on household food security. The education component of CRECER leads to increased knowledge of critical health and nutrition behaviours and practices. Increases in *knowledge* of better child healthcare and nutrition practices are clear for all participants; the extent to which this knowledge is put into practice was found to be less dramatic. CRECER clients were also more likely to have spent money on expenses such as medical costs and clothing. These impacts can be attributed partly to the internal loan feature of the methodology which permits emergency spending, but also to improved cashflow associated with trade-based activities, as well as the regular generation, and access to, household savings.

3.3.3 Social Impacts

Whilst the motivation for many MFIs to target women is often instrumental, based on women being more compliant, reliable and easier to reach, there are also important motivations based on the need to impact on poverty. The evidence is that women are generally more disadvantaged, marginalised and poorer than men. There is a large body of literature examining the building of women's social assets or capital and their empowerment through microfinance. Sebstad and Cohen (2000, p98-100) review this literature and conclude that microfinance does strengthen social assets and some aspects of women's empowerment. The evidence for these impacts is variable and in some cases contentious, and is often dependent on the manner in which microfinance services are delivered.

Economic and well-being changes impact on the social relations and sense of well-being and confidence of MFI clients. Impacts may also result through the *process* of participating in a microfinance program and the way in which an MFI delivers its services and combines financial with non-financial services. Economic changes may lead to women being able to make more economic decisions within the household, participating more widely in community activities, or engaging with authorities outside of the community. The skills and experiences gained through participation in a microfinance program, particularly those that emphasise group work, may lead to changes in poor peoples' self-perception and ability to interact with other people within the household (for example impacting on gender relations), the community or with wider political and social structures. The ability of MFI clients to engage more as equals with other people in their community may strengthen their 'social capital'.

CRECER and SHARE exclusively target women. Both are effective in achieving social impacts and empowering women, but the degree of empowerment is very much dependent on the way the program is implemented.

- ***CRECER clients are empowered through participating in the program.*** Changes take place at both household and community levels. An empowerment score looks at women's status and social networks in the community. On average clients scored 4.2 (7 being the maximum) while non-clients and controls only scored 2.6 and 2.8 respectively. At the household level, positive effects were notable in decision-making on expenditures usually associated with men, such as house repairs. Few impacts were evident in women's intra-household bargaining power or work responsibilities. At the community level, participants were more likely to be members of a community group, to give advice on health or nutrition matters, or income-generating activities.
- ***SHARE clients experienced increased feelings of confidence and self-esteem, but community-level empowerment remains weak¹⁷.*** Small changes have taken place at a household level, with 11 out of 24 clients reporting joint-decisions with their spouses about the use of the loan and profits. 40% of women report making small personal choices for themselves, although these remain limited. At a community level, the impact on women's empowerment is conspicuous by its absence. Social activism is not part of SHARE's objectives and the program displays no evidence of change to clients' social vulnerability.

3.3.4 Impact on Risk and Vulnerability

Recent studies of the impact of microfinance, have placed a much greater emphasis on the role of financial services in reducing client risk and vulnerability (Sebstad and Cohen, 2000; Snodgrass and Sebstad, 2002; Wright, 1999). Financial services have the capacity to interact with many aspects of clients' lives, not just to develop a microenterprise. Microfinance is thus an important enabling input. It has a potential to impact on poverty in a holistic way, supporting client livelihoods, reducing vulnerability, fostering social and economic empowerment, and releasing people's potential to achieve their goals.

Even where there are no net gains in income, significant impacts in terms of reduced vulnerability can be achieved through the establishment of more regular, reliable, diversified and resilient income sources, consumption smoothing, increased savings and assets, expanding options for credit, and improving household money management (Snodgrass and Sebstad, 2002). The combined effect of these changes reduces risk of crises and emergencies occurring, and increases the ability of clients to cope if they do occur. Diversified incomes, managed by MFI clients with increased skills, are less likely to fail due to mismanagement or as a result of an external shock. Savings reduce vulnerability, allow for planning and management of household finances, consumption smoothing, and accommodating predictable life-cycle needs as well as for coping with unpredictable negative events, and responding to opportunities. Insurance can provide lump sums that can be used to pay for unexpected needs. Increased investment in food, health, housing, education etc lead to healthier, more skilled people living in more secure environments, who are also better equipped to deal with problems. The social capital developed through group-based interaction may mean there is an increased network of people to assist in the case of a crisis. Empowerment in turn improves poor peoples' ability to seek outside support and demand the services and support they may be entitled to.

These changes in risk and vulnerability are central to the achievement of poverty reduction, not just in terms of short-term income or food intake, but in many of the long-term structural factors that lead to generation after generation of people remaining in poverty. Snodgrass and Sebstad (2002, p68) conclude that the "three AIMS assessments firmly establish the "protective" role of microfinance...Microfinance reduces vulnerability". Indeed Sebstad and Cohen (2000) conclude that the impact of microfinance on vulnerability is more generalised and less conditional than impacts on income poverty.

Although CRECER and SHARE are not achieving all of the potential impacts outlined above, it is clear that they impact on a number of areas that combine to reduce the vulnerability of their clients. In particular increased and diversified income, increased savings and improved financial and business management skills reduce vulnerability and increase the ability of clients to pay for life-cycle needs from their increased incomes, savings or loans.

- **SHARE:** Clients experienced changes to more rewarding and diversified income sources, an increase in the number of earners, expenditure smoothing and the accumulation of savings. Mature client households were found to have a greater number of income earners and more diversified sources than new clients. Over half of clients interviewed used the profit of their investments on family events – thus avoiding the indebtedness often associated with these events. One-third had used all or a major part of a loan for these purposes without suffering any terminal repayment problems. An interesting feature of SHARE’s programme is that making savings voluntary has not damaged that component, instead it has been revived and 67% of clients now cite savings as their favourite aspect of the programme, with 84% having increased their savings balances during the previous year.
- **CRECER:** 86% of clients felt that their savings had increased. The bulk of those are ‘new savers’: 78% of CRECER clients previously had no savings. This is a significant impact in terms of vulnerability reduction, and its success is partly due to the internal fund mechanism, which increases the motivation to save as clients receive dividends based on their savings. The impact assessment also found participants were less likely to sell off animals in times of food stress, and more likely to use their business profits, or assume debt. Although the majority of households in all groups do regularly suffer hardship in the hungry season, only 22% of CRECER clients resort to selling animals (compared to 45% for the control group). This helps them protect their productive assets in times of economic hardship. CRECER’s impact on these coping strategies is dependent on a number of factors: encouraging diversification (through a financial product most suited to non-farm activities and business training); permitting access to emergency cash from means other than selling assets such as animals; lowering of food expenditure and insecurity by permitting bulk-buying of food at appropriate times; and improving the general cash flow of the household through improved profits, access to emergency loans, and savings.

3.3.5 Impacts of Non-financial Services

There is clear evidence of strong potential synergies between microfinance and other poverty reduction interventions - “the benefits derived from microfinance, basic education, and primary health are interconnected, and programs have found that the impact of each can increase when they are delivered together” (Morduch and Haley, 2002, p2). The challenge for most MFIs is how these additional services can be provided without compromising their core functions and strengths. Gulli (1998, p78) concludes for example, “Commercial MFIs are likely to be less effective when they expand into new non-financial activities”. Most MFIs do not attempt to provide additional services, although they may play a facilitating role and act to link clients to other organisations or government services. A significant minority, such as SHARE and other Grameen bank replicants, do provide specific and limited non-financial services such as workshops on business and finance management or on social development issues such as health and nutrition practices. Others, such as CRECER and other Freedom from Hunger affiliates, provide more integrated education services. A small number of specialised microfinance organisations attempt to provide a more holistic range of services, but these, with the notable exception of BRAC in Bangladesh, are rarely financially sustainable. In addition there are a wide range of development organisations that have as their primary objective poverty reduction, women’s empowerment or the promotion of community based organisations. These organisations may not necessarily conform to microfinance best-practices, particularly in terms of financial sustainability, but do demonstrate the important synergies between microfinance and other development interventions.

CRECER makes a conscious effort to integrate education services into their work. This is done specifically to link with the financial services and to increase the range and the extent of positive

impacts. In an integrated program such as CRECER's it is difficult to attribute specific impacts to specific parts of the program. However, it is clear that CRECER does achieve far greater social impacts than SHARE, particularly in terms of knowledge and practice in health and nutrition. CRECER's ultimate goal is to impact on nutritional status and food security. Although positive impacts were not measured on maternal nutritional status there is evidence that children's weight-for-age was positively associated with the quality of the education services provided.

3.3.6 Impact on the Poorest

One of the key tenets of this paper is the need to focus on the role of microfinance in addressing the needs of the poorest. Although Morduch and Haley (2001, p6) report that "the poorest can definitely benefit from microfinance", Snodgrass and Sebstad (2002, p x) find that there are only "modest impacts experienced by poorer households in the study", which suggests "scope for improving the relevance of products and services for this group". Reviewing the evidence from the case-study organisations, which do actively focus on the needs of the poorest, only SHARE provides impact data that indicates whether impacts are experienced differently by non-poor, poor and very poor clients. CRECER's impact assessment looks at the whole client group, therefore it is not possible to see if, for example, the 34% of CRECER clients who did not experience income increases are disproportionately from one poverty level¹⁸.

The evidence we have from SHARE demonstrates clearly that very poor clients are benefiting from their services. In fact the impact on the poorest is significantly greater than for less poor clients. ***89% of very poor clients experience positive change compared to 76% of all clients. 60% had moved from very poor to moderately poor, whilst 28% moved from being very poor to being non-poor.*** Very poor clients were not more likely to exit than less-poor, therefore SHARE is not only effective in reaching very poor people, but ensures that they remain as program members long enough to experience positive impacts.

3.3.7 Client Exit and Negative Impacts

Credit is debt and therefore has the potential to lead to substantial negative impacts. There is much literature on cases of negative impact – business failure, indebtedness, increasing vulnerability, and increasing social and intra-household tensions and negative impacts on women's empowerment. These effects do occur, but do not generally seem to be widespread and most impact assessments predominantly report positive or neutral findings. The AIMS assessments for example found that "there was limited evidence that participation in microfinance programs has a negative impact on these [poor] households" (Snodgrass and Sebstad, 2002, p54). Research conducted for the World Development Report similarly shows generally positive impacts (Sebstad and Cohen, 2000). However, most impact assessments look at existing clients only. Where there is a high rate of exit, there are large numbers of former clients who are eliminated from the impact assessment. Common reasons for client exit include negative experiences of business failure, increased work burden for women, conflict in the family or program, and debt problems (Simanowitz, 2000; Hulme, 1999). High rates of exit may therefore be an indication of negative impacts¹⁹.

SHARE has a high rate of client exit (17%, calculated on an annual basis), and it was therefore important to include a large number of interviews with former clients in its impact assessment. CRECER has a very low exit rate²⁰ and therefore did not include former clients in its sample. Interviews that look specifically at negative impact, indicate that this does occur, but it is seldom severe, and affects very small numbers of clients.

- ***SHARE has very little negative impact on mature clients, but large numbers of former clients have not benefited.*** Just 1.6% of interviewed SHARE clients had experienced a negative change in poverty level. However, large numbers are not benefiting from reduced poverty level because they

leave the program. SHARE has an exit rate of 17%, with 41% of former clients citing failed ventures as a key reason for leaving, and 33% reporting their incomes had stayed the same or decreased. However, only 6% reported that they had experienced no benefit through their participation in the program.

- **CRECER: Few clients experience negative impacts.** 7% of clients report a decrease in income, but there is almost no delinquency and a very low exit rate.

4.0 Can MFIs Reach and Impact on the Poorest and be Financially Sustainable?

The previous sections demonstrate that MFIs can and do reach very poor clients; that very poor clients can benefit from the full range of financial services; and that microfinance should be a central part of poverty-reduction strategies. I now move on to the critical question of whether poverty-focused MFIs that are designed to reach and impact on very poor clients are also able to grow to reach large numbers of clients and achieve institutional financial self-sufficiency (IFS).

4.1 Achieving poverty outreach and financial self-sufficiency

At the heart of this question is a fundamental difference of opinion as to whether microfinance should be orientated to build institutions for those commonly excluded from the formal banking sector, or should provide financial services to help reduce poverty. Advocates of the latter approach contend that “large-scale sustainable microfinance can be achieved *only* with the financial systems approach” (Robinson, 2001,p.2; my emphasis).

To be able to reach large numbers of clients MFIs need to achieve self-sufficiency, but this should not be attained at the expense of the benefits to these clients in terms of poverty impact. The Microcredit Summit Campaign is founded on the belief that it is possible for MFIs to serve very poor clients and achieve self-sufficiency. A paper commissioned for the Campaign presents evidence from the academic literature and detailed case-studies of three MFIs that are achieving this objective (Gibbons and Meehan, 2000). It concludes that there is no inevitable trade-off between poverty impact and the rapid growth of MFIs to serve large numbers of clients. Full self-sufficiency can be reached by organisations serving very poor clients. “Thus it is not the clientele served that determines an MFI’s potential for IFS, but the degree to which its financial services program is well-designed and managed.” (Gibbons and Meehan, 2000, p. 4). Further recent evidence has been documented which supports this conclusion. For example, an analysis of 114 MFIs in the Microbanking Bulletin concluded that there is no evidence that sustainable MFIs cannot work with very poor clients - “The data suggest that it is possible to provide very small loans and be financially self-sufficient...Low end organisations also target women more effectively than sustainable programs that provide larger loans” (Churchill, 2000, p.10).

The two case-studies reported here, both demonstrate that MFIs can achieve excellent performance in the combined objectives of poverty impact and self-sufficiency. SHARE and CRECER have both achieved 100% financial self-sufficiency, and are rated *investment grade* by internationally recognised rating agencies.

CRECER achieves excellent financial performance, with an investment grade rating G4*, the third best grade on a ten-grade scale, by PlaNet Finance²¹.

- **Operationally and financially self-sufficient** (102% and 100% respectively).

- **Good lending performance:** CRECER's portfolio quality is rated as very good, with a Portfolio at Risk >30 days at 0.26%. Its lending methodology promotes ownership and deters delinquency by implicating clients and giving them the opportunity to generate profit from internal loans, which in turn supports the high client retention rate.
- **Encouraging long-term prospects for efficiency and profitability:** CRECER's profitability has greatly improved in 2001, leading to a positive Return on Equity (ROE) before adjustments; after adjustments it was still not profitable in 2001. Administrative efficiency has improved due to the increase in lending activities between 2000 and 2001 and to a policy change reducing meeting frequency between promoters and village banks to biweekly. At 39% CRECER is rated as a little less efficient than its peers, but this is due to its dual mission (finance and social), as well as to the fact that it targets rural areas. *CRECER thus appears to be on a positive path towards greater profitability and maintaining self-sufficiency, providing it continues to increase its lending activities while containing its operating costs.*
- **A strong commitment to financing activities with commercial funds:** CRECER has built up good relations with commercial banks. Its limited dependence on the donor sector has allowed it to follow clear strategies of increasing self-sufficiency.
- **Governance and alliance advantages:** CRECER has a strong governance structure based on a competent management team and an involved and skilled board of Directors.
- **A key support role for CRECER's international partner:** Freedom from Hunger continues to give significant inputs in terms of guaranteeing of commercial loans, and providing technical assistance, and strong research and development expertise.²²

SHARE achieves excellent financial performance, with an $\alpha+$ (alpha plus) investment grade rating by M-CRIL²³ and "mfr3" rating (on a scale from mfr1 (highest) to mfr10 (lowest)) by CRISIL²⁴

- **Operationally and financially self-sufficient** (107% and 100% respectively).
- **An excellent lending performance, with a repayment rate of 100%:** SHARE has a Portfolio at Risk (>30 days) of 0%, made possible by the strong organisational culture of zero tolerance, which is instilled among clients during the pre-loan phase of group formation and training. Other factors which account for this excellent performance are the close supervision by field staff (including their responsibility for record-keeping), small weekly repayments, and the policy of removal of problem members from groups, or closure of whole groups in some cases.
- **Good mobilisation of funds and capital structure:** SHARE succeeds in accessing members' savings by having set up an offshoot cooperative, SIM. It has also been mobilising share capital from its members, and as of March 2001, paid-up capital had reached over US\$1 million, of which 99% is owned by SHARE clients. SHARE's has mobilised significant external loan funds from donors and banks, borrowing approximately US\$3 million from 8 lenders as of March 2001.
- **Increasing efficiency:** SHARE's efficiency at institutional and administrative levels is increasing; the number of total clients per field staff rose from 134 to 343 in the year leading up to March 2001, and loan portfolio per field staff also rose from US\$ 6,455 to US\$19,987. Administrative efficiency improved from 25% to 19%, but rose to 25% as of April 2002. The cost per unit of money lent has been decreasing steadily since 1999, and was at 0.07 in November 2001. Keys to this financial health can be seen in SHARE's strategy of building up solid systems before the expansion it undertook in 1997, in its emphasis on discipline, but also in its minimalist approach to financial services provision.

4.2 Costs and benefits of working with the poorest: balancing the goals of impact, poverty outreach and self-sufficiency

SHARE and CRECER are remarkable organisations. They are successfully achieving the difficult balance of excellent financial performance, outreach to the poorest people in their countries, and significant positive impacts on the lives of their clients. Poverty-focused MFIs clearly can achieve

excellent financial performance. However it is likely that the process of striving towards these goals will involve trade-offs between the social and financial objectives. The nature of these trade-offs will vary in different contexts and there is little research exploring them. This section aims to give some pointers as to where the trade-offs and benefits might lie.

4.2.1 Costs of poverty-focus

A poverty focus can create costs in a number of areas. The process of understanding the needs and targeting very poor clients demands staff time. Active poverty targeting, if used, demands development and management and staff time. Poorer people often live in more remote, inaccessible or less densely populated areas, which create additional supervision and operational costs. Once very poor people are reached they are likely to take smaller loans which generate less income and need greater levels of support. Increasing the flexibility of financial services, and adding non-financial services can increase the effectiveness of an MFI in poverty outreach and impact. However these may be costly and complicated to implement.

4.2.2 Minimising the costs of a poverty-focus

Poverty-focused MFIs adopt a number of mechanisms aimed to reduce the additional costs imposed by a poverty focus. CRECER and other organisations using the *Credit with Education* methodology provide an important example of how a specialised non-financial service can be integrated into operations, without imposing huge costs (this is explored in detail in Chapter ? by Dunford). CRECER's education component is made sustainable by embedding its costs in the interest rate, with the educational component representing approximately 6% of total operational expenses. The additional marginal costs are kept low since the same field agent provides the education and financial services at the same regular village bank meeting. CRECER works primarily in remote rural areas, but cross-subsidises this by also working in some high density, accessible, peri-urban areas. It preserves its poverty focus by setting a 70%-30% ratio for rural-to-urban borrowers. Cross-subsidising through individual loans is also planned.

4.2.3 Benefits of a poverty focus

Although a poverty-focus undoubtedly creates costs, these are balanced to some extent by benefits created by this focus. For example, the industry has embraced the goal of targeting women as it is recognised that this creates positive financial as well as social benefits.

One of the most obvious but unquantifiable benefits comes with offering services that are appropriate for the market. MFIs that do not differentiate according to the needs of different client groups are inefficient, and they will find that clients do not perform as well as they might otherwise. Thus a simple first step that can be taken by all MFIs is to better understand their market, and ensure they are offering the right products and services for the clients they wish to reach. CRECER for example, by providing services that meet the needs of poorer clients and working in more remote communities is able to find a market niche where few other MFIs are operating, and is often the first to enter a market. Thus, in the context of high market penetration and competition CRECER is able to achieve high rates of growth, for example increasing its portfolio outstanding by 25% in 2001 compared to 2000. CRECER has achieved this growth during a period when many Bolivian MFIs have experienced crisis due to debtors' associations and massive default.

Organisations that work with very poor clients depend to a large degree on the success of these clients. To begin with, very poor clients take small loans, repay little interest and need a lot of support. However, they use their limited resources effectively and are adept at making the most of few resources. If an MFI can succeed in supporting the poorest in overcoming their vulnerability and in coping with shocks as they occur, then there is a good chance the clients will improve their position, and as they do

so, have increasing need and capacity for financial services. They will be more likely to save more, take larger loans, experience fewer problems and therefore require less staff input. This in turn will lead to the financial success of the MFI. There is anecdotal evidence that very poor clients are more committed to the MFI and less likely to default. CRECER, for example, reports that there is a very low delinquency rate for very poor clients, pointing to the benefits of working with poor people “for whom ancient moral values of duty and honesty are still a reality”, reflected in a high retention and low delinquency rate.. This may mean that once they have reached a more stable position they are less costly to the MFI. Higher initial costs may be partly balanced by lower costs at a later stage. What is clear is that MFI sustainability very much depends on the sustainability of its clients. A focus with much more attention to client needs is therefore required.

The experience of SEF in South Africa raises a number of interesting points, many of which support CRECER’s experience. The two charts below present data from SEF’s two programs: MCP, a Grameen replication adapted to the South African context and reaching clients from a range of poverty levels, but on average less-poor than the general population; and TCP, a poverty-focused program using a similar methodology to MCP but with active poverty-targeting, loan terms and sizes tailored to the needs of very poor clients and greater support provided by field staff.²⁵

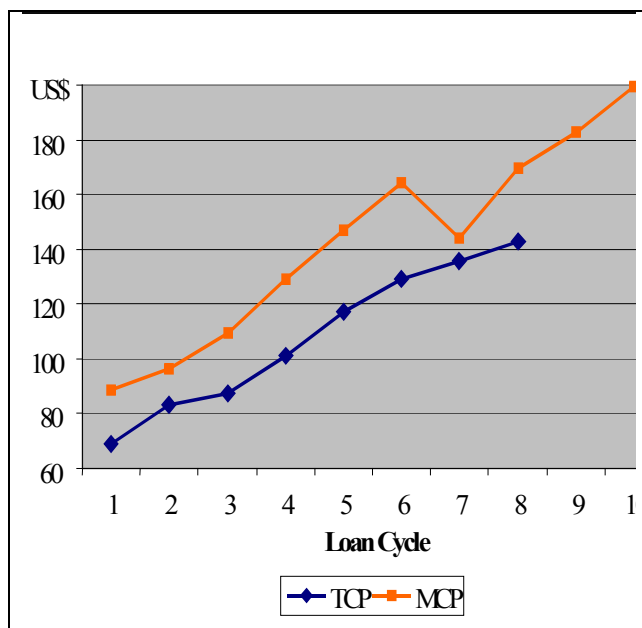


Figure 6: SEF, Comparison of Average Loan Sizes

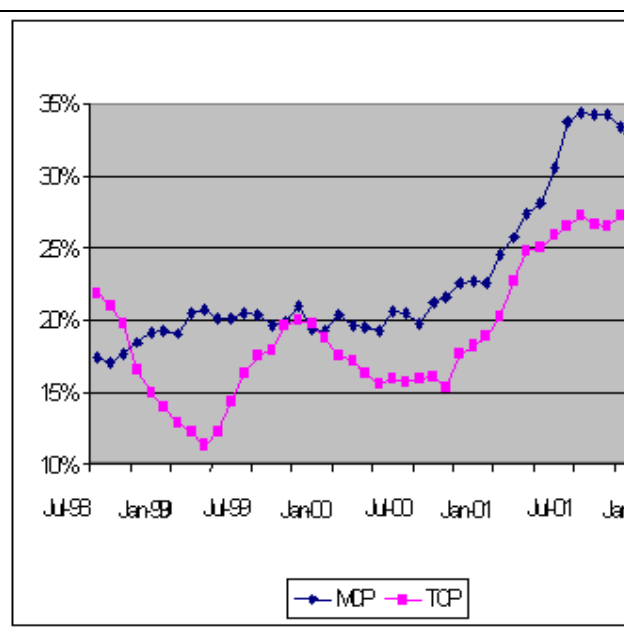


Figure 7: SEF, Comparison of Drop-Out Rates

TCP = Poverty-focussed program MCP = Non-targeted program
 (Source: Presentation given to *Imp-Act* Global Meeting, April 2002)

The first chart (Figure 6) shows that the average loan size of TCP is lower than that of MCP and therefore income per client is lower (assuming the same interest rates). However, although TCP clients initially take substantially smaller loans than clients in MCP, the *rate of growth* of average loan size is approximately the same in both programs.²⁶ There is an effective lag of two loan cycles with TCP loans on the third cycle approximately the same size as those in MCP on the first loan cycle. The similarities in rates of growth mean that although TCP would take longer to reach IFS than MCP, it is feasible for this to be achieved. The second chart (Figure 7) looks at one of the benefits of TCP’s poverty focus and charts significant and consistently lower exit rates in TCP compared to MCP²⁷. These lower exit rates contribute to the financial performance of TCP and would go some way to balancing the higher costs of the poverty-focused program. Anecdotal evidence from SEF, supported by reports from other MFIs,

suggests that poorer clients are less likely to leave than less-poor clients. The greater levels of support given to TCP clients are also likely to be a contributing factor to lower exit rates.

PART TWO: Good Practice for Banking with the Poorest²⁸

In part one, I demonstrated that microfinance can and does reach very poor people, impacts positively and sustainably on their lives, and does so through financially sustainable organisations. I challenge the commonly-held view that there is a relationship between poverty level and the type of financial or non-financial services that are appropriate. Further, the case-study examples challenge the notion that poverty-focused MFIs cannot also achieve excellent financial performance and reach scale.

In part two I move on to examine the design and delivery of poverty-focused microfinance using the experience from the case-studies and other MFIs. The selection of the case-studies necessarily biases this paper towards large-scale institutionalised microfinance and group based methodologies. However, I draw on the experience of other approaches, and discuss issues that are relevant to a wide range of organisations. There are a number of frontiers where innovation and research can lead to improved practice. In particular I look at the mechanisms which act to exclude a large number of the poorest, ways in which barriers can be removed, how services can be designed to be more appropriate, and how very poor people can be encouraged to participate.

5.0 Including the Poorest: Overcoming Exclusion

The first challenge for any MFI that wishes to impact on very poor clients is to attract the right people into the program. This is in part about designing services that are attractive to the poorest, but it is also about understanding who is reached and why some people are excluded. The most commonly used, and much criticised proxy for depth of poverty outreach is loan size. This is likely to give very misleading conclusions - large loan size is certainly a good indicator that very poor clients are not being served, but it does not follow that small loan size implies very poor clients are being served. Dunford (2002, p6) concludes for example, "Loan size is often much more a reflection of the institution offering the loan than of the characteristics of the borrower".²⁹ In the light of the weakness of this proxy and the desire of some MFIs to actively target very poor clients, a number of low-cost practitioner tools have been developed to give reliable poverty outreach information (See Simanowitz et. al., 2000).

My starting point for this section is to look at how very poor people are actively or passively excluded from microfinance programs and how this can be overcome.

5.1 Mechanisms of exclusion

There are norms in society that lead to the poorest being regarded as inadequate and incapable of achieving – this is reflected in self-perceptions by the poorest, perceptions by the wider community, perceptions by MFI field staff, and perceptions in MFI management and the microfinance industry. By not adopting a specific 'poorest focus', MFIs tend to reflect these patterns that lead to marginalisation. Outlined below are the deliberate and inadvertent processes that operate to exclude the very poor.

1. Formal exclusion by MFI: MFIs may take a decision to provide services only to a specific group of clients. For example, many MFIs only provide loans to clients with an established microenterprise.

2. Informal exclusion by clients: Whilst the MFI may have a commitment to reaching the very poor, these people may both choose not to join or be prevented by other members. This is often a particular problem where there is a mix of very poor and less poor clients.

- *Self-exclusion:* Poor people’s lack of confidence constrains their capacity to believe that microfinance can be beneficial, or have the perception that the services provided by MFIs are not intended for them. An example of this is seen in Nyesigiso, a cooperative in Mali where the very poor self-exclude most often because of “the poverty of their household” or “lack of experience or means for starting an income-generating activity; fear of tainting their reputation or the trust of others if they can’t repay and pressure to meet immediate consumption needs such as food and clothing” (Ntezigyaremye, 2001, p2-3).

- *Exclusion by other members:* In group-based lending (solidarity groups, self-help groups, villages banking, cooperatives) there is a tendency for stronger people in the community to exclude those who are poorer. There is often a negative perception by the community of the very poor (useless, lazy, unlikely to be able to repay a loan) resulting in other members not wanting them in their group. This is particularly apparent where group liability is operated, and group members are encouraged to exclude any person who may be a bad credit risk.

3. Client exit: Where policies are not orientated to the needs of the very poor it is likely that they will experience a greater proportion of problems, and therefore be more likely to choose to leave the program, or to be pushed out by other members.

4. Informal exclusion by MFI: Whilst intending to reach a defined set of clients the MFI unintentionally excludes people who should not be formally excluded. This is a result of a complex inter-play of factors at all levels of the organisation

- *Exclusion by staff:* Loan officers may have explicit or implicit incentives to exclude the poorest. This may be based on a perception that the poorest are problematic and will create an increased work burden. This can be exacerbated by an organisational culture and incentive schemes that emphasise financial targets above the need to work effectively with the poorest. This will encourage loan officers to focus on achieving greater productivity, increasing portfolio outstanding, and reaching larger number of clients, rather than achieving greater poverty impact.

- *Exclusion by design:* Many aspects of the methodology design of a microfinance program may deliberately or inadvertently exclude the poorest. These may include entry fees, rules that exclude people who do not have an existing business, inappropriate or inflexible loan terms, automatic loan size increases, inaccessible or compulsory savings, group liability rules, providing services from central offices rather than in community based situations, or locating the program in accessible rather than remote areas. Other aspects of program design may not exclude the poorest, but may be biased towards the less-poor. These are discussed in section 6.0.

Table 6: Mechanisms for exclusion of the very poor from MFIs

Action	By Whom & Why
Formal exclusion by MFIs <ul style="list-style-type: none"> • E.g. eligibility criteria 	<ul style="list-style-type: none"> • Deliberate and considered MFI policy
Informal exclusion by clients <ul style="list-style-type: none"> • Self-exclusion of very poor people 	<ul style="list-style-type: none"> • Lack of confidence and perceptions of MFIs by clients

<ul style="list-style-type: none"> • Other clients prevent very poor joining 	<ul style="list-style-type: none"> • Self-interest of existing clients e.g. to exclude 'weak' people.
<p>Exit of clients</p> <ul style="list-style-type: none"> • Self-selection • Pushed out by other clients 	<ul style="list-style-type: none"> • Decisions by clients due to perceived lack of benefits • Exclusion of "problem" clients by others
<p>Informal exclusion by MFIs</p> <p><i>Staff</i></p> <ul style="list-style-type: none"> • Active exclusion by staff assumptions/practices <p><i>Design</i></p> <ul style="list-style-type: none"> • Inappropriate products/services 	<ul style="list-style-type: none"> • Response by staff at all levels to job priorities, mission and incentives • Unexpected side effects of MFI policy and practice.

5.2 Overcoming exclusion (1): understanding client needs and wants

Each MFI needs to understand what processes of exclusion are taking place within their own organisation. The products and services, and the way in which they are delivered, can then be modified to overcome this. As microfinance in general becomes more 'client-driven' and responsive to differing client needs, it is vital that we hear the voices of the poorest. MFIs may undertake market research to understand their client or potential client needs, but without careful attention they will hear the needs of the less-poor and not the poorest. The poorest by definition are the least vocal and least likely to express their needs within program structures or through market research.

At the African Microcredit Summit meeting of Councils, I gave an example from the experience of SEF, South Africa.

“At SEF, we heard from clients, “we need larger loans, we need shorter loan terms. We need these different products.” What we were hearing was not the voices of the very poor; we were hearing the voices of less-poor people in the program... The organisation which is listening to the demand of the clients becomes a demand-driven organisation; but the demand that you're listening to is not the demand of the very poor.”
Simanowitz, cited in *Microcredit Summit 2001, p4*

Services need to be designed to address clients' perceived needs and wants, that they will therefore use and pay for (creating good financial performance of the MFI). In addition MFIs should understand the underlying needs of the poorest so that the services will reduce their vulnerability and poverty. At times there may be a contradiction between these two priorities and the demands of clients may not be the same as the MFI's analysis of what would most impact on poverty. It is a controversial point, but clients do not always know best. People do make decisions that are not in their long-term best interest. For example, many MFIs that insist on regular weekly loan repayments are asked by their clients to move to monthly repayments and meetings. Some organisations that have heeded this call have found that this change leads to loan instalments that are unmanageable and increased problems of business failure, arrears and default.³⁰

Market research then, should be contextualised in a deeper and broader understanding of poverty. To make a sustainable impact on poverty, MFIs need to see their work holistically, and understand how their intervention fits with the patterns of their clients' livelihoods and the changes that are necessary to reduce their level of poverty. Local conceptions and experience of poverty are important in this.

This is not to say that MFIs should expect to tackle the multiple dimensions of poverty themselves - simply that they should know where the provision of financial services fits into the bigger picture. In

many cases credit and savings can act as a key contribution transforming clients' lives. In others there may be other constraints that make it difficult for clients to utilise these services, or may even result in negative impacts.

5.3 Overcoming exclusion (2): poverty targeting

The case-studies demonstrate that careful poverty-focused program design, which includes geographical targeting, can go a long way to overcoming barriers to participation. CRECER and SHARE both design their programs around an understanding of the needs of the very poor and have established an ethos of poverty focus. This creates a culture that both promotes the participation of the poorest, and provides support to ensure that the vulnerability of the poorest does not lead to their experiencing problems and leaving. CRECER targets the poorest areas in Bolivia to work in, but does not further target clients within these local areas, yet is able to reach significant numbers of very poor people. CRECER is able to achieve such good depth of outreach through a number of active mechanisms:

- *Geographic targeting:* CRECER employs a rigorous process of identification of the poorest areas in Bolivia, and sets specific targets in terms of the balance between rural and peri-urban areas. Data is used from two sources which give detailed poverty data according to a range of poverty indicators. For example, CRECER only works in those areas classified as very low and low on the United Nations Human Development Index.
- *Active program promotion:* CRECER uses promoters from the same villages as clients. These promoters have a good understanding of the local conditions, and knowledge of the local area, and have a sense of 'helping their own people'.
- *Staff commitment:* There is a strong organisational culture of poverty-focus, which is reflected in staff commitment to work with the poorest women. This is supported through management, particularly at the level of branch coordinator, staff training, incentives, and through the experience of staff that very poor people are generally easier to work with and more committed to their village bank.
- *Product design:* CRECER has minimised the obstacles to very poor people joining the program. The banks are easily accessible, and the group-based methodology encourages more reticent women to join in.

It is noteworthy, however, that SHARE's depth of poverty outreach is significantly greater than CRECER's, and that SHARE's client profile is much more biased towards the poor and very poor (see Section 2.0). The difference is that SHARE actively targets the poorest people within poor areas. This is also the experience of SEF and Caissees Feminines, both of which successfully use a poverty-targeting tool, and suggests that poverty-targeting at client level is an important part of program design for MFIs that wish to reach *predominantly* very poor clients³¹. Active targeting is important since it allows an organisation to identify a clearly defined group of potential clients, and enables these people to be motivated to join. SHARE, for example, stresses the use of both active client targeting and motivation. SHARE uses a targeting tool based on household assets and per capita income. It sees this tool as an investment rather than a cost, gaining client data which feeds into its management information system and enhances management's access to timely and high-quality information. Through this targeting, SHARE lays the ground for good client monitoring and can tailor services to its clients' changing needs so as to maximise impact.

Each organisation must choose whether to focus exclusively on specific clients or not, but needs to be aware of who is reached and who is excluded, and for what reasons. As a minimum, poverty-focused MFIs should work in areas identified as having high concentrations of very poor people. This may not always be practicable due to remoteness and low population density of some very poor rural areas, but in these cases there needs to be a conscious decision not to work in these areas, and an awareness of the exclusion process taking place. Where targeting is used it is important that the system allows for the dynamic nature of poverty whereby people move in and out of poverty.

6.0 Design and Delivery of Microfinance for the Poorest

6.1 Working with the poorest and most vulnerable

Few MFIs are specifically designed to meet the needs of the poorest. As understanding about the range of client needs increases, the design of poverty-focused microfinance is changing. Previously the focus was on designing products that would be unattractive to the less-poor – small loans, weekly meetings, group liability, high interest rates. These were delivered with little or no flexibility, and very often these same design characteristics made the services less than ideal for the poor. In a non-competitive environment poor people (and many less-poor people) made the choice that a less than ideal service was better than no service. As the market becomes more competitive, and there is increasing focus on impact, there is much greater pressure for MFIs to deliver flexible services that meet the needs of different groups of clients.

Earlier sections of this paper outlined the nature of the vulnerability that constitutes the livelihoods of the very poor. This shapes the way in which financial services need to be provided. SEF, in South Africa provides a useful example of an organisation that has two distinct client groups in separate programs (MCP and TCP), and has analysed and developed different approaches suitable to these two groups. Figure eight summarises the differences between these programs and sets the background for the discussion in this section, which looks at how MFIs can over-come the factors that act to exclude the poorest, and design and deliver services that meet their needs. Within the confines of this paper it is not possible to explore the range of financial services available in detail. I will highlight key areas where the poorest are disadvantaged and look at alternatives for improvements. These relate particularly to the delivery of credit, since there is much excellent work highlighting the role of other financial services, particularly savings (e.g. Rutherford, 2000).

	MCP: Poor and vulnerable non-poor	TCP: Very Poor
Vulnerability	Either not quite able to meet their families essential needs or are just managing to do so. Have more confidence (probably have a life experience that has shown them that they can succeed). Currently less vulnerable in all meanings of this word but are certainly in danger of being thrown into poverty by a financial shock. With opportunities to improve their income they could not only protect themselves from being thrown into far more dire circumstances but they could do a lot better.	In many ways they have the opposite characteristics to MCP clients. They do not meet basic needs (including food and clothing) and are very vulnerable in all senses of the word. Have very low self-confidence; previously have not had life experiences that says life can be different.
Current income source	Have an existing enterprise; often have someone else in the household who brings in wage income.	Often have no existing enterprise; no regular wage employment in the household. Rely on irregular casual work and often beg for food.
Access to and ability to repay credit	Can take on some debt based on their existing household income flows. Will respond to appropriate financial services - they will "access" financial services; have a strong potential of employing others (even though these may be family members).	Often will not access financial services even if they are available. It is very risky for these households to take on debt based on their existing household income flows. They must take on debt based on future income from a future micro-enterprise.

Figure 8: Meeting the needs of very poor clients: Experience from SEF, South Africa (Source: John de Wit, email correspondence)

6.2 Access to credit: the myth of the ‘economically active’

Exclusion of those without an existing business

The concept of ‘economically active poor’ is often used to describe those poor people who are likely to benefit from credit. For example, CGAP (2001a, p2) states "For microcredit to be appropriate, a pre-existing level of ongoing economic activity, entrepreneurial capacity and managerial talent is needed. If not, then clients may not be able to benefit from credit, and will simply be pushed into debt". This is then translated into policies that require borrowers to have an existing microenterprise to qualify for a loan. However, experience of many MFIs has demonstrated the economic activity of very poor people, particularly through their ability to save (Rutherford, 2000). Others successfully lend to people without an existing microenterprise by ensuring careful supervision of the productive use of loans (see Sections 6.3 & 6.4).

The concepts of ‘economically active’ and ‘entrepreneurial capacity’ need to be challenged. The reality is that the majority of the poorest do not have an existing enterprise but are economically active – they are by definition otherwise they would not survive - and have considerable experience of some kind of self-employment or income-generating activity.³² Very poor people survive – individually or collectively - by undertaking a number of economic activities that together create an inadequate and erratic livelihood. The majority are not *entrepreneurs*, but run small businesses or other activities as part of their overall household activities. Their aim is to secure a reliable and sufficient income for their household needs, rather than to develop a business. Their strategies are therefore generally low-risk, focusing on traditional activities with which they are familiar, and certainly in the early stages not venturing into new unexplored markets. Many clients do become more entrepreneurial over time, particularly as their incomes are stabilised and they have more scope for undertaking other activities.

6.3 How do the very poor repay loans?

Clients will often use loans and savings as they see fit, rather than as the MFI hopes. This creates a specific problem when lending to very poor people without an existing enterprise and low level of skills. ie. with weak ability to repay a loan. Very poor people can often use credit productively, but programs need to be more cautious and supportive, and to ensure that their products and services are flexible enough to meet the needs of the poorest. Two questions need to be asked:

- What capacity do the very poor have to repay the loan – is it to be repaid from existing income sources or from the profits generated by the loan?
- How can the risk of the loan be lowered so that if a crisis does take place it does not create an unacceptable burden?

Understanding household cash flow and the mechanism by which clients repay a loan is fundamental to understanding how credit can be delivered in an appropriate and supportive way. Many people argue that very poor people cannot take loans as they do not have the income streams with which to repay. There are two possible mechanisms to overcome this, each of which lead to very different strategies of credit delivery:

a) *Repayment from future savings made from existing income streams:* Work by Rutherford (2000) and others has demonstrated that virtually all people are able to save. Even the poorest have some income from which they are able to make small payments – either instalments on a loan, or savings.

Most microfinance models assume that repayments will be made from savings from existing income sources, and not necessarily through productive returns on the loan. Clients demonstrate their ability to save, and to take loans based on this saving. Where a client saves regularly for several months or years before taking a loan, she demonstrates the capacity of the household to save over an extended period of time. There is a good chance that this level of saving can continue as repayment of loan instalments in the future. In addition the client will have built up a significant amount of savings that can be used to repay the loan should a crisis take place. Increasing levels of savings demonstrate increased capacity to manage debt and entitle clients to a larger loan. Very poor people with erratic incomes and savings will take some time to build up the required levels of savings and thus are likely to be able to access loans less frequently and which are smaller, compared to less-poor clients. This is a low-risk approach to working with the poorest, and is successfully applied to many MFIs.

b) *Repayment from income generated by the loan:* In many cases very poor people can use credit to invest in a microenterprise, and use the profits from this investment to repay the loan. The loan can be given based on the capacity of the client's business to create a surplus that can be used to repay the loan, rather than existing household income streams to cover the loan instalments. Lending to very poor clients 'starting-up' a new business is very different to lending to moderately poor people with a reasonably secure income with which to repay the loan. If the client fails, then she will have few resources to fall back on. The lending methodology therefore needs to ensure that they maximise their chances of succeeding and minimise the risk of suffering negative consequences.

6.4 Lowering the risk of credit

Given the high vulnerability of the very poor, it is important that MFIs design and deliver credit in a way that minimises the risks to clients, and does not create an unacceptable burden if a crisis occurs. A number of features can be considered:

6.4.1 Participation should not be linked to taking a loan

Many 'credit-led' MFIs define participation in terms of taking a loan, and provide little room for clients to remain if they do not wish to borrow. This clearly does not fit in with current understanding of poor people's livelihoods and the usefulness of credit and other financial services. Life-cycle and seasonality factors may determine when in the year is an appropriate time to take a loan, and inflexible and immediate repeat loans lead to less than optimal timing of loans. This can be both damaging for poor people's livelihoods, and serve to exclude the poorest.

6.4.2 Linking loan-size and instalments to clients' needs and ability to repay

For very poor households with erratic and unreliable incomes, it is essential to make sure there is a good chance that the loan can be repaid without creating hardship for the client. Each MFI must work out what combination of loan term, loan size and consequent instalments suit which clients, and balance this against the capacity of the MFI and its staff to manage a range of loan products. "Matching the variable nature of clients' multiple income streams with appropriate repayment amounts and cycles may improve a client's capacity to repay and borrow over the long term and thereby reduce the risk of borrowing for them, as well as reduce the risk of lending for the MFI" (Sebstad and Cohen, 2000, p111).

- **CRECER's** loan products are designed to attract and retain the very poor, and permit slow build-up of income increases: small initial loan sizes; small increments with successive loans; frequent repayments; joint feasibility assessments of loan applications; compulsory but accessible savings; internal lending³³; and free use of the loans are all methodological features which ensure that CRECER attracts, retains and impacts on very poor clients.

- **SHARE's** loan products are designed to make loan management as easy as possible for clients. Initial loan sizes are kept small (6000 Rs in 1st year; US\$ 150). Subsequent loan ceilings are set at appropriate levels to enable income source diversification without scaring the very poor away. Weekly repayments over 50 weeks (for the general loan) ensure instalments are small.

6.4.3 Loan sizes should not automatically increase

An important example of loans that are not linked to ability to repay is the common practice of automatically increasing the size of repeat loans if the repayment record for the previous loan is good. MFIs that do so risk undermining clients' livelihoods. Where the client does not demonstrate an increasing ability to save or increased productive capacity, increasing loan size results in a narrowing gap between the client's capacity to repay and her loan instalment. Instalments will become increasingly difficult to manage, and this increases her risk and makes her more vulnerable to the negative consequences of shocks. Increasing loan size can also create an incentive for clients to borrow from informal sources or other MFIs to repay loans, in the knowledge that they can repay this from the next loan from the MFI. This can create dangerous situations of indebtedness. For less-poor clients with diverse income sources this is unlikely to be problematic – at least not until loans grow quite large. However for very poor clients with limited existing income sources automatic loan increases can rapidly create problems.

6.4.4 Flexibility of loan use

There is much debate about the fungibility of money and the resulting inappropriateness in insisting that a loan is used for productive purposes (e.g. Sebstad and Cohen, 2000). Many MFIs, such as CRECER, encourage clients to invest in productive activities but accept that clients will use loans for different purposes at different times, and do not attempt to monitor how they are used. Thirty percent of CRECER clients in the impact reported that they had used all or part of their previous loan for consumption (almost a quarter of participants reporting having used some or all of their most recent loan to buy food for the family). To safeguard its members against over-indebting through excessive non-productive use of loans, CRECER emphasises business education and the members' own feasibility assessments of each others' proposed activities. Sebstad and Cohen state that “in many cases, credit used for consumption serves as a temporary substitute for another source of income (or expected income)...In most cases, *especially when multiple sources of income exist*...or when other resources are available to draw upon, this loan use does not endanger the client's ability to repay” (2000, p83; my emphasis). However, if the loan is based on repayment from business profits, and particularly in the case of the very poor, then there is a strong case for encouraging the productive use of loans. Very poor clients report that in the context of competing household demands, the discipline of regular fixed loan repayment and loan use supervision encourages them to spend time on their business, and to reinvest profits. In addition to encouraging productive use of credit it is also helpful to provide a range of alternative loan products such as emergency loans or housing loans. SHARE, for example, uses loan utilisation checks and visits to encourage clients to invest in microenterprises, and so ensures that very poor clients are able to generate a surplus with which to repay the loan. SHARE also make available a range on non-productive loans for housing, sanitation and seasonal loans.

6.4.5 Appropriate loan term

Loan products are often inflexible and this can create problems for or lead to the exclusion of very poor clients. This has been exacerbated by the trend to provide working capital loans to businesses with fast turnover which has led to shorter loan terms without accompanying reductions in loan size, and therefore in larger instalments. Because of their erratic and unreliable incomes, it is very difficult for poor people to conform to the strict credit discipline that requires regular repayments and savings. For example, a poverty outreach study of Nyèsigiso found that lack of flexibility in loan term and coercion in repayment creates problems for very poor clients in terms of cash management, and adds to negative

community perceptions that prevent very poor people from joining the program (Nteziyaremye and MkNelly, 2001). Flexibility is needed to ensure that when other household needs demand money there is not a conflict between the need to repay the loan and these other needs.

“Seen from this perspective, one can perhaps better understand why the pressure of weekly repayment, particularly as it increases with larger loan sizes, becomes more acute over time. The implication is to base loan cycles and repayment schedules on a household's capacity to repay rather than assume clients are managing a specific enterprise that has the capacity to absorb larger amounts of working capital and generate ever increasing regular weekly returns.”
(Nteziyaremye and MkNelly, 2001, p60)

Flexibility is also important in terms of the provision of a range of savings and credit products that are accessible as and when necessary by clients. Emergency loans, for example, are often important in assisting clients to recover from a shock and avoid the use of negative coping mechanisms such as taking a loan from a money lender or selling-off assets. This flexibility of course needs to be balanced against institutional needs and capacity, as it can impose pressure on management, information systems and internal controls.

a) Repayment from future savings: Where repayment is being made from existing income sources, clients should be allowed maximum flexibility (within the capacity of the MFI to administer) to make repayments or to save as and when they want to. Savings-led models of microfinance such as SafeSave in Bangladesh advocate high levels of flexibility in the repayment of loans and taking of savings. Clients are allowed to make larger or smaller payments (or no payments) according to the cash flow situation in their household. Very poor people are therefore not excluded or negatively affected due to their erratic incomes.

b) Repayment from business profits: For productive loans, very poor clients need an instalment that will not create too much of a burden should the business fail, and the anticipated income not materialise. Loans should be timely with small, manageable repayments, and with a regular instalment that helps with cash management, but with the option of greater flexibility if a crisis takes place. Grameen II for example has a mainstream program that continues with the traditional strict ‘credit discipline’, but with an opt-out ‘slow stream’ that allows for complete flexibility in repayments (Yunus, 2002). A loan term that is too long leads to increasing chance that the client will have to divert funds away from their business for other uses, which may lead to business collapse. If the loan term is too short this encourages dependency and does not allow for growth of the business. A very poor client may take several loans before she establishes a reliable business and is able to make repayments without problems. Provided the loan term is relatively short and loan size is small, then the risk is low, and even where a client has problems she can return for a new loan and try again without having been damaged in the process.

6.4.6 Providing other support services

The risk of credit to very poor clients can be reduced by providing support services that serve to increase the chances of successful productive use of a loan, and decrease the risk of a shock occurring. For example, where credit is given to very poor clients with little or no previous business experience, and without an existing business, the chances of failure due to in-experience or mis-management are high. Pressure of loan repayment and supervision of the productive use of the loan can help to focus the client on the business. In addition, MFIs need to ensure appropriate support for clients in gaining the skills needed to run their businesses. This support can come from other clients through the group structures, from field staff, from formal business skills training, or a combination of the three.

Additional inputs may take other forms of support to the income-generating activity. BRAC’s microfinance program for example, is notable in its ability to lower the risk of credit for its borrowers,

through the provision of an integrated range of inputs from product ideas, training, veterinary inputs, marketing and retail outlets. BRAC also provides insurance should the enterprise fail.

6.5 Supporting livelihoods and reducing vulnerability

As discussed in part one, reducing poverty is much more than increasing income. The design and delivery of microfinance programs can have a major impact on their effectiveness in reducing client vulnerability and strengthening livelihoods. This section outlines a number of areas where MFI practice can be improved.

6.5.1 Products and services

Part one outlined the mechanisms by which microfinance can act to support clients' livelihoods and reduce their vulnerability. However, the erratic nature of many very poor people's livelihoods may make it difficult for them to participate in a microfinance program, particularly to take the risk of a loan. MFIs need to consider providing a range of products and services in addition to credit that act to help stabilise and increase income, and are based on an understanding of how financial services are used by very poor people.

Savings: Savings are particularly important for the poor, in terms of reducing vulnerability. Saving needs to be easily accessible, private, and not linked to borrowing. SHARE, for example, switched to voluntary rather than obligatory savings. By doing so, SHARE is reducing the instances of loans being used non-productively, which in turn helps to maintain financial effectiveness and improves chances of positive impact.

Insurance: Recent developments have led to new microinsurance products that may have an important role to play in the ability of very poor people to cope with crises and to reduce their vulnerability. However, "the delivery of insurance services is complex and may be beyond the capacity of most MFIs to provide directly." (Snodgrass and Sebstad, 2002, p69).

Other financial service products: There are a range of products that MFIs develop in response to specific needs of their clients. These may include loans for emergencies, housing, education, consumption, or a variety of savings products. CRECER, for example, has internal group loans which help clients cope with economic vulnerability such as food insecurity, the uncertainty of having sufficient income for repayments – particularly where these are not coming from the activity in which the loan is invested, if this is a longer-term yield activity – and other shocks that make demands on family cashflow and effect socio-economic well-being.

Grants: Programs such as BRAC's Income Generation for Vulnerable Group Development program (IGVDG) provide grants or food for a fixed period of time. When carefully managed, these can help stabilise the incomes of clients. IGVDG clients are then able to join BRAC's mainstream program to access credit to establish an income-generating activity, with a much lower risk of poverty leading to economic demands that undermine the viability of the business.

6.5.2 Creating a supportive environment and retaining clients with the program

Financial services can go a long way to reducing client vulnerability, but for the poorest and most vulnerable clients, it needs to be recognised that problems are almost certain to occur at some stage. These can lead to negative impacts and their leaving the program. Once clients have left, there is no opportunity for the program to achieve positive impacts. MFIs therefore, as well as delivering the right products, need to engage in an active process of identifying who are the people most likely to

experience problems and to target support to these clients. Many MFIs use their first loan as a 'testing loan' whereby 'problematic' clients are weeded out. When working with the poorest, it is the first loan where inexperienced clients are likely to have problems and leave the program. The challenge is to retain and support the very poor, not to weed them out.

Minimalist MFIs are not well set up to support clients when problems do occur. Some organisations opt to include a number of social elements in their design, but obviously this increases costs. The approach of the MFI in terms of how it views client problems can go a long way to allowing clients the space they need to be able to recover. Group-based programs, for example, have opportunities for creating supportive networks amongst clients, but those must be actively pursued rather than assumed. The approach of staff therefore needs to be less a focus on 'credit discipline' and ensuring repayment, and be more supportive, to facilitate solving of problems and development of skills that will prevent clients from not 'being disciplined'. Sebstad and Cohen (2000, p108) suggest that "maintaining access to credit is an important risk management strategy for the poor". Clients are very aware of what they have to lose if they leave the program, and are likely to make every effort to repay their loans, even to the extent of making drastic cut-backs in household consumption.

"Sometimes, we have to give up on some family expenses (food, other social events) in order to repay each week. Even if your husband is starving, you first have to assemble all the money needed to make the payment in order to leave the meeting place....Some women cry when they can't manage to come up with the amount they need for payments. " (Nyesigiso members, quoted in Ntezigyaremye and MkNelly, 2001, p58)

A culture of strict credit discipline may ensure that clients are kept motivated and on the right path, with difficulties highlighted before they have the time to grow into insurmountable problems or indebtedness, but the lack of flexibility can create problems which may, for example, be a cause of SHARE's relatively high exit rate (17% for 2000). In the light of this it is important for MFI staff not to be coercive but to create a supportive environment where problems are understood and clients collectively take responsibility for sorting them out, facilitated by MFI staff. Repayment policies also need to allow sufficient flexibility to deal with repayment problems in a more humane way. The Grameen II, for example, has moved away from the policy of strict 'credit discipline' and is based on the belief that poor people always pay back their loans. "There is no reason...to get uptight because a borrower could not pay back the entire amount of a loan on a date fixed at the beginning of the disbursement of the loan. Many things can go wrong for a poor person during the loan period...We see no reason why the sky should fall on anybody's head because a borrow took longer tie to pay back her loan." (Yunus, 2002, p2).

6.5.4 Improving the social and empowerment impact of microfinance³⁴

Microfinance has an important role in women's empowerment. However, this impact depends to a large degree on how the program is designed and delivered. Activist organisations, such as PRADAN in India that work through self-help groups, put primary emphasis on the empowerment of small groups of women. Financial services are part of this empowerment process, but not the primary objective. Sustainability for PRADAN and similar organisations is based on the sustainable functioning of the group as an independent unit, and there is no long-term commercial role for the organisation. MFIs that seek to deliver financial services directly to clients need to operate in a different manner from organisations with a primary goal of empowerment. However, there are many lessons that can be learned from a range of approaches used by formal microfinance organisations, development organisations and community organisations.

Groups have the potential to facilitate skills development, building of confidence and social capital. Group liability conditions often serve to undermine this positive potential of groups and leads to a more coercive and conflictual environment that discourages the participation of the very poor. Moving to individual loans risks losing the potential empowering role of the groups. Whilst the group guarantee can be problematic, when it works well, it does serve to create cohesion and encourage clients to take responsibility for others in their group, ensuring that appropriate loans are taken, and that support is given to members who experience problems. Group liability lending thus has the potential to bring many benefits that act to support the needs of very poor clients. The achievement of these benefits is not automatic and needs active facilitation by the staff of the MFI.

6.5.5 Linking microfinance to other development services

A holistic view of poverty leads to the question of whether MFIs should be developing an integrated range of services. For some organisations such as the SEWA bank in India or BRAC in Bangladesh, this is the path that they have taken. In many cases paths out of poverty may be constrained by factors beyond the usefulness of financial services, or may even prevent people from accessing the financial services available. In these cases there may be a strong argument for interventions other than microfinance, or to supplement financial services with other inputs such as health education, training, market support services etc. BRAC for example, argues that in their context the poorest often cannot productively use credit, and need to be given a ‘jump start’ whereby grants are given to get them up to a level where they can operate sustainably in the market.

But recognising that poverty is multi-faceted does not mean that MFIs should be trying to do everything. MFIs succeed through being focused and by doing what they do well! There is a real danger of MFIs trying to do other things because they feel they ‘should’, doing it badly, and damaging their effectiveness in providing financial services. The history of development interventions is littered with failed integrated development programs that attempt a comprehensive analysis of poverty, and then try to deliver all components necessary to change these. Microfinance takes a very different approach in providing minimal inputs in a sustainable way, allowing clients to make decisions as to how resources should be used.

There is clearly great potential to enhance the impact of microfinance through linkages to other development services, such as the inclusion of education and training components in CRECER and other *Credit with Education* programs³⁵. MFIs can also use their existing structures and contacts with clients to create linkages with other service providers. Decisions about integrating other services into microfinance or creating linkages need to be based on a clear conceptual understanding of poverty, and in the context of capacity and resources, and the trade-offs between the benefits and the costs to the financial performance and focus³⁶.

6.6 Managing for outreach and impact

A poverty focus requires a deliberate effort. Successful poverty-focused organisations succeed in two areas – vision and systems. The establishment of an organisational ‘culture of poverty’ is central to ensuring that staff and clients at all levels make decisions that are centred on improving poverty outreach and impact. Both CRECER and SHARE demonstrate that organisational vision, mission and commitment from board and senior management level are essential ingredients to an effective poverty-focused organisation. The message is heard by staff at all levels and by clients, and is a significant factor motivating and focusing the MFI’s work. The vision helps guide the systems to meet the needs of the poorest, and are implemented and monitored with this focus at the forefront. The right systems cannot work in an organisation that does not have the vision and commitment to work with the poorest.

Similarly vision is not enough by itself, and must guide innovation and the development of appropriate systems.

"Programs that make poverty reduction an explicit goal and make it a part of their organisational culture are far more effective at reaching poor households than those that value finance above all else" (Morduch and Haley, 2002, p1)

6.6.1 Organisational culture

A *culture of impact* should be created that promotes support for the very poor both within the organisation and by clients. As MFIs pursue financial sustainability, they have been effective in creating organisational cultures that emphasise efficiency and productivity, and have reinforced this culture with staff incentive schemes. If MFIs are serious about their poverty focus, they need to build a similar culture and incentives for this. Achieving the commitment and understanding of front-line staff is key to organisational effectiveness in poverty outreach and impact. Central to this is designing incentive systems that motivate staff to be effective and efficient in terms of impact and poverty outreach, as well as financial performance. CRECER, for example, bases its staff incentive scheme on a mixture of traditional indicators - loan portfolio size and quality, and the quality of educational services delivered. Poverty outreach is emphasised with a weighting given to clients included from more difficult to reach areas³⁷. This serves to back up the organisational culture of cost-effective delivery of financial services combined with the social side of the educational services.

Grameen II have instituted a "five star" system of staff incentives based on branch and staff performance. For each performance area where targets are met a coloured star is awarded which can be worn by staff. Stars can also be earned by individual staff member performance. Performance stars are awarded for a mixture of outreach, impact and financial/operational objectives: 100% repayment record; profitability; savings deposits; school attendance and completion of primary school; borrowers crossing the poverty line. (Yunus, 2002)

Given the active involvement of clients in supporting one another, or in expelling 'problematic' members, it is important that clients feel this culture too. This raises questions about how clients are involved in organisational processes in general, and how much the organisational objectives reflect the priorities of the people they seek to serve. More participatory processes to involve clients in organisational governance and decision-making may be one way to address these questions. There is little experience of these issues in practice, and this is an area for future innovation.

6.6.2 Gender as part of program practice

An understanding of gender issues and the possible positive and negative impacts of microfinance need to be integrated into organisational culture and practice. This needs to take place at three levels. Firstly, an awareness of how gender issues operate in the clients' lives, and the potential for women's increased decision-making and financial responsibility to have both positive and negative impacts on intra-household dynamics. Secondly, staff interaction with clients is hugely important in addressing gender inequalities. If they act as positive role models, challenge inequalities and educate, they can help to redress inequalities within the community. However, if their attitudes and behaviour mirror conventional societal norms, then they will serve to reinforce inequalities. The organisational commitment to challenging inequalities *within the organisation* will be key to developing good practice amongst field staff within communities.

For example, the dynamics of groups favoured by most poverty-focused methodologies have the potential to influence social networks and support given between people in the community (social capital). This influence can be positive, for example by fostering a culture of support, or negative, for example by exacerbating tensions and creating conflict over group guarantees or support. The impact

assessment of CRECER found that positive impact on women's empowerment is in part due to the program exclusively targeting women, but is also associated with a number of village bank methodological features: women running their own bank, making decisions on feasibility of each others' proposed activities, electing their leaders, or setting the terms and conditions of internal loans. The concept of solidarity is also built upon through the group structure. Furthermore, regular meetings imposed by CRECER develop the women's links and knowledge about one another, and the education received also helps boost self-esteem.

6.6.3 Organisational learning and innovation

Poverty-focused MFIs need to be innovative and responsive to the needs of their clients. Internal learning systems should allow for monitoring of client performance through listening to clients' experiences and views, particularly those of the very poor. Monitoring systems therefore need to be set up in a way that gives information about the poverty level of clients. The MFI also needs to be flexible enough to make changes in response to this learning.

PART THREE: Lessons and Conclusions

7.0 Implications for the Microfinance Industry

This concluding section summarises the main implications of the discussions of parts one and two for the practitioners who deliver microfinance, and for the donors and policy-makers who support them. It is clear that we have moved away from blue print models that can be replicated, and need to apply general principles of practice and performance instead.

7.1 The importance of microfinance in poverty eradication

I started this paper by questioning the lack of emphasis placed on microfinance in donor strategies for the realisation of the Millennium Development Goals. This paper has demonstrated the fallacy that microfinance cannot be an appropriate strategy for the poorest. Conceptual analysis and detailed impact assessment studies of the work of the case-study organisations show clear pathways for both economic and social impact. These lead to direct impacts on the first Millennium goal of halving absolute poverty and hunger, and potential indirect impacts on most of the other goals.

“The literature confirms that most microfinance programs do not serve the poorest. However, there are some institutions that do, and the evidence indicates that the poorest can definitely benefit from microfinance in terms of increased incomes and reduced vulnerability” (Morduch and Haley, 2001, p6).

7.2 Design of poverty-focused microfinance

Poverty outreach and impact are not automatic. Conventional microfinance acts through both deliberate and unintentional mechanisms which exclude the poorest. Programs therefore need to be designed to include the poorest, and to facilitate mechanisms that will lead to poverty impacts.

There is a spectrum of organisations and there is no blue print for success. Some choose to commit themselves fully to a poverty focus, others remain broad-based. All MFIs, however, need seriously to consider the position of the poorest in their organisations. Most MFIs do include some of the poorest as

their clients. Some of these may well have negative impacts on these clients. Through increasing their understanding of poverty, and who is included or excluded and for what reasons, MFIs can take simple steps to improve their outreach and their effectiveness for the poorest.

Improving outreach to the poorest: The main challenge is to ensure that the poorest are not artificially excluded from services. "There needs to be sustained, proactive effort at trying to reach poorer people. Conventional microfinance does not automatically push itself deeper" E. Littlefield (presenting institutional view of CGAP, email correspondence, 14th February 2002).

- MFIs need to improve their contextual understanding of poverty and the needs of the very poor.
- Market research that takes active measures to overcome the exclusion of the poorest can lead to an understanding of their needs.
- MFIs should work in areas with high numbers of very poor people (geographical targeting).
- Rather than putting up barriers to less-poor people, programs should be designed with an understanding of client needs. This can be effective in encouraging participation of the very poor.
- Active targeting of clients is necessary if an MFI wants to exclusively focus on the very poor and the poor.

Appropriate products: Very poor clients need a range of financial services that fit in with their erratic income and expenditure patterns and help them cope with unexpected demands for money.

- Both credit and savings are important for the very poor to allow for income stabilisation and smoothing, investment in income-generation, and reduced vulnerability.
- Design of products should be based on their potential to reduce poverty, risk and vulnerability, not just in terms of their attractiveness to clients.
- Where loan repayment is made *from existing income sources* there is a need for flexibility in savings and loan repayments. Savings in particular should be easily accessible, both for deposits and withdrawals. Loans do not need to be tied to a particular activity.
- Where repayment is made *from profits from an income-generating activity*, regular repayments and pressure from the MFI are important to encourage focus on the business activity and to develop business management skills.
- Where an overwhelming crisis or emergency occurs, clients should be able to move out of the rigid repayment cycle of enterprise loans, and move to a more flexible schedule.
- A range of other products, such as emergency loans and insurance, can help clients cope with emergencies, smooth consumption, and generally reduce their risk and vulnerability.
- Client need for flexibility and a range of products needs to be balanced with an MFIs capacity to manage an increasingly complex and diverse portfolio.

Delivery: Services need to be delivered in a way that recognises the vulnerability of very poor clients, and seeks to help them stay in the program if they experience problems.

- There should be no compulsion to take a loan.
- Access to credit should be linked to ability to repay – either through demonstrating savings capacity or business performance.
- Client problems and failure should be expected, and the client should be supported rather than being expelled from the program - supportive, not coercive, relationships should be developed.
- Group liability can exclude the poorest: this can be overcome by removing liability from groups, facilitating group functioning, or giving individual loans.
- A culture of poverty-focus and impact in an MFI is key to achieving positive impact.
- Client support and skills-sharing should be encouraged. There is a lot to learn from community-based organisations and other models of microfinance, such as self-help groups.
- Gender awareness should be integrated into program practice at the level of field staff-client relations, and within organisations' procedures and culture.

7.3 Trade-offs and balances

With no social objectives, MFIs could achieve faster growth and greater profits. With no financial objectives, MFIs could work intensively with small numbers of people, ensuring that few of the target group are excluded and that dedicated staff spend long hours with individual clients to ensure their success. Microfinance is a compromise where the social and financial objectives must be balanced. The challenge is to marry the best practice of poverty outreach, impact, and self-sufficiency, and work out where compromises lie that allow for an achievable mix these of three goals. The key challenges are:

- To better understand the trade-offs and benefits. What are the positive effects of a poverty focus? To understand this there is a need for better comparative information about MFI operating ratios such as staff salaries compared to average loan sizes, or population density compared to number of clients per loan officer.
- To be able to innovate to make poverty-focused microfinance more cost-effective. How important is a focus on the success and sustainability of clients in this?
- To innovate to improve the impact of microfinance, for example through cost-effective opportunities to improve impact through provision of or linkages with additional services.
- To set realistic performance targets for organisations with these objectives.

7.4 Measuring performance

"Currently the majority of MFIs neither determine the composition of the clientele upon intake nor evaluate the effectiveness of their program in terms of poverty reduction. The development and use of the new tools for market analysis and evaluation suggests that failure to monitor and evaluate can cut costs in the short-run at the expense of achieving long-term social and economic goals." (Morduch and Haley, 2002, p2).

The microfinance industry has established clear best practice for measuring and reporting on financial performance. We are still a long way from establishing comparable standards for performance in poverty outreach and impact.

There is clearly a need to broaden the concept of best practice to take account of the balance between different objectives that MFIs must achieve. Performance needs to be measured in terms of effectiveness as well as efficiency. The social objectives of poverty outreach and impact need to be given higher prominence and systems developed to allow for transparent reporting of such data.

7.4.1 Measurement and reporting of poverty outreach

"Average loan size is an easy but inadequate indicator for depth of outreach. Minimal extra effort in data collection can yield much richer information for marketing and evaluation" (Morduch and Haley, 2002, p1)

In an industry that is heavily subsidised by donors on the basis of its poverty impact, there is a strong case for conditions to be imposed requiring MFIs to report on poverty outreach using credible indicators. This is a particularly contentious issue in the U.S. at present, where 'Microfinance Self-Reliance Act' mandates that 50% of the US Agency for International Development (USAID) funding for microenterprise development should be directed towards the 'very poor', in order to encourage practitioner innovation to serve this market.

The key operational point for MFIs is to focus on who is excluded and for what reasons. Achieving good poverty outreach is about providing the right products and services as far down the poverty scale

as is possible. For this to take place two key measures of poverty outreach are important – working in the poorest areas of the country and working with the poorest people relative to the population in an MFI’s operational area.

Poverty assessment tools are available to both practitioners and donors which can provide poverty outreach data. These tools provide excellent information about poverty relative to local conditions, but can be improved to allow better comparisons to be made at national and international levels. There needs to be widespread acceptance of the importance of MFIs reporting on this basic performance data.

Basic poverty outreach data should be based on the following:

- Loan size is an inadequate indicator of poverty outreach.
- MFIs should monitor and report on the poverty level of new clients, as well as who they are not reaching. This data should be relative to the local context, but should also be comparable to national poverty line calculations.

7.4.2 Measuring and reporting on impact performance

Impact performance is difficult to measure in a cost-effective way, and few would call for all microfinance organisations to undertake detailed impact assessment studies. However, basic impact information is needed for program design to ensure effective management towards improved impact on the poorest. There are two areas to be emphasise in monitoring and reporting on impact performance:

- *Client monitoring and organisational learning systems* can be developed that give basic, regular information about a small number of proxy indicators for impact³⁸, and which collect detailed qualitative information from clients. These could form the basis of industry-wide indicators that can be reported on, with the credibility of data being determined by the manner in which it has been collected.
- *Poverty auditing*: The establishment of standards of good practice in terms of design and delivery of poverty-focused microfinance can create a basis for monitoring whether MFIs are likely, given their approach, to impact positively on poverty. The CGAP Poverty Audit is an excellent framework that looks at the overall organisational approach to poverty impact, conceptual understanding of poverty, organisational culture and commitment to a poverty focus, staff-client interface, design features which serve to improve its outreach and impact to the poorest, and organisational learning and impact monitoring processes. Together these do not measure poverty impact, but give a good performance measure of the organisational commitment, design, and monitoring to achieve it.

Basic proxies for impact that should be monitored include the following:

- Reporting on who does not join and who leaves the program and why, disaggregated by poverty level.
- Disaggregation of client loan and/or savings performance by poverty level.
- Reporting on ‘penetration rate’ ie. the concentration of poor people reached in an area.

7.5 Creating space for innovation – the role of donors

In this paper I have demonstrated that there are many lessons for practice and many pointers as to how the microfinance industry can improve its social impact without compromising the necessity to establish sustainable organisations. This is now a time for innovation and experimentation. Existing tested models of microfinance can be adapted, new approaches developed, and lessons learned from approaches outside the ‘mainstream’ of microfinance, from organisations that do not conform to the primacy of IFS as a goal. For example, many development organisations use microfinance as a tool to achieve poverty reduction and empowerment goals. These organisations incorporate financial service

components into their existing activities, and do not necessarily seek to achieve sustainability. They are clearly not an alternative to mainstream microfinance since they rely on continuing subsidies and are limited in their scale. However, they are innovating and expanding the experience of the effectiveness of microfinance in poverty alleviation, and there is scope to feed lessons from their experience into mainstream microfinance.

Donors can play a positive role in this process in three ways:

1) Providing financial incentives towards the achievement of certain goals, for example depth of poverty outreach. This is not an argument for greater subsidies for poverty-focused MFIs, rather a call for targeted financial incentives to promote a process of experimentation and innovation in the areas outlined in this paper.

2) Creating space for MFIs to improve their effectiveness. Rigid performance requirements based on financial best-practice standards push MFIs into a narrow path of chasing financial self-sufficiency. Different pathways need to be explored, and perhaps different time-frames for donor finances to allow them to reach the point of financial self-sufficiency. This needs to be linked to the establishment of clearer industry standards for good practice in poverty-focused microfinance, and to much greater transparency in terms of reporting on poverty outreach and impact. However, balance needs to be struck between providing greater space for innovation, for example, by allowing pilot phases in MFI development, and ensuring that innovation is not used as an excuse for poor practice and inefficiency.

3) Development of industry standards and reporting guidelines based on performance measures that take into account both efficiency and effectiveness measures. The performance standards may well vary according to the objectives of the MFI to take into account trade-offs between the financial performance and poverty impact objectives. Much more research is needed to be able to determine at what levels these performance standards would be set.

8.0 The Way Forward

In this paper I have presented evidence of the need and possibilities for a microfinance industry that includes as a major objective the eradication of poverty through the delivery of a range of financial services to very poor people. The case-studies demonstrate that this is taking place, but the industry must rise to the challenge of expanding the boundaries of microfinance and innovating to develop more effective and more cost-effective services for the poorest. Too often conclusions are being reached based on false assumptions.

For poverty-focused microfinance to move forward, there is a need for more transparent reporting of achievements, and development of standards. This includes:

- Incentives from donors in funding policies for MFIs to reach the poorest.
- Demonstrated poverty outreach and impact should be included in donor criteria for MFI support.
- A need for transparency in reporting on who is being reached, who stays in the program and for how long, and basic indicators of impact
- A need for better indicators and tools for measurement of poverty outreach - loan size is inadequate.
- A need for development of good practice guidelines for poverty-focused microfinance.

Microfinance should be given greater prominence in all strategies that seek to integrate a range of approaches to combat poverty. This paper is a call to the microfinance community to apply their expertise and explore the potential of microfinance in all its forms to impact on the lives of the poorest. It is a call to give equal weight to the goals of poverty outreach and impact, rather than letting them be subsumed by the overarching goal of sustainability.

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Annex: US\$/day poverty level of SHARE clients

(Syed Hashemi, CGAP. 15th August, 2002)

According to the Indian national poverty line, based on minimum caloric intake, in 1994, 35% (rural – 37%) of the people were below the poverty line. The World Bank estimates that in 1997, 44 % of the people were living on less than a dollar a day (PPP adjusted). Given that there are no indications of any serious deterioration of poverty levels between 1994 and 1997, it would seem that the Indian national poverty line is set substantially lower than the \$1 a day level of international absolute poverty level.

Since the national poverty line is based on minimum caloric requirement, we can assume that going without a meal would constitute a caloric intake of less than the poverty line figure. If we look at SHARE data for clients, we find that 60% of the households missed at least 1 meal in the last 2 days preceding the survey (see Table 1)

	Frequency	Percent	Cumulative
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No. of meals			Percent
1	1	.5	.5
2	7	3.5	4.0
3	14	7.0	11.0
4	56	28.0	39.0
5	41	20.5	59.5
6	81	40.5	100.0
Total	200	100.0	

Table 1. No. of meals served in last 2 days

Further, out of the 81 households which did have 6 meals in the last 2 days, 26 were reported to have spent at least 2 days having meals of rice or bread (roti) without *any* vegetables or pulses. In other words these people were subsisting only on a bowl of rice or a couple of rotis. We assume that these people, while probably consuming the minimum caloric intake, would not have been able to afford other nutritional requirements. We classify these people as above the national poverty line but below the \$ 1 a day line. Adding this figure to the figure above, provides us with a total of 145 SHARE clients (out of 200) or 72.5%, who would be below absolute poverty levels of \$ 1 a day.

No. of meals	Frequency	Percent	Cumulative Percent
0	36	44.4	44.4
1	19	23.5	67.9
2	14	17.3	85.2
3	7	8.6	93.8
4	4	4.9	98.8
5	1	1.2	100.0
Total	81	100.0	

Table 2. No. of days RICE/ROTI with Chilli only served in last 7 days for households with 6 meals in 2 days.

¹ Absolute poverty is defined as families living on less than \$1 a day, purchasing power parity (PPP).

² A Microcredit Summit July 2002 review of websites of leading donor agencies such as the United Nations Development Program (UNDP), USAID, DfID, and the World Bank) found no reference to microfinance in the agencies' strategy papers on the Millennium Development Goal of cutting absolute poverty by half by 2015.

³ Copies of these case-studies are available from the Microcredit Summit. www.microcreditsummit.org

⁴ Assessing Impact of Microenterprise Services. Implemented by USAID's office of microenterprise development.

⁵ In this paper I use the term microfinance rather than microcredit. Microfinance refers to credit, savings and a range of other financial services offered to the poor. The Microcredit Summit uses the term *microcredit*, but also defines this term as including savings and other financial services.

⁶ CRECER was set up as a *Credit with Education* program of FFH, and was registered as a Bolivian NGO in October 1999.

⁷ Share Microfin Limited (SHARE) is a community-owned MFI, with 2 offshoot cooperatives: SHARE India MACS Limited (SIM) for savings mobilisation from members, and SNEHA, another cooperative set up to provide microfinance in one particular district. All come under SHARE Group, also including SHARE, the Society, which continues to administer two branches but will have a support role mainly (training, technical and capacity building services). In this paper the term SHARE is used to refer to SML.

⁸ It does seem that the national poverty line is set very low in India (see discussion in Annex).

⁹ Interest and fee expense on funding liabilities divided by average gross loan portfolio.

¹⁰ In this section I focus deliberately on the use of credit. This is not to play down the importance of other financial services, but to emphasise that need for credit is not linked to poverty level. This paper seeks to challenge the orthodoxy that very poor people cannot productively use credit but rather need savings, insurance and other services instead.

¹¹ For further information about the CGAP Poverty Assessment Tool and its effectiveness see Simanowitz (2002) and the Poverty Targeting Centre on the Microfinance Gateway <http://www.microfinancegateway.org/poverty/index.htm>

¹² SEF, SHARE, OTIV-Desjardins (Caisses Feminines), and CRECER. SEF operates a modified Grameen solidarity group methodology. Caisses Feminines is a *Credit with Education* program operating a village banking approach similar to CRECER. It was initiated by OTIV through a partnership with Freedom from Hunger and CRS Madagascar.

¹³ Sebstad and Cohen (2000, p33) describe risk as follows: “the chance of a loss or a loss itself, *risk* has many sources – (1) structural factors such as seasonality, inflation or... weather; (2) unanticipated crises and emergencies, such as sickness or death of a family member, loss of employment, fires and theft; and (3) the high costs associated with life cycle events such as marriage, funerals, and educating children. Likewise, risks are associate with (4) operating an enterprise and with (5) taking a loan”.

¹⁴ CASHPOR-Philnet conducted an assessment of SHARE using a modified AIMS methodology. Changes were analysed using both longitudinal data from a base-line created from member in-take data, and cross-sectional data using a control group of pipe-line clients. Freedom from Hunger conducted an impact evaluation of CRECER. A rigorous quantitative methodology was used collecting base-line data in 1994/5 with follow-up in 1997.

¹⁵ The lack of commonality between impact assessment results was also observed in the three studies conducted as part of the AIMS project (Snodgrass and Sebstad, 2002, pvi).

¹⁶ A mature client is defined as a client who has remained with the program for three years or more.

¹⁷ A recent study of women’s empowerment reputedly demonstrates significant impact on women’s empowerment.

Unfortunately the report from this study was not available at the time of writing this paper.

¹⁸ This is a speculative comment used for illustration and is not based on any evidence that this is a plausible association.

¹⁹ Note, not all client exit is for negative reasons or programmatic reasons. Successful clients can graduate to other sources of financial services; clients can also leave because they move away from the operational area or move to a competitor.

²⁰ As reported by the PlaNet finance rating. However CRECER is not systematically tracking exit rates, and it is therefore possible that the rating figures for client exit are inaccurate.

²¹ PlaNet Rating is a branch of PlaNet Finance, an international non-profit organization based in Paris. PlaNet uses the GIRAFE methodology, and has been recognised by CGAP to provide ratings under the CGAP Rating Fund. Note the investment grade rating for CRECER was only the fourth awarded by PlaNet out of 29 rating conducted.

²² As is common practice these inputs have not been adjusted for in the PlaNet rating.

²³ M-CRIL, is a microfinance capacity assessment division of EDA Rural Systems, Delhi. M-CRIL has been recognised by CGAP to provide ratings under the CGAP Rating Fund.

²⁴ CRISIL is one of the mainstream-rating agencies in India, which is recognized by the Reserve Bank of India. CRISIL has been recognised by CGAP to provide ratings under the CGAP Rating Fund..

²⁵ A detailed discussion of these two programs and their effectiveness in poverty outreach is presented in the report from the CGAP poverty assessment of SEF (van de Ruit et.al., 2001).

²⁶ This is not so clear for the 7th and 8th loan cycle in TCP, but the sample size is very small for these loans. Since loan size growth is linked to business performance, this represents a real growth in clients’ ability to use credit, rather than a policy by the MFI to grant increasing loan size.

²⁷ Client drop-out or exit is defined as the percentage of clients finishing one loan cycle not taking a repeat loan within one month. Many ‘drop-outs’ do subsequently return, but these are not captured in these figures.

²⁸ This section is informed by a workshop of the *Imp-Act* Thematic Group "Microfinance for the Very Poor", hosted by the Small Enterprise in South Africa, 26-29 November 2001. For more information see www.Imp-Act.org

²⁹ This paper discusses the problems of the use of loan size as a proxy for poverty outreach.

³⁰ Reported during discussion at *Imp-Act* global meeting .

³¹ It is important to distinguish between assessment, screening and targeting: *Assessment* involves analysing the existing poverty outreach of an MFI and presenting these figures; *Screening* involves assessing the poverty status of people who apply to join the program to determine eligibility; *Targeting* is an active process to identify *all* people who would qualify to join the program, so as to allow active motivation of these people to join.

³² Obviously there are a small number of dependent people in each community who cannot engage in economic activities eg. those who are severely physically and mentally disabled.

³³ The internal loans seem to be a highly valued and useful feature of CRECER’s services. They give people greater flexibility within a relatively rigid lending methodology.

³⁴ For a more detailed discussion of the role of microfinance in the empowerment of women see Cheston and Khun in this book.

³⁵ For detailed discussion of these issues see Dunford 2002. <http://www.microcreditsummit.org/papers/healthintro.htm>

³⁶ Examples of synergistic combinations are given in Morduch and Haley (2001, pp86-91).

³⁷ Areas are divided into low, high or extreme difficulty in terms of operating conditions and remoteness. CRECER’s incentive scheme is currently being re-developed to include poverty outreach as well as improved impact indicators.

³⁸ Poverty-sensitive impact monitoring should include: information about who (poverty level and characteristics) the programme is reaching, not reaching, and who exits, and changes in this over time; information about the penetration rate; indicators that measure changes in livelihood (eg. income sources, food security and quality, housing, clothing expenditure, land and asset ownership) ; gender differences in poverty characteristics and changes.