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Role of microcredit and microfinance in the eradication of poverty

Report of the Secretary-General

Summary

The present report is submitted in response to General Assembly resolution 63/229. It assesses the benefits and limitations of microcredit and microfinance as a poverty eradication strategy, reviews the impact of the financial and economic crisis on microfinance and addresses various measures that Governments are taking to improve the delivery of microfinance services and to build inclusive financial systems. The report concludes with policy recommendations that focus on expanding financial access and strengthening policy coordination to meet poverty and related development challenges.

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I. Introduction

1. In recent years, there has been increasing recognition of the role microfinance can play in providing people living in poverty with basic financial services. The Monterrey Consensus,[1] adopted in 2002, noted the key role of microfinance and microcredit for micro-, small and medium-sized enterprises in strengthening the social and economic impact of the financial sector. The development of microfinance as a strategy to eradicate poverty was a central theme of the International Year of Microcredit in 2005.

2. An important outcome of the International Year of Microcredit was a publication entitled *Building Inclusive Financial Sectors for Development*,[2] widely known as the "Blue Book", which explored obstacles to financial inclusion and appropriate policy responses. The United Nations Advisers Group on Inclusive Financial Sectors, which was established as a follow-up to the International Year, strongly recommends that Governments, regulators, development partners and the private sector, as part of their efforts to reduce poverty, strive to provide greater access to a range of appropriate financial services for poor populations and small enterprises. Importantly, the Advisers Group notes that while wider financial outreach is associated with strong performance in standard economic development indicators, broadening access to financial services is an important policy goal but will not in and of itself eliminate poverty.[3]

3. The Group of 20, at its leadership summit held in Toronto, Canada, in June 2010, endorsed a set of principles to foster an enabling policy and regulatory environment for innovative financial inclusion. The principles were developed under the Group's Financial Inclusion Experts Group, created in September 2009, which will also issue an action plan for enhancing financial access for the poor at its summit to be held in Seoul in November 2010.

4. The present report provides an overview of the contributions of microcredit and microfinance to economic and social development, with particular reference to poverty reduction and social protection. It examines the growth of microfinance, which has the potential to provide a broader development platform, while pointing out its limitations as a universal strategy for poverty eradication and concerns about the drawbacks of unfettered commercialization. The report addresses the impact of the financial and economic crisis on microfinance and identifies aspects of microfinance that may contribute to the development of a more stable financial model. It also addresses key measures that Governments are taking to improve the delivery of services to promote inclusive finance, including through adapting and expanding regulatory frameworks to facilitate market entry and agent banking. The report concludes with a set of policy recommendations.

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[1] *Report of the International Conference on Financing for Development, Monterrey, Mexico, 18-22 March 2002* (United Nations publication, Sales No. E.02.II.A.7), chap. I, resolution 1, annex.

[2] United Nations publication, Sales No. E.06.II.A.3.

[3] United Nations Advisers Group on Inclusive Financial Sectors, "Microcredit, microfinance, inclusive finance: building on success" (2008).

II. Microfinance as a tool for development

A. Background

5. In most developing countries, the percentage of the population with a bank account at a formal financial institution is less than 50 per cent, and in many countries less than 20 per cent, according to the World Bank. Microfinance is widely considered to have emerged as a response to the failure of the formal financial sector to serve the needs of rural populations, informal sector workers and people living in poverty.

6. Microcredit, or small loans provided to poor and low-income people, was intended as a favourable alternative to borrowing from often exploitative local moneylenders. The Grameen Bank's success in Bangladesh has often been held up as a model in demonstrating the creditworthiness of people living in poverty and the potential positive socio-economic impact of microfinance. The Grameen Bank is particularly known for two innovative practices: serving mainly women clients and lending to small groups, with shared liability replacing monetary collateral.

7. As a market-based approach to fighting poverty, microfinance is focused on developing entrepreneurship and expanding self-employment. Microfinance institutions today serve approximately 155 million people.[4] They are characterized by close relationships with clients, simplified procedures and extension of support to clients through group networks and other resources, such as basic loan repayment training. The industry has become highly diverse, reaching various segments of society although not always reaching the poorest. Providers are similarly varied, ranging from non-governmental organizations, cooperatives, government and commercial banks, credit unions, self-help groups and point-of-sale partners such as shops and post offices. Increasingly, technology is helping to facilitate access to financial services and reducing their administrative costs. Product portfolios are widening to include various types of savings and insurance mechanisms, leasing, remittance services, emergency loans and more, reflecting increased recognition of the many dimensions of financial empowerment.

B. Social development benefits

8. In general, poor households in many developing countries face the common challenges of small, irregular and uncertain incomes. People living at or below the poverty line, like wealthier households, resort to the use of credit and savings to smooth their consumption over time, as well as to cope with emergencies or pay for major expenses. A recent study of the financial practices of poor households in Bangladesh, India and South Africa found that the average household in the sample employed 8 to 10 different instruments in the span of a year on multiple occasions. People living in poverty often have to pay for services that many others enjoy for free or pay more than others for using the same services. For example, in parts of Africa and South Asia, deposit collectors are paid in effect a 30 to 40 per cent

[4] Sam Daley-Harris, "State of the Microcredit Summit Campaign report 2009" (Washington, D.C., Microcredit Summit Campaign, 2009).

annual rate for safeguarding small savings.[5] Demand for microfinance is thus based on a range of needs, and there is considerable scope for improving the quality, design and delivery of financial products to be more responsive.

9. Microcredit and microfinance schemes are often accompanied by social service programmes that can empower the poor. In addition to providing funds for microenterprises or financial assistance to cover essential needs, microcredit and microfinance schemes promote the exchange of knowledge and experience within a group, the establishment of credit history and financial experience and the acquisition of livelihood skills and health information. Some institutions integrate the building of skills and knowledge into microfinance programmes, addressing non-income dimensions of poverty and providing business skills needed for successful entrepreneurship. Under the right conditions, microfinance can increase incomes, improve housing and promote better education, health and nutritional practices, as well as lower birth and child mortality rates.[6]

10. There has been significant growth in the microfinance industry. With more than 3,500 institutions worldwide, often serving remote rural areas, microfinance has significant reach as a broader development platform. Many organizations are working to leverage their distribution channels for greater human capital investment. In this regard, health literacy and financing tools, mosquito nets and maternal care are among the products and services that can readily be integrated more widely into microfinance operations. Such integrated service delivery programmes satisfy demand and build loyalty.

Social protection effect

11. Some 75 to 80 per cent of the world's population lacks social protection, which is often understood to consist of a minimum income and livelihood security, as well as access to essential services for vulnerable persons and persons living in poverty. Where a national social protection floor is not yet fully in place, microfinance can bridge an important safety net gap and enhance economic empowerment, factors crucial for the eradication of poverty. Although most microloans are intended for starting up or expanding a business, there is evidence that suggests that they are also used for consumption, including food, education and health. Borrowers of Bank Rakyat in Indonesia use their loans for household needs around 30 per cent of the time.[7] Although the use of loans for such consumption-smoothing can improve family welfare and capital, there is also the risk of creating debt traps.

12. Microinsurance, in particular, is designed to mitigate the risk that persons and households will fall into poverty or that the degree of their poverty will increase. Microinsurance policies generally provide inexpensive limited short-term coverage, most often for risks to life and health but also for property, livestock or crops, against weather and catastrophe, and for funerals and pensions. Nevertheless, despite the significant need in Africa for agricultural risk management to ensure

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[5] Daryl Collins and others, *Portfolios of the Poor: How the World's Poor Live on $2 a Day* (Princeton, New Jersey, Princeton University Press, 2009).

[6] Muhammad Yunus, "Poverty as distant history", *Harvard International Review*, vol. 29, No. 3 (fall 2007).

[7] Barbara Kiviat, "Next step for microfinance: taking deposits", *Time*, 30 August 2009. Available from www.time.com/time/printout/0,8816,1918733,00.html.

food security, a study found fewer than 80,000 persons covered by livestock, crop or various agriculture-related index products.[8] There is scope to expand the availability of microinsurance to poor people. Investors and large commercial insurers are increasingly attracted to the industry, whose market potential is estimated to be 1.5 billion to 3 billion policies.[9] There is also scope for innovation in the industry: in one recent pilot project in Bangladesh, refunds or discounts were offered to clients on subsequent premiums when no claims were made during a term.

13. Savings has been referred to as the neglected element of microfinancial services[10] and is often considered a better form of risk protection. Savings require no approvals and can be used flexibly at no cost to productive assets. When people living in poverty have the opportunity to save, they are often prevented from doing so securely in formal institutions because of the constraints imposed by distance, formalities and costs. The need for savings is estimated to be far greater than that for credit. Nevertheless, the reality is that the savings accumulated by poor households is often insufficient to handle large shocks, such as major illness or loss of employment, and the savings gap needs to be covered by other instruments, such as insurance or formal social protection.

Strengthening social inclusion

14. The financial exclusion of people living in poverty is closely linked to such factors as lack of land ownership, statehood or documentation, complex loan requirements, illiteracy and belonging to socially excluded groups.

Gender

15. Microfinance has been advanced as a strategy to promote women’s empowerment and gender equality. With women comprising the majority of the world’s poor, largely excluded from the formal financial sector and subject to various forms of gender discrimination, there is an urgent need to deepen and broaden their financial inclusion. Currently, women represent more than 70 per cent of all microfinance clients, and more than 83 per cent of the poorest clients.[4] Group interactions and the social ties they cultivate can further increase women’s agency and potential for collective action, including intervention in domestic violence cases, reflecting strengthened community capacity to overcome gender barriers.[11]

16. The actual impact of microfinance on women’s empowerment, particularly from the perspective of improved gender relations, has been questioned, however. For instance, the much-cited high repayment rates may not indicate higher profits, but rather strict enforcement or a heavier work burden. Even when incomes rise, women’s entrepreneurship generally continues to rely on segregated home-based work, limiting meaningful economic empowerment. Moreover, some studies have

[8] Michal Matul and others, “The landscape of microinsurance in Africa”, Microinsurance Innovation Facility, Briefing Note 1 (Geneva, International Labour Organization, 2009).

[9] “Insurance in developing countries: exploring opportunities in microinsurance”, Lloyd’s 360° Risk Insight, 2009. Available from www.riskebiz.com.

[10] See ST/ESA/2009/DWP/83.

[11] Paromita Sanyal, “From credit to collective action: the role of microfinance in promoting women’s social capital and normative influence”, *American Sociological Review*, vol. 74, No. 4 (2009).

found that microcredit has contributed to the inflation of dowries[12] and that women are used as a conduit for credit by men in the household. Thus, microfinance may not necessarily translate into improved economic and social status for women. An important link, however, has been identified between women's participation in microfinance and a lower incidence of domestic violence.

17. Women have a particular interest in microsavings and microinsurance. Where women have few legal rights, personal savings can serve as an extra buffer in case of unanticipated events such as divorce or widowhood. Women's multiple responsibilities combined with reproductive health needs and vulnerability to violence highlight some of the particular risks to women's health. Microinsurance initiatives are increasingly providing gender-sensitive products. Programmes in Guinea and India include incentives or requirements to cover all family members so that women and girls cannot be excluded. BancoSol in Bolivia partnered with Zurich Insurance to offer comprehensive women's health coverage with a lower-than-average waiting period to boost the availability of maternity benefits.

18. While it is generally accepted that microfinance alone is not a panacea for either poverty or gender inequality, it is increasingly evident that microfinance programmes that carefully incorporate gender considerations and goals into their design will greatly enhance their impact on reducing poverty and gender inequality. Microfinance can and does contribute to some measures of women's empowerment, but it is important to recognize that other factors, such as gender-sensitive legislation and free education, are also crucial and mutually reinforcing.

Older persons

19. It has been projected that with rapid ageing of the population, the old-age dependency ratio will almost triple in less developed regions between 2005 and 2050. At the same time, changing family dynamics are increasing the number of nuclear households, eroding a traditional support mechanism for older persons. With older persons disproportionately affected by poverty, the need for pension protection is assuming even greater importance. Programmes providing income support, savings and other services to older persons can facilitate their full participation in family and community life as well as in the economy.

20. Micropensions, combining microinsurance and microsavings to produce retirement income, are an emerging area of microfinance. The largest initiative is in India, where approximately 85 per cent of the workforce is in the informal sector and a similar percentage of workers do not qualify for a pension. Over the past four years, more than 200,000 workers have enrolled in a micropension scheme developed by Invest India Micro Pension Services, which reduces costs by leveraging technology and existing infrastructure. The programme is being implemented with a range of partners, including state governments, cooperatives, non-governmental organizations and international organizations, and adapted into various models. As one example, the Rajasthan government contributes to the

[12] Santi Rozario, "The dark side of micro-credit", *openDemocracy*, 10 December 2007. Available from http://www.opendemocracy.net/article/asdgn_asdg.

worker's pension account an amount identical to the worker's contribution, subject to a maximum annual co-contribution of 1,000 rupees.[13]

Emerging areas of coverage

Climate change

21. With the growing emphasis on responsible finance, some microfinance institutions are extending their reporting to include social and environmental performance, and some are actively involved in such efforts as fighting climate change. Strategies to reduce poverty and climate change intersect; in the poor countries most affected by global warming, people living in poverty are least able to respond. Unchecked climate change is expected to increase the frequency and severity of natural disasters and disease outbreaks, with serious consequences for health, agriculture and livestock. Those events can have a negative impact on the operations of microfinance institutions, including lowering repayment rates.

22. There are opportunities to encourage microfinance clients to reduce their carbon emissions and improve their health by giving them access to clean energy sources. Typically, the majority of energy consumed by microfinance clients is for home cooking and lighting. In Asia and the Pacific, 74 per cent of the population cooks with solid fuels, the indoor pollution from which is linked to a rate of mortality from respiratory diseases that is three times higher for women than for men.[14] Given that the majority of existing microfinance clients are women and that women bear the bulk of responsibility for household food production and fuel and water supply, microfinance institutions have the potential to influence changes in those areas. Moreover, removing from women and girls the burden of collecting water and traditional fuels can increase their time available for both school and income generation.

23. Microfinance institutions often have among their clients small enterprises that supply renewable energy equipment. Through their established distribution channels, they can make loans to households for the purchase of energy-saving devices and finance the entrepreneurs who supply them to homes and even communities, with ample scope to significantly develop new client bases and portfolios.[15] Grameen Shakti in Bangladesh has installed more than 130,000 solar home systems, which it links to income-generating activities, and 5,000 improved cook stoves. As with similar initiatives of other institutions, it partners with product suppliers for installation and servicing. Energy-efficient devices reduce the need for often expensive traditional energy sources as well as long-term health expenses. Returns are thus often generated from cost avoidance instead of revenue building.

[13] United Nations Development Programme and Invest India Micro Pension Services, "Co-contributory pension and insurance schemes for the working poor: lessons from the Rajasthan government Vishwakarma Yojana", National Policy Workshop for State Governments, New Delhi, 5 December 2009. Available from http://www.micropensions.com/sites/default/files/UNDP-IIMPS_WorkshopReport.pdf.

[14] Eva Rehfuess, "Fuel for life: household energy and health", Geneva, World Health Organization, 2006.

[15] Paul Rippey, "Microfinance and climate change: threats and opportunities", Focus Note No. 53 (Washington, D.C., Consultative Group to Assist the Poor, March 2009).

An important policy consideration is the legal restriction in some countries on extending microcredit for non-productive purposes.[16]

Disaster relief and recovery

24. Microfinance, given the right conditions, can play a significant role in disaster relief and recovery. In post-disaster situations, urgent relief efforts must overcome complicated logistical barriers and may not reach the neediest. Yet microfinance institutions' established grass-roots-level networks have repeatedly proven to be lifelines. This was made evident most recently following the January 2010 earthquake in Haiti. While all commercial banks in Port-au-Prince were out of operation, half of the 42 agencies of Fonkoze, the largest microfinance institution in Haiti, were distributing small sums of cash within four days;[17] it delivered more than $1 million in remittances and savings within a week of reopening.[18]

25. Microfinance institutions were also instrumental in providing assistance following Hurricane Mitch in Nicaragua and Honduras, several cyclones and floods in Bangladesh, typhoon Ketsana in the Philippines and the 2008 earthquake in China. They have distributed emergency cash and goods and provided loans and shelter. There have been cases in which microfinance institutions insisted on timely repayment even after disasters, and debate exists over whether or not loans in such cases should be cancelled or temporarily suspended. In addition to inserting disaster-specific provisions in account policies, some institutions are providing emergency and subsistence loans for disaster preparedness.

C. Limitations of microfinance as a poverty reduction strategy

26. There is still a dearth of hard evidence on the impact and accessibility of microfinance. Oftentimes evidence is anecdotal. Although microfinance has been lauded as a strategy for lifting people out of poverty, many experts assert that it is appropriate and effective only for the entrepreneurial and marginally poor, or even the non-poor, and that it diverts valuable resources. Debate continues over the degree to which microfinance reaches — and helps — the very poor. Whereas the Microcredit Summit Campaign found that more than 68 per cent of all microfinance clients were very poor at the time of their first loan, others assert that microfinance generally does not reach the poorest, who are better served by subsidies, grants and other safety net programmes providing cash transfers, shelter, food aid and employment.

27. Microfinance operates on the premise that poor households earn high returns, as they receive a significant boost from additional income. Yet poor households may have fewer resources with which to make credit productive, such as education, business skills or market contacts, resulting in inadequate returns and a debt

[16] Sunderasan Srinivasan, "Microfinance for renewable energy: financing the 'former poor'", *World Review of Entrepreneurship, Management and Sustainable Development*, vol. 3, No. 1 (2007).

[17] "Big crisis, small help", *Newsweek*, 10 February 2010. Available from: www.newsweek.com/id/233334.

[18] Asma Azmi, "Microfinance: new helpline during natural disasters?", *Microfinance Focus*, 27 February 2010. Available from www.microfinancefocus.com/news/2010/02/27/microfinance-new-helpline-during-natural-disasters.

burden.[19] Two important studies using randomized controlled trial methodologies in India and the Philippines revealed no impact of microfinance on average consumption or welfare.[20] The India study found some positive effects on business outcome and household expenditure, however. Existing business owners increased spending on durables, apparently for business expansion; households considered most likely to start a business reduced spending on non-durables and items such as alcohol and tobacco, apparently to expand an initial investment; and others increased non-durable (e.g. food) consumption. The number of new businesses also rose by one third.[21] As the studies provide short-term assessments, it may be that average consumption failed to increase because clients diverted income into business investments. Thus, improvements in poverty, empowerment, health and education may appear only in the long run.

28. The absence of conclusive evidence that microfinance lifts people above the poverty line should not minimize the evidence that it improves lives by easing the management of expenses and preventing further hardship.[22] Some experts assert that its ability to reduce vulnerability by smoothing consumption and reducing risk may outweigh its income-generation function. Accordingly, its impact on poverty may be less apparent using income measures rather than multidimensional analysis. This approach highlights the need to combine microfinance with complementary interventions that further address aspects of poverty, such as investments in health and skills training.

D. Commercialization of microfinance

29. As microfinance institutions demonstrated the sustainability of microlending, commercial banks have transformed the model into a major global industry. Between 2004 and 2008, such institutions experienced average annual asset growth of 39 per cent and accumulated more than $60 billion in total assets. In 2008, the majority of foreign capital came from private investors interested in the double bottom line of social and financial returns. Some institutions, availing themselves of plentiful private capital instead of limited donor funding, have adopted a for-profit approach. Many contend that such private investment is necessary to achieve the scale needed to affect aggregate poverty levels. Others believe, however, that profit has no place in poverty eradication work, asserting that business interests necessarily put social justice in the back seat, a result referred to as “mission drift”.

30. One of the major concerns about the commercialization of microfinance relates to high interest rates. Globally, annual interest rates and fees on microloans average approximately 37 per cent, though they can reach 125 per cent. It has been argued that appropriate interest rates are between 10 and 15 per cent above the cost of

[19] Jonathan Morduch, “How can the poor afford microfinance?”, Focus Note (New York, Financial Access Initiative, January 2008).

[20] *Forbes*, “How to measure microfinance’s social impact’, 2 December 2009. Available from www.forbes.com/2009/12/02/microfinance-poverty-wharton-entrepreneurs-finance-wharton.html.

[21] Abhijit Banerjee and others, “The miracle of microfinance? Evidence from a randomized evaluation” (Cambridge, Massachusetts, Abdul Latif Jameel Poverty Action Lab and Centre for Microfinance, 2009).

[22] Karol Boudreaux and Tyler Cowen, “The micromagic of microcredit”, *The Wilson Quarterly* (Washington, D.C., winter 2008).

raising money, yet one estimate found 75 per cent of institutions charging higher rates. It may be that rates vary because of local business costs, reduced access to technology and other factors. Nevertheless, the central argument that higher rates are justified because they reflect the higher cost of providing microfinance services is not entirely convincing. Poor borrowers should not have to pay for inefficient lending. Without necessarily making microcredit unsustainable, interest rates can be lowered by promoting competition and innovation, both of which improve efficiency and lower prices. Consumer education is also key to ensuring that consumers of microfinance services have the skills necessary to make informed financial choices.

31. In many countries, microfinance institutions are required by law to transform into regulated for-profit corporations in order to provide savings and other non-loan services. While such transformation allows institutions to diversify their products to better meet clients' needs, improves access to funding and can enhance management and governance, it also fuels the debate over mission drift.

32. Prior to the economic crisis, the biggest self-reported microfinance industry risks were institutional in nature, such as poor management and increased competition.[23] Along with rapid industry growth, over-indebtedness has also emerged. Some countries with previously robust markets are now showing signs of stress that cannot be fully attributed to the economic crisis, prompting concerns about overheating. A recent study on microfinance markets in Bosnia and Herzegovina, Morocco, Nicaragua and Pakistan, which all experienced significant periods of growth followed by a repayment crisis, found a common set of vulnerabilities. The first is concentrated market competition and multiple borrowing which, although it can in some cases improve repayment rates, will lead to some clients borrowing beyond their means and increasing risk. The second vulnerability is overstretched systems and controls of microfinance institutions, as rapid growth and staffing can compromise quality as well as strain supervisory capacity and the internal controls needed for discipline and security. The third is erosion of lending discipline, as a focus on efficiency and cost savings overshadows customer service and face-to-face relationships. The study also observed that savings was not a key service or funding source in the four markets.[24]

III. Impact of the economic and financial crisis on microfinance

33. As microfinance institutions are increasingly integrated into domestic and international markets, they become more vulnerable to the impact of economic downturns. Part of this vulnerability relates to resource mobilization, as each category of resources is affected differently. Local deposit-taking institutions are generally better insulated than those relying on international funders.

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[23] Centre for the Study of Financial Innovation, Citigroup and Consultative Group to Assist the Poor, "A different world. A follow-up to Microfinance banana skins 2009, 'confronting crisis and change'", February 2010. Available from www.citigroup.com/citi/microfinance/data/diff_world.pdf.

[24] Greg Chen, Stephen Rasmussen and Xavier Reille, "Growth and vulnerabilities in microfinance", Focus Note No. 61 (Washington, D.C., Consultative Group to Assist the Poor, February 2010).

34. The impact of the current economic and financial crisis has been compounded by the effects of earlier food and fuel price inflation. A survey in 2008 by the Consultative Group to Assist the Poor of microfinance institutions found that the food crisis led to clients consuming less food as well as cutting back on other spending, including on health, withdrawing savings and, in many cases, struggling with payments. Although prices have since declined, they nonetheless remain higher on average than before the food crisis. In addition, recent high unemployment rates in developed countries have reduced remittance flows. The decreased purchasing power of clients and their need to tap savings to a greater extent decreases the liquidity of microfinance institutions and raises credit risks.

35. While funds continued to grow in 2008, the first five months of 2009 saw a rapid rise in portfolio delinquency, with past due loans increasing from a median of 2.2 per cent to 4.7 per cent and profitability falling by two thirds. Since June 2009, the landscape has improved somewhat. Faced with the prospect of slower growth and reduced new lending, national and multinational development agencies have established emergency liquidity facilities. Some regions have been more affected than others; Central America, Eastern Europe and Central Asia have experienced the greatest impact, while parts of South America and South Asia — most notably, Bolivia and India — have seen few or no signs.[25] Yet institutions in all regions except Africa have reported that the economic crisis is the greatest risk they currently face. Global reporting ranks credit risk, the state of the macroeconomy and funding risk as the most pressing concerns.

36. As the microfinance sector continues to attract significant capital, more institutions are expected to further expand, albeit more slowly and with enhanced risk management. While microfinance is by no means immune to the crisis, it has proven more resilient than commercial banking.

37. As Governments turn to strengthening financial policies to prevent future crises, the timing is ripe to implement changes that broaden access for the poor. In the wake of the crisis and recent bank failures, there may be important lessons to be learned from microfinance principles and practices about how to promote a more socially responsible, stable and sustainable model of finance. We should not overlook the value of having a focus on small, local banks that reward repayment with larger loans and emphasize long-term profitability and shared benefits that are responsive to communities. Responding to local needs with simple and accessible banking that focuses on knowing the clients, providing long-term value, operating with transparency and ensuring that clients understand their rights and responsibilities can serve as a platform for a new finance model.[26] The low rate of loan loss among microfinance institutions demonstrates that such principles are both financially viable and socially responsible.

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[25] Xavier Reille and others, “All eyes on asset quality: microfinance global valuation survey 2010”, Occasional Paper No. 16 (Washington, D.C., Consultative Group to Assist the Poor, March 2010).

[26] “The global financial crisis: what does it mean for microfinance?” (Consultative Group to Assist the Poor, Washington, D.C., 15 December 2008).

IV. Strengthening the impact of microfinance on poverty eradication

A. From microcredit to inclusive finance

38. The shift from microcredit and microfinance to inclusive finance begins with the recognition that access to credit alone is insufficient for poverty eradication. A set of useful, flexible services and reliable delivery mechanisms are required to meet a range of changing economic and social needs.

39. Inclusive finance envisions increased outreach to unserved and underserved households as well as to micro-, small and medium-sized enterprises through a continuum of financial institutions offering appropriate products and services to all segments of the population. It takes account of the numerous causes of financial exclusion, the diversity of demand for affordable financial services on the part of poor and low-income clients and the various types of financial service providers, as well as private, public and government sector considerations such as corporate governance and regulation. Inclusive finance is further characterized by sound institutions and financial and institutional sustainability.[2]

40. People living in poverty, like wealthy people, seek portfolios of various financial instruments to manage their range of vulnerabilities with flexibility. They seek to diversify their portfolios to spread risk and avoid dependency on any one instrument. Inclusive finance places emphasis on ensuring access to a wide range of financial services to all households and enterprises. In accordance with this broad vision, enhanced lending to vulnerable and priority sectors can contribute to poverty reduction and inclusive growth with decent work. In particular, small farmers have limited access to services that can help to increase agricultural productivity, and small and medium-sized enterprises at the lower end of the market have been overlooked by mainstream financial institutions. The central bank of Bangladesh recently launched several refinancing support lines to increase lending for agriculture and to small and medium-sized enterprises, as well as for solar, biogas and other renewable energy projects and other sectors.

41. For the first time, Bangladesh Bank set a target for loan disbursements by banks and non-banking financial institutions to small and medium-sized enterprises. Priority is being given to rural populations and women in the production and service sectors. In addition, the agricultural credit programme for the 2010 financial year enjoins all banks to lend for a comprehensive range of on- and off-farm rural economic activities. Along with commercial banks, the central bank initiated several steps to provide accessible loans for farmers, including landless and marginal farmers, which it publicized through a countrywide campaign. The policy changes should be evaluated for their effectiveness and potential replication.

42. On average, loans issued by non-governmental organizations are estimated to be less than one quarter the size of those issued by commercial microfinance banks. This results in higher operating costs, increasing the difficulty and expense of providing services to the very poor (assuming that loan size indicates a client's poverty level). Organizations therefore rely on subsidies or charge higher interest rates, pointing to a trade-off between microfinance outreach and efficiency. Other trade-offs exist among these and additional factors, such as profitability, regulation and competition, underscoring the challenges in reconciling the pursuit of social

objectives and financial efficiency. Those factors must be weighed in the development of microfinance strategies and inclusive financial systems.[27]

B. Government measures to enhance the effective delivery of microfinance services

43. Governments can assume many roles in the building of inclusive financial sectors. They maintain macroeconomic stability through sound monetary and fiscal policies, develop infrastructure, promote financial access and protect customers. Some Governments have provided financial services directly, and some have set up bank incentive programmes.

Market data

44. A study found that fewer than 70 per cent of 139 countries surveyed gathered information on the number of bank deposit accounts, and far fewer countries had information on the number of loans or deposit accounts with regulated non-bank institutions. There is a need for regular, accurate information on standardized indicators for all regulated financial institutions, including the number of deposit accounts and loans, clients and borrowers and financial access points, to guide the design of policies, set priorities and goals and evaluate progress. Regulators can achieve this by setting clear reporting guidelines.[28]

Subsidies

45. The issue of subsidies continues to divide opinion, but may be less relevant amid the influx of private investment and the enhanced use of deposits. An increasing number of microfinance institutions have reached or are approaching sustainability. One view holds that there is no place for State subsidies, which can be put to better use elsewhere. Others argue for short-term subsidies to support institutions until they reach an adequate scale and level of efficiency, wary of the risk of overdependence, which can lead to inefficiency. The Consultative Group to Assist the Poor recommends a five-year limit in its donor guidelines. Another position rejects a solely financial measure of the impact of microfinance and asserts that the goal of financial viability may be incompatible with the mission of poverty eradication. There is also the perspective that carefully designed subsidies of limited duration can achieve a merger of market efficiency outcomes and social benefits. A growing view seeks a shift towards longer-term performance-based contracts between donors or Governments and microfinance institutions. Such contracts would hold institutions accountable for meeting efficiency targets. Broader agreement exists on the use of subsidies to meet the essential needs of the very poor until they “graduate” into microfinance programmes.

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[27] Robert Cull, Asli Demirguc-Kunt and Jonathan Morduch, “Microfinance tradeoffs: regulation, competition, and financing”, Policy Research Working Paper No. 5086 (Washington, D.C., World Bank, October 2009).

[28] “Financial Access 2009: measuring access to financial services around the world” (Consultative Group to Assist the Poor, Washington, D.C., 2009).

Regulation

46. The extent of regulation and supervision in microfinance must take account of the need for balance between expanding access and ensuring safety. Some countries, including Nepal and the Philippines, have introduced proportionality in regulation according to which the degree of supervision is linked to the extent and size of deposit services.[29] At the same time, it is important to invest in supervisory capacity to achieve meaningful financial system security. In addition to simplifying and enhancing the flexibility of regulation, Governments may consider permitting the operation of mobile bank branches to facilitate access to financial services. This has been effective in Kenya and other countries.

47. Much debate surrounds the issue of interest rates, which many argue can be unreasonably high and run counter to the goal of financial inclusion. Evidence reveals slower growth in access to finance in countries with interest rate caps. Instead, policies are promoted to encourage competition through such measures as transparent pricing and consumer education requirements to raise efficiency and lower fees. Such steps taken in Cambodia helped to reduce interest rates from over 60 per cent to around 30 per cent.[29]

Government-to-person payments

48. The electronic transfer of Government payments to individuals is a promising tool for building financial inclusion among people living in poverty. Several Governments are delivering social transfers as well as wage and pension payments electronically rather than in person. This mechanism is convenient for recipients and reduces the likelihood of fraud and corruption. Over time, it also lowers administration costs. Brazil was able to reduce the costs of delivering Bolsa Familia grants more than sixfold by adopting electronic benefit cards provided through a Government-owned financial institution. The safe storage of funds in financial institutions and the transactional ability that they can enable are key components of inclusive financial services. Branchless banking can also ensure accessibility. Worldwide, Governments issue regular payments to approximately 170 million people living in poverty. However, fewer than one quarter in most countries are issued to financially inclusive accounts. Research shows that recipients of those payments do indeed utilize financial services when offered them.[30]

Market infrastructure

49. Sound market infrastructure can help to reduce microfinance risks by making financial performance information available regularly. Investments can be directed towards the establishment of credit information bureaux, performance disclosure standards, external ratings and standards for external audits. The use of social performance management and portfolio testing tools by microfinance institutions is increasing and can contribute to external evaluations. The central bank of the Philippines recently approved rules and regulations for the recognition and derecognition of agencies that rate banks having microfinance operations with the

[29] United Nations Capital Development Fund, “Widening access to financial services for balanced economic growth”, May 2009. Available from http://www.uncdf.org/english/news_and_events/index.php?record=72.

[30] Mark Pickens, David Porteous and Sarah Rotman, “Banking the poor via G2P payments”, Focus Note No. 58 (Washington, D.C., Consultative Group to Assist the Poor, December 2009).

aim of building an enabling environment for accurate and objective third-party ratings.[31]

50. Credit information bureaux, which provide lenders with borrowers' credit histories, are becoming essential for risk management. Countries with higher-quality credit information systems also have higher rates of individual lending. Regulators are increasingly promoting and requiring the sharing of credit information through public registries, which collect data on regulated providers, or private registries, which gather information on both regulated and non-regulated providers. As many non-regulated entities serve people living in poverty, collaboration between public registries and private bureaux is crucial. In Ecuador and Peru, public registries are shared with approved credit bureaux.[28]

Consumer protection

51. As more commercial banks enter the microfinance industry seeking a return on their investment, greater attention is being paid to strengthening consumer protection. Microfinance clients may be particularly vulnerable, as many were previously excluded from access to finance and may be disproportionately illiterate. Governments can focus measures on disclosure requirements, lender practice prohibitions and requirements, complaints and disputes. Most countries have requirements for the disclosure of loan interest rates, although the disclosure of penalties, terms and conditions and changes in terms may also be required. Regulators in Peru require lenders to post sample loan repayment schedules, and some countries mandate plain language.[28] Although difficult to enforce, such requirements improve transparency.

52. Lender prohibitions and requirements often seek to prevent the pressuring of potential clients to take loans and abusive debt collection practices. Mechanisms for redressing grievances should be in place to deal with any problems that arise. The Micro Finance Regulatory Council of South Africa, for example, has a toll-free call centre that connects consumers to complaints officers.[32]

Financial literacy

53. Financial literacy helps clients to better manage risks and utilize financial services, enhancing the contribution of finance to poverty eradication. Governments can expand financial literacy through school programmes, national campaigns and information and communication technology channels, as well as by promoting and clearly defining requirements for the provision of financial education by financial institutions. The central bank of Uganda recently announced a plan to partner with the education ministry on incorporating financial literacy programmes into school curriculums.

54. Many microfinance institutions and non-profit organizations provide training in financial literacy. Compartamos Banco in Mexico has offered courses since it

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[31] Lailany P. Gomez, "BSP issues microfinance rating rules", *The Manila Times*, 31 March 2010. Available from www.manilatimes.net/index.php/business-columns/14442-bsp-issues-microfinance-rating-rules.

[32] David Porteous and Brigit Helms, "Protecting microfinance borrowers", Focus Note No. 27 (Washington, D.C., Consultative Group to Assist the Poor, May 2005).

went public, with 60,000 clients participating in the first year.[33] The Aflatoun programme provides social and financial education to young children in schools and non-formal education settings in 41 countries.

Infrastructure and technology

55. Advancements in technology have fuelled the growth of microfinance. Among the most promising of current developments for expanding financial access to people living in poverty is branchless banking. Such banking allows for the provision of a range of financial services in the absence of physical bank branches, especially in rural and remote areas, through mobile phones, bank cards and banking agents. Agents are local partners already established in communities, such as retail stores, gas stations, kiosks or post offices. By relying on existing infrastructure, operational costs are reduced significantly, and clients benefit from convenience and time savings. The Internet is further expanding the reach of microfinance, including through several websites that allow anyone to extend small loans through connections to microfinance institutions.

56. Currently, 65 mobile money systems, termed m-banking, are in operation globally, and more than 80 more will soon be launched.[34] Most programmes are run by telecommunications companies supported by non-bank agents, such as mobile phone or airtime vendors. The systems generally allow for money transfers, which are especially valued for sending remittances. This function has significant implications for the African region, where between 30 and 40 per cent of all remittances are directed to rural areas and transfer costs are very high because of a limited number of payout locations.[35] Most recently, the m-Pesa mobile money transfer service in Kenya partnered with Equity Bank to provide savings services, called m-Kesho. Subscribers can open savings accounts, earn interest and access credit and insurance.

57. Branchless banking poses new challenges for regulators, who must address such issues as liability to clients, the range of services agents can provide, customer protection, liquidity management and agent security. Regulators permit agent banking in 40 per cent of 139 countries surveyed, of which more than half allow payment-related services. Non-bank actors are also using agents to provide financial services. The opening of postal branches to professional financial service providers can greatly expand access at significant savings for financial institutions and generate revenue for postal systems. India's post office savings bank retail network offers payment and savings services through 155,000 branches, 90 per cent of which are in rural areas.[28]

58. A recent study found that although most microfinance institutions are interested in information and communications technologies, a low adoption rate exists partly because of inadequate electricity supplies. Some 70 per cent of institutions at the branch level had occasion to frequent electricity cuts, and 17 per cent in Africa had no supply.[36] Despite the potential of branchless banking, a lack of

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[33] *The Economist*, "Doing good by doing very nicely indeed", 26 June 2008.

[34] Jane Wakefield, "Mobile banking closes poverty gap", 28 May 2010. Available from www.bbc.co.uk/news/10156667.

[35] *Sending Money Home to Africa: Remittance Markets, Enabling Environment and Prospects* (Rome, International Fund for Agricultural Development, November 2009).

[36] Asako Matsukawa, "Is ICT fueling the growth of microfinance institutions?", *Microfinance Insights* (Mumbai, India, Intellecap, 2010).

reliable infrastructure in many developing countries inhibits its scaling-up, pointing to the need for a range of investments that complement microfinance if it is to achieve its full social and economic impact and reduce poverty. In addition to energy infrastructure, these must apply to transport, health care, technological innovation, employment and entrepreneurial skills training.

V. Conclusions and recommendations

59. **The present report underscores the contribution of microfinance to reducing vulnerability among people living in poverty by smoothing consumption and generating self-employment, which can play a social protection role. The impact of microfinance may be reflected less in income measures than in broader dimensions of poverty, such as access to health or education. This perspective highlights the need to complement microfinance services with other development strategies focused on building human capital and creating an enabling environment to maximize the poverty eradication potential of microfinance.**

60. **Inclusive financial systems provide access to a range of services responsive to varied demand among all households and small and medium-sized enterprises. Further research and analysis of financial practices, particularly among poor households, is needed to enhance the quality, structure and availability of financial products. There is great scope for microfinance to further contribute to poverty eradication and other development goals, particularly in the areas of environment, health and social inclusion. Microfinance can thus serve as a broader development platform and advance progress towards the achievement of the Millennium Development Goals.**

61. **In the wake of the financial and economic crisis, the fundamentals of microfinance may offer lessons for a new, more stable financial model. The principles and characteristics of microfinance, including the focus on small, local banks, simple and accessible services, knowledge of and provision of education to clients, transparency and long-term profitability, can contribute to socially responsible and sustainable finance. With the world's attention focused on financial policy reform, Governments should seize the opportunity to extend access to financial services.**

62. **Policies should provide for regulatory frameworks that permit diverse institutions and bank agents to deliver varied and innovative financial services, contingent on fulfilling proportional requirements that provide for adequate consumer protection. Additional measures should include regularly collecting and managing data on financial access, developing sound market infrastructure and promoting financial literacy. Electronic government-to-person payments may also be considered as a cost-effective means to advance financial access. Financial inclusion policies should be developed in coordination with other social, economic and environmental policies to ensure adequate attention to and investment in areas such as health care, energy, education and livelihood skills, technology and transport, which complement and support the positive effects and potential of microfinance.**

63. **Governments may wish to consider the following recommendations towards strengthening financial inclusion:**

(a) **Adapt regulatory frameworks to expand the range of institutions permitted to provide savings and other non-lending services by providing for proportional supervision so as to enhance competition and widen financial access to people living in poverty;**

(b) **Expand regulatory frameworks to enable agent banking, in accordance with balanced and appropriate controls and protections, with a view to supporting the scaling-up of branchless banking;**

(c) **Establish clear reporting guidelines for regulated financial institutions while supporting the development of and coordination with an effective market infrastructure, including in particular credit bureaux, to facilitate the availability of regular and accurate market data for use in product development and regulation;**

(d) **Expand partnerships and coordinated investment in employment and in the development of entrepreneurial skills and infrastructure as key means of enhancing microfinance outcomes among excluded households and enterprises;**

(e) **Develop mechanisms to strengthen financial policy coordination to improve responses to complex and interlinked development challenges, including poverty, climate change and social exclusion;**

(f) **Strengthen support to local and community banks and to financial literacy programmes and promote know-your-client principles so as to ensure long-term financial sustainability;**

(g) **Encourage empirical research into the impact of microcredit and microfinance on accelerating poverty reduction and expanding social protection, including improved data collection to achieve this purpose.**