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GRADUATING THE POOREST INTO MICROFINANCE: LINKING SAFETY NETS AND FINANCIAL SERVICES

CGAP

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Does microfinance reach the poorest?

Microfinance—or formal financial services for the poor—helps people fight poverty on their own terms, in a sustainable way. Poor people use loans, deposits, and other financial services to reduce their vulnerability, seize opportunities, and increase their earnings. Indirectly, microfinance improves schooling, health, and women's empowerment.[1] In most settings, however, microfinance does not reach the people at the very bottom of the socioeconomic scale—the "poorest."

Today there is much debate about whether microfinance is for the poorest. Many millions of people living on less than a dollar a day (the very poor) are already being served by microfinance institutions (MFIs). And yet few MFIs reach the "poorest" customers at the bottom of the poverty scale in their own countries.[2] Even in the case of MFIs that focus on reaching very poor clients, there are substantial numbers of people who are too poor to participate. For example, in Bangladesh, where MFIs are strongly focused on serving the very poor, MFI concentration is highest among the second poorest quintile group; it is lowest among the poorest quintile. Microfinance services are not aimed at the poorest communities.[3] Why is this?

One reason extremely poor people may prefer not to borrow is because they think debt is more likely to hurt rather than help them. If a woman has no reliable income source, she may feel that obligating herself to make a regular weekly or monthly payment will make her more vulnerable rather than less. Although her investment of the loan proceeds in a new microbusiness may raise and stabilize her income, this investment is a risky proposition given that a large percentage of microbusiness start ups fail. Realizing this, many extremely poor people decide that their life is already risky enough without taking on debt. Arguably, some of these fears may be more about confidence than reality, but the poor are usually the best judges of their own situation.

On the other hand, suppose a very poor woman with no reliable existing cash flow *is* willing to borrow money. In an MFI that uses a group loan methodology, the

[1] Littlefield, Elizabeth, Jonathan Murdoch, and Syed Hashemi, "Is Microfinance an Effective Strategy to Reach the Millennium Development Goals?" Focus Note 24, Washington, D.C.: CGAP, 2003.

[2] In this Focus Note the very poor are defined as those living on less than a dollar a day. The poorest is the bottom subset of this group—the destitute who do not have any reliable sources of earnings.

[3] Zaman, Hassan, ed., "The Economics and Governance of Non Government Organizations (NGOs) in Bangladesh," Consultation Draft, Washington, D.C.: World Bank, 2005.

other women in the group may be unwilling to increase their own risk by guaranteeing repayment of her loan.

In addition to self-exclusion and exclusion by group members, some of the exclusion is driven by MFI policy. Because most microcredit is uncollateralized, MFIs have found that loan default quickly turns into an uncontrollable epidemic unless they keep it at very low levels. Precisely because new microbusiness start ups are so risky, MFIs have found—with few exceptions—that they cannot keep default within controllable bounds if they lend to borrowers who are new to microenterprise and who don't have other income sources to repay the loan if the new business isn't successful. That policy is entirely rational if the MFI wants to stay in existence and serve growing numbers of poor customers in the future, but adhering to this policy means that some of the poorest people are excluded from financial services.

Another factor is that many of the poorest desperately need nonfinancial support, such as food, grants, or guaranteed employment, before they are in a position to make good use of loans or deposit services. Over the years, most MFIs have concluded that they can deliver financial services more efficiently and sustainably if they focus exclusively on their financial business and either avoid nonfinancial services like nutrition, health, and training altogether, or at least isolate those services from their microlending operation by keeping them in a separate department with separate staff. In addition to issues of efficiency and focus, clients may become confused if the same unit is donating social support to them with one hand while insisting on repayment of the loans that it is giving with the other hand.[4]

These choices by clients, borrower groups, and MFIs are generally sound, and this paper does not recommend a reversal of those directions. But still, the result is that MFIs are limited in their ability to serve the poorest—those who need more help than any other group and who also should have priority over others for that help. With rare exceptions, even MFIs dedicated to reaching the very poor fall short of reaching those at the very bottom.

Microfinance is not the only way to help people. There are other services and institutions, such as "safety net programs," that are usually better suited to the circumstances and needs of the poorest. One approach to helping the poorest gain access to appropriate financial services may be to start with safety net programs that will eventually help the poorest gain access to financial services. This Focus Note explores a few cases (perhaps the harbingers of an emerging trend?) where the poorest participate in grant-funded safety net programs, where they receive nonfinancial support, such as employment, food aid, training, etc., as well as support to graduate from their existing levels of poverty to a level where they can make good use of access to appropriate financial services. These examples raise the questions: Can microfinance help the poorest? If so, how? And can people "graduate" from being recipients of grants to becoming full-fledged microfinance clients?

Can microfinance be linked to safety net programs?

Social protection programs promote the economic and social security of the poor through a range of interventions—from safety nets (food aid or guaranteed employment) for those in immediate desperate need, to social insurance to buttress those at risk of slipping down to the ranks of the destitute.[5] Safety nets, as part of a social protection strategy, have been successful in reaching and helping people at the bottom of the economic ladder—people who are too poor for conventional microfinance.

Unlike microfinance, safety net programs need to be highly subsidized. Most of the people they serve cannot bear the costs of the support provided. In addition, the skills needed to deliver

[4] A minority of MFIs—e.g., those who use Freedom from Hunger's "credit with education" model—continue to integrate nonfinancial services into their microfinance operations.

[5] The World Bank defines social protection as "public interventions to (*i*) assist individuals, households and communities better manage risk and (*ii*) provide support to the critically poor." Holzmann, Robert, and Steen Jorgensen, "Social Risk Management: A New Conceptual Framework for Social Protection and Beyond," Social Protection Discussion Paper # 6, Washington, D.C.: World Bank, February 2000.

safety net services are quite different from the skills needed to deliver credit and other financial services. For these and other reasons, MFIs should not try to deepen their outreach by offering safety net activities along with financial services.

Without abandoning this general rule, some MFIs are finding ways to team up with existing safety net programs in hopes of making themselves at least indirectly useful to the poorest. Some safety net and grant programs are deliberately providing financial training and information to their clients so that their clients can subsequently link with MFIs. This collaboration is based on the premise that many of the destitute can save, start building assets, and eventually gain the resources and confidence to engage in sustainable economic activities, at which point they can make good use of loans and other financial services offered by MFIs. In other words, people who benefit from safety net programs may "graduate" to become full-fledged microfinance clients.

This Focus Note discusses two basic models of linkages between MFIs and safety net programs. In the first model, safety net programs themselves develop basic financial services for their clients to help them better manage their livelihoods. The MFI's engagement with the safety net program is limited: the MFI simply coordinates with the safety net program to recruit successful "graduates" as customers. The advantage for the MFI is that the safety net program generates information about participants' behavior that can later help the MFI make better decisions about the likelihood these participants will repay loans. An MFI would consider a safety net participant with a track record of showing up for work, saving regularly, or even repaying a loan offered by the safety net program to be a less risky borrower when she eventually approaches the MFI for regular microcredit. An MFI with access to such information can make safer loans to poorer clients than an MFI without this information.

The relationship also benefits safety net participants, because it gives them a long-term path forward and motivates good performance while they are with the safety net program. This win–win situation creates little extra cost or risk for either the program or the MFI. Even a weak MFI can use this strategy to pursue its social mission to sign up promising clients without jeopardizing its ability to achieve sustainability.

The second model involves a more intense collaboration between an MFI and a safety net program. In this model, the MFI establishes a separate subsidiary or affiliate that works directly with safety net participants. In cooperation with the safety net program, the MFI subsidiary provides nonfinancial services and, perhaps, some subsidized savings or credit. Successful graduates gain access to the MFI's regular programs. The MFI subsidiary will need access to soft money to be able to offer its services to participants, until participants are able to join the mainstream microfinance program.

This second model entails high costs and risks for the MFI, including the risk that handing out "grants" as part of the safety net program could undermine the culture of strict repayment discipline that is an essential part of the MFI's microcredit operation. There needs to be a clear distinction between the safety net and MFI components. This is typically accomplished by using separate staff working in a separate subsidiary. This direct engagement model would work well only for a mature, exceptionally strong MFI whose core business is operating so solidly and sustainably that it can afford to have its management and staff resources diluted.

Safety Net Programs Providing Training and Delivering Clients to MFIs

CARE/Bangladesh: The Rural Maintenance Program

The Rural Maintenance Program (RMP) of CARE Bangladesh began in 1982 as a public works program that provides employment for destitute rural women—women who are heads of households or married to disabled men and who have no other income source. Women are recruited to the RMP for a fixed four-year period. They receive cash wages for maintaining earthen village roads. Women who

are selected for the program must be 18–35 years old and physically able to do the job. Every woman in the program is required to participate in a compulsory savings plan that captures a fifth of her earnings.[6] The participants are trained in numeracy, human rights, gender equity, and health and nutrition, as well as income-generating skills and microenterprise management. CARE continues to provide business management advice for a year after the end of the program cycle.

RMP is active in 90 percent of rural districts in Bangladesh. Program crews maintain 84,000 kilometers of roads. More than 40,000 women participate in the program at any one time, with 10,000 completing the program each year.[7]

RMP aims to move its participants beyond needing continuous external assistance. The strategy is to create new microentrepreneurs with adequate skills training and seed capital from the forced savings. Although not all women succeed as microentrepreneurs, RMP has an impressive track record. Seventy-nine percent of graduates continue to be self-employed in microenterprise activities three years after the end of the program cycle. Women in the program receive information on local MFIs and are encouraged to approach the MFIs for working capital and expansion needs after they graduate. A CARE Bangladesh "Household Security Survey," conducted in early 2005, indicates that 63 percent of RMP graduates remain members of NGOs three years after graduation.[8]

DFID–CARE/Malawi: CRIMP—A Not So Successful Replication

RMP's success should not suggest that graduating participants from an employment program to microfinance is easy. A replication of the program in Malawi failed to provide long-term sustainable solutions to its participants.

The Central Region Infrastructure Maintenance Program (CRIMP), a DFID–CARE program in Malawi, was started in late 1999 in two districts of the Central Region of Malawi. CRIMP was designed as a two-year pilot project to provide employment to poor women in rural roads maintenance. The program employed 1,600 women. Participants were trained in group solidarity, confidence building, and basic business skills. They also received help selecting appropriate economic activities. A third of their earnings was deducted as compulsory savings, which they received at the end of the employment program. Participants also saved for a voluntary group fund and used it to distribute loans to other women in the group. The project ended in early 2002. Some elements of the project were subsequently incorporated in the national safety net program.[9]

CRIMP successfully targeted the poorest women, built an effective savings program, and provided useful skills training. Program assessments indicate that earnings from the road maintenance work plus the training helped most of the participants start income-generating activities (generally in petty trade and farming). Savings proved extremely useful in meeting emergency consumption needs, especially in a "maize crisis" period when most households faced long periods of hunger.[10] About half of the CRIMP participants maintained a culture of savings even three years after the end of the program, and said they used their savings for emergencies and to operate their small businesses.[11] However credit constraints remain and long-term economic recovery is not forthcoming.

CRIMP started with the assumption that the training and savings participants received would set them up as microentrepreneurs who would then borrow from MFIs for working capital, business expansion, and other financial services. But CRIMP

[6] The current daily wage is about US$ 0.85; $0.17 is withheld as compulsory savings.

[7] 10,000 new women are inducted each year to replace the 10,000 that leave at the end of four years. Ahmed, Shaikh S., *Delivery Mechanisms of Cash Transfer Programs to the Poor in Bangladesh*, Washington, D.C.: World Bank, May 2005.

[8] Email from Dr. Phillip Tanner, Program Coordinator, RMP.

[9] Potter, Harry, et al., "Malawi Central Region Infrastructure Maintenance Programme: Final Output to Purpose Review," Lilongwe, Malawi: CARE Malawi, 2002. www.caremalawi.org.

[10] Pinder, Caroline, "Economic Pathways for Malawi's Rural Households," Lilongwe, Malawi: CARE Malawi, 2003, and Potter (2002).

[11] Scharff, Xanthe, "Ex-Post Evaluation of CARE International's Central Region Infrastructure Maintenance Program (CRIMP) in Malawi," December 2005, Mimeo.

failed to bring MFIs into partnerships. The districts were too poor to attract MFI operations. So while the program created a mechanism for savings, encouraged financial discipline, and helped start income-generating activities, it failed to support transition to MFI services.

Direct Engagement of MFIs in Safety Net Programs

BRAC/Bangladesh: The IGVGD Program

The Income Generation for Vulnerable Groups Development (IGVGD) program in Bangladesh is a collaboration among the government, the World Food Program (WFP), and BRAC, a leading MFI. Program participants are destitute rural women who have little or no income-earning opportunity. BRAC discovered early on that it is difficult to include the very poorest in its conventional microfinance operations because they need immediate grant assistance for basic survival, rather than credit. BRAC also knows that government assistance does little to solve the long-term problems of limited and unpredictable access to food among the destitute and that there are not enough government funds to serve all the destitute over long periods. IGVGD's goal is to build a bridge that helps participants move from a highly subsidized survival program into a sustainable microcredit program.

IGVGD is built on a government safety net program that provides free grain for 18 months to destitute, female-headed households that are at the highest risk of hunger. A BRAC unit that is completely separate from the regular microfinance operation organizes the women into groups, collects savings, and provides skills training, such as vegetable gardening or raising poultry and other livestock. After the skills training, participants receive tiny loans ($50) to use in funding small-scale income-generating activities. The payments on these loans are so small that they can be financed out of the grain the women receive. BRAC makes no effort to recover its finance and administrative costs on these loans, so these costs, along with the rest of the services, have to be subsidized with grants. By the time the cycle of free grain ends, participants have received training, managed credit, tried some kind of entrepreneurial activity, and accumulated savings that can be used as investment capital. They have also gained confidence through group participation. At this stage, most participants are ready to engage in income-generating activities and become clients of regular microfinance programs.

IGVGD's results are impressive. The program has reached 1.6 million destitute women since its inception. Nearly two-thirds of these participants have "graduated" from absolute poverty to become microfinance clients who have not slipped back into requiring further relief assistance. Surveys of IGVGD clients show increases in client incomes and material assets (e.g., homestead plots, land, beds, and blankets), as well as decreases in begging. Studies of client self-perceptions indicate that IGVGD participants feel more confident after being in the program and believe their lives have improved.[12]

The IGVGD model is being replicated in Bangladesh. The government and WFP collaborated with ten other MFIs to deliver a similar package of grain and financial services to about 44,000 women in the 2003–04 cycle.

Alexandria Business Association/Egypt: TSEP

Alexandria Business Association (ABA) in Egypt was established in 1988 as a nonprofit organization. It runs two microfinance programs—the Small and Micro Enterprise Project, with an average loan size of US$500, and the Blossoms of Micro Enterprise Program, which exclusively targets the very poor, especially women, with loans ranging from $25 to $125.

In March 2000, ABA launched its Towards Self-Employment Project (TSEP) for people unwilling or unable to become members of the Blossoms program because they are too poor. Funded by charitable gifts the business community makes as part of its religious obligations, TSEP gives grants of $50 to unemployed people. The first installment of $25 is

[12] Hashemi, Syed, "Linking Microfinance and Safety Net Programs to Include the Poorest," Focus Note 21, Washington, D.C.: CGAP, 2001. Matin, Imran, and Rabeya Yasmin, "Managing Scaling Up Challenges of a Program for the Poorest," in *Scaling Up Poverty Reduction*, Washington, D.C.: CGAP, 2004.

given to clients when they demonstrate to program staff that they are serious about engaging full time in an economically viable enterprise. The second $25 installment is given to clients when they successfully complete three months of business activity and make further commitments to business expansion. TSEP is designed so that successful participants graduate first to the Blossoms program and then to the Small and Micro Enterprise project.

TSEP provided 2300 grants until late 2005. Seventy percent of these clients have continued with their business activities but, as yet, only 5 percent have joined the Blossoms program. According to TSEP, participants are slow to graduate to the Blossoms program because using credit staff to provide grants sends mixed messages to clients. As a result, TSEP is developing new systems that use separate staff and provide better communication. TSEP staff will work with clients to make sure they understand that grants are meant to be a one-off activity and that future business operations and expansions are contingent on access to reliable credit sources.

Lessons

The case studies presented in this Focus Note suggest ways in which links can be established between existing subsidized safety net programs and microfinance programs. They show how appropriate sequencing of support can produce good results for the poorest. Starting with grants to meet immediate consumption needs and build "micro-assets," these programs then provide skills training, business management training, savings services, and sometimes small credit to prepare clients for running microenterprises. Those who successfully move forward in this sequencing are likely to be ready to graduate to become conventional microfinance clients.

Although there are no guarantees that everyone who successfully moves through these support programs will graduate to microfinance, properly structured support programs hold great potential as a pathway to microfinance. However, it should be noted that, even in the best cases, a fifth to a third of the women who complete these programs fall back into destitution and need further safety net support.

The safety net and microfinance partners in these linked programs have their own comparative advantage. Mixing safety net and microfinance functions can compromise the effectiveness of the linkage model. The skills needed to administer grants are different from the skills required to deliver sustainable financial services. Viable microcredit depends on strict repayment discipline, which could be compromised if the lending institution is also providing grants.

Safety net or grant programs need to engage in effective targeting first, then they need to ensure clients are provided appropriate support. If the safety net program includes tiny subsidized "training" loans, it is probably best that these loans be managed by microcredit specialists, but separately from the regular lending operations of the participating MFI. Financial institutions, for their part, need to ensure they have a process to recruit "graduates" so they eventually join the ranks of their regular client group. Successful programs tend to do the following:

- Rely on a separate professional agency to implement subsidized grant programs or social protection programs. These types of programs are not part of an MFI's core competency.
- Do not send mixed messages on grants and loans. MFIs must ensure graduates into their programs understand the need to adhere to strict financial discipline.
- Start financial services with savings, even when participants are just enrolling into social protection programs. This builds micro-assets, provides a cushion against shocks, and initiates participants into a culture of regular payments.
- Provide skills training, business advice, and information on financial institutions as part of the social protection program.
- Start with simple loans for easy economic activities; once enterprises take off, participants are ready to become clients of conventional MFIs.

- Identify enterprising participants for graduation to MFIs services.

The cases discussed highlight both the potential for success in graduating to microfinance services and some of the inherent difficulties in this. Even in the best cases (BRAC–IGVGD and CARE–RMP, for example), a fifth to a third of participants fall back into destitution and need continuing support from safety net programs.

In the first model, safety net and grant programs provide training and information to prepare participants for entry into microfinance programs. MFIs offer financial services to safety net graduates who have performed well. This is a win–win model that benefits both the MFI and the safety net program, while creating little additional burden or risk if the MFI already has systems suitable for very poor clients. Even a young and relatively less solid MFI can link to a social protection program in this way.

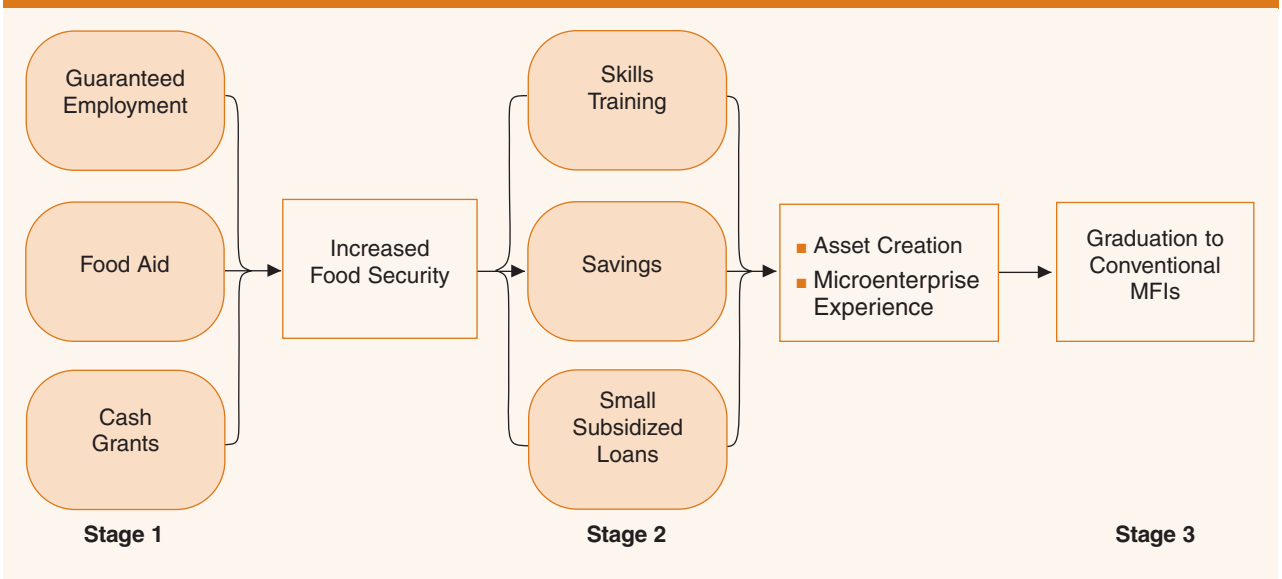
The second model puts much heavier demands on the MFI, especially where the collaboration involves delivery of subsidized loans to destitute social protection participants to finance start-up activities. An MFI should consider such a collaboration only if it is a mature institution whose core microlending business is operationally and financially stable and sustainable.

Conclusion: Toward Dialog and Experimentation

The poorest people, whom microfinance has difficulty reaching, are precisely the focus of a fundamentally important development initiative—safety nets as part of a social protection strategy. But the microfinance industry has generally ignored social protection or deliberately distanced itself from it. Microfinance practitioners often equate social protection (specifically, safety nets) with grants and subsidies that distort markets and hamper efforts to become sustainable. In turn, social protection experts commonly associate microfinance with indebtedness that increases poor people's vulnerability.

These beliefs impede creative exploration of some important potential synergies. The microfinance sector needs to explore new approaches if it is to extend the impact of its services to the poorest. Safety net programs need to help their participants create a viable long-range plan—a graduation scenario—that includes access to financial services. Practitioners of microfinance and social protection may be able to serve both these needs through carefully structured collaborations. This potential can be exploited if professionals in both fields leave preconceptions behind, start talking to each other more, and engage in mutually beneficial, collaborative efforts.

Sequencing for Graduation to MFIs



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