

# **Can the Financial System Serve the Northern Poor?**

---

## **Microfinance and Grants for Community Development**

**William F. Steel**  
Adjunct Professor  
ISSER, University of Ghana

Seminar on Economic  
Development and Northern Ghana  
14 September, 2006

# Outline

---

- I. Sustainable financial systems and the poor
- II. Dilemma for choice of approach –  
    outreach and sustainability of different  
    types of rural/micro finance institutions
- III. Financial institutions and community-based  
    approaches
- IV. Subsidy strategy

# Why are financial services important for the poor?

---

- **Financial services improve the ability of households to manage risks & build economic security**
  - **Savings** services enable people to put aside small sums of money that grow to usefully large sums for emergencies, festivals, health and education
  - **Credit** services enable people to start or expand small businesses, improve their homes, acquire assets, manage cash flows, and cope with variable income & expenditures
  - **Insurance** services allow people to protect their assets
  - **Payment** services allow people to send and receive remittances from family members living in other places
- **None of these services are very useful unless they are always available —**
  - that is, provided by *sustainable* institutions.

# What is microfinance?

---

- Microfinance is provision of savings, credit, insurance, money transfer, and other financial services on a business-like basis:
  - In relatively small amounts;
  - To low-income households and micro/small enterprises who cannot normally access commercial banks.
- Microfinance is NOT: handing out “loans” from government & donor funds based only on social welfare and political criteria

# Why is *sustainable* microfinance hard to achieve?

- Sustainable microfinance is a complex **business** requiring specialized skills and excellent systems.
- Many of the people and organizations that care about the poor don't have these **skills and systems**, and have difficulty acquiring them.
- Banks have difficulty serving the poor:
  - They can earn more from corporate and middle-income clients
  - Systems, products, staff and culture often not suitable for the poor
- Sustainable microfinance needs to be accompanied by a supportive **enabling environment**, including:
  - policies such as removal of restrictions on interest rates;
  - training and business.development services to improve performance of micro and small enterprises

# Dilemma for choice of approach and institutions in northern Ghana

---

**Issue:** *How to address lack of skills, institutions & access to finance in low-income communities*

- Financial NGOs are more oriented toward serving poor communities in northern Ghana  
=> Use NGOs for community development and channeling funds for poverty reduction
- But: rural & community banks (RCBs) have greater outreach and sustainability  
=> Strengthen financial institutions for sustained impact

# RCBs have greatest outreach

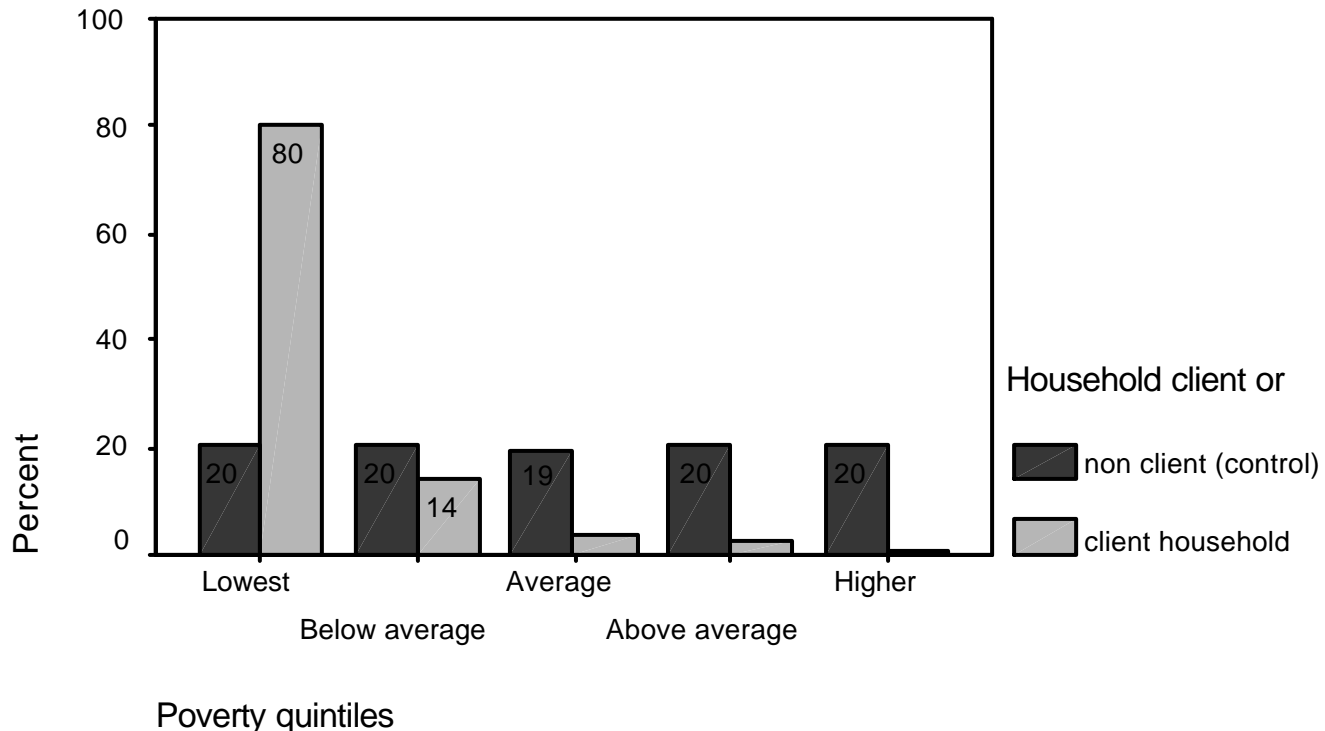
**Table 1: Outreach of Rural and Micro Finance Institutions by Type**

Institution	Depositors		Borrowers	
	2003	2004	2003	2004
Savings & Loans (10)	194,904	243,888	19,454	44,651 (est)
Credit Unions (240)	118,288	160,459	75,869	83,804
Rural & Community Banks (115)	1,202,416	1,509,413	183,368	221,818
NGOs (29)	36,729	87,423	82,143	107,093
Susu Collectors (913 registered)	249,177	257,609	n.a.	n.a.
<b>TOTAL (All RMFIs)</b>	<b>1,838,243</b>	<b>2,258,792</b>	<b>360,834</b>	<b>457,366</b>

# MFIs in north do reach the lowest quintiles by national poverty index

Poverty outreach in Northern region

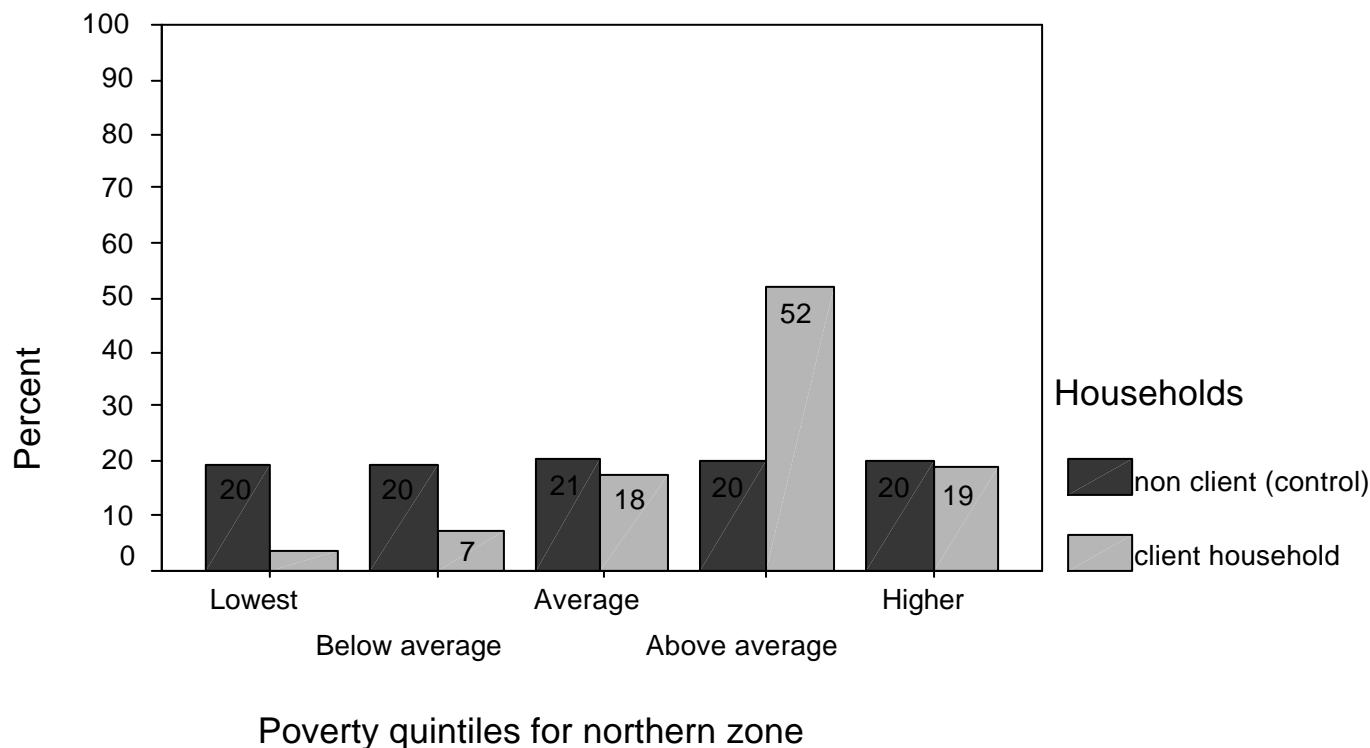
Northern clients against national poverty index



# But: MFIs in north reach the “entrepreneurial poor” by northern standards

Northern region poverty outreach

Northern clients against northern poverty index



# RCBs are more self-sufficient than financial NGOs & government programs

**Table 2: Sustainability of RMFIs by Type (%)**

<b>INSTITUTION</b>	<b>Cost recovery</b>	<b>Financial Independence</b>
	(operational self-sufficiency)	(financial self-sufficiency)
<b>Rural Banks</b>	135	114
<b>FNGOs</b>	101	64
<b>Savings &amp; Loans</b>	122	63
<b>Credit Unions</b>	116	106
<b>Government Programs</b>	61	n.a.

*Implication:* Need RCBs & credit unions for sustained access and impact

# Can the Financial Systems Approach be used in social funds and community-based development?

---

- This approach focuses on building strong financial institutions and systems that work for the poor
- Financial systems approach can be difficult for social funds (SF) and community-driven development (CDD) because:
  - It requires financial expertise that may not be available.
  - Many important interventions are “institution-focused” rather than “people-focused”; that is, build institutional processes and systems.
  - CDD projects often provide revolving loan funds directly to communities but don’t provide the technical skills necessary to manage them effectively or link them financial institutions.
  - The “learning by doing” so central to CDD is hard to apply in a business that requires specialized skills and systems.

# Community-based institutions approach

---

- Starting point if competent banks, RMFIs or cooperative networks don't exist or can't be attracted to the target area:
  - Establish local skill base and well-functioning savings & credit groups that can be linked to RMFIs in the future.
- Focus on building sustainable local institutions: CBOs should not be viewed as just a way to deliver funds and services to target groups..
- Recognize that managing a financial operation is far more difficult than managing infrastructure sub-projects.
- Design should include savings, if possible, and protect them from fraud and mismanagement
- If loan fund is capitalized with a grant, ensure that ownership is well-defined and provide incentives for good management

# Solution: Need to combine top-down and bottom-up approaches

---

- **Financial systems:** Give incentives for rural and micro finance institutions (RMFIs) to *reach down* to provide services directly to low-income communities:
  - Strengthening capacity of existing RMFIs;
  - Creation of new, specialized RMFIs;
  - Fund expansion into rural areas;
  - Support RMFI linkages to commercial banks.
- Help **grassroots** community-based organizations to:
  - improve business and financial management skills;
  - form and manage savings & credit groups/associations;:
  - *link up* to RMFIs (e.g., linkage of self-help groups to banks in India)
- **Challenge:** How to jump-start increased income generation

# Dilemma for financing poor farmers

---

- Productive assets for poor farmers in north have relatively **low rate of return** – but can still help them out of poverty
- Lending for agriculture is **risky**
- Microfinance is **costly** to deliver & manage
  - Interest rates of 3-5%/month to cover costs, risks
- Implications for financing private investment:
  - Farmers cannot afford to borrow heavily at high rates to finance assets
  - RMFIs cannot afford to lend at low rates
  - Hence, ***subsidies are required*** in such a way as to ***leverage savings***

# Subsidies on interest rates are self-defeating

---

- Can't cover costs of servicing loans
  - Makes RMFIs (or credit programs) unsustainable
- Typically undermines repayment:
  - Signals to borrower that it's a political/social benefit, not a business deal
- Even if borrower repays, not viewed as a good client for loans at commercial rates

# Solution: Matching grants for asset cost

---

- Farmer provides, say, 10% equity:
  - (Social fund) matching grant => 20% asset cost
  - Loan => 70% asset cost, at, say 30% interest
- Debt repayment is equivalent to 0-interest loan for 90% of asset cost (repayments = grant + loan principal)
- Advantages:
  - Subsidy is transparent and limited
  - Subsidy is targeted to poverty objective
  - Loan is on a commercial basis: good repayment establishes borrower as good client for future commercial loans
- Being utilized by Community-Based Rural Development Project (CBRDP)

# Conclusions

---

- **Financial services improve ability of households to manage risks & build economic security**
- **Poor people need savings and credit services over the long term**
- **Long-term access requires sustainable institutions; build and link up both:**
  - Rural & micro finance institutions
  - Community-based savings & credit groups/associat'ns
- **Pursue poverty objectives through transparent matching grants on assets, not subsidized interest rates**