



IFPRI

### RESEARCH PROGRAM MISSION

The research program titled Rural Financial Policies for Food Security of the Poor seeks to identify policies and institutional arrangements that help the poor integrate themselves into sustainable savings and credit systems in order to increase capacity to invest, bear risk, and preserve livelihoods.

### FOCUS COUNTRIES

- Bangladesh
- Cameroon
- China
- Egypt
- Ghana
- Madagascar
- Malawi
- Nepal
- Pakistan

### ABOUT THE AUTHORS

Manohar Sharma is a postdoctoral fellow of the Food Consumption and Nutrition Division at IFPRI.

# RURAL FINANCIAL POLICIES for FOOD SECURITY of the POOR

POLICY BRIEF No 14 • JULY 2000

## The Scope for Policy Reforms in Rural Microfinance\*

MANOHAR SHARMA

This brief considers the scope for policy action in seven areas: (1) regulation of microfinance institutions, (2) provision of saving services, (3) product innovation, (4) organizational issues in microfinance, (5) poverty impact of microfinance, (6) agricultural finance, and (7) subsidy and sustainability issues.

### Regulation of Microfinance Institutions

The principal objective of regulation should be to create a policy and legal framework that makes it feasible and attractive for microfinance institutions (MFIs) to operate in rural areas and serve the poor on a sustainable basis. To the clients, especially the savers, prudential regulation increases the level of confidence in banking transactions.

Three priority areas are noted: (1) prudential regulation enabling secure and sustainable internal financial management, (2) specific regulation governing transactions between financial agents and institutions, and (3) regulation ensuring competitive conditions.

### Provision of Savings Services

It is recognized that (1) the poor place great value on saving services when such services match their saving patterns and (2) mobilization of local saving provides MFIs a reliable, inexpensive, and sustainable source of funds for on-lending. Well-designed saving services therefore are indispensable characteristics of a successful microfinance institution.

\*This is a summary of the conclusions and recommendations resulting from the international workshop on Innovations in Microfinance for the Rural Poor: Exchange of Knowledge and Implications for Policy, 8-13 November, 1998, in Accra, Ghana. The workshop was jointly organized by Deutsche Stiftung für Internationale Entwicklung (DSE), the International Food Policy Research Institute (IFPRI), and the International Fund for Agricultural Development (IFAD).

In order to be successful, saving services have to respond to the level and patterns of saving by the poor. Liquidity and safety of deposits are of primary concern to poor households. Hence, flexibility in deposits and withdrawals as well as assurance of safe, prompt, and reliable service become important factors in designing successful saving products.

### Product Innovation

As with savings, innovations in financial products need to be primarily demand-oriented. It is only when products match clients' preferences that a market niche for MFIs is established and pricing at full cost—a requirement for financial sustainability—becomes at all feasible. Supply-side considerations are important too, for there needs to be a conducive policy environment that nurtures and provides incentives for MFIs to innovate and improve. For this reason, regulatory conditions as well as the organization and management structure of MFIs become important determinants of the pace and quality of product innovations.

**Demand-Oriented Innovation.** A closer understanding of demand patterns and preference structure of poor rural households is essential for demand-induced innovation. This requires continuous action-oriented interaction between practitioners/program managers and their clients. Decentralization in decision-making and adequate representation of the clients in the governance and management structure are powerful catalysts for innovations.

**Collateral Substitutes.** Developing collateral substitutes represents one important line of innovations that can greatly improve access of the poor who generally lack traditional collateral-suitable assets. Making use of local information to trigger positive group dynamics as well as bringing down costs of group-based participation is likely to have beneficial effects. There also remains scope for finding new collateral substitutes in individual-based lending. In general, not just physical assets, but many other things that are regarded to have some intrinsic value in a particular society—general reputation, threat of

INTERNATIONAL FOOD POLICY RESEARCH INSTITUTE

2033 K STREET, NW, WASHINGTON, DC 20006-1002 USA

Web: [www.ifpri.org](http://www.ifpri.org) • Phone: 1-202-862-5600 • Fax: 1-202-467-4439 • Email: [ifpri@cgiar.org](mailto:ifpri@cgiar.org)

public citation of default, sanction by village or society elders—can potentially be used as a collateral substitute. Better training of MFI staff in loan appraisal methods can assist them in recognizing good borrowers. Further, introducing incentive systems for MFI staff based on loan performance can also lead to better monitoring and enforcement of loan contracts.

**Insurance Products.** Income variability and unexpected expenditures arising from illness and other emergencies put considerable stress on the food security and livelihood of the poor. Hence insurance products are highly valued. Though credit and saving products themselves act as good insurance substitutes, innovations that reduce the cost of providing health, accident, and life insurance will have considerable impact on the poor. It is admitted that introducing innovations in this area is highly challenging. A first step for MFIs could be to consider retailing insurance products provided by formal financial institutions and make further assessments based on this experience.

### Organizational Issues in Microfinance

Organization principles adopted have to be strictly aligned with organizational objectives. A widely endorsed objective is that MFIs develop a high level of competence in providing a core set of financial services in a sustainable manner.

**Strategic Organization and Management.** Whether member-based or not, organization and management should be based on the adoption of an entrepreneurial culture that gives due attention to market realities and potentials. A strong management information system that lets managers make decisions in the light of best possible information is also required. Hence, market analysis, product design, and incentive compatibility should be treated as key management concerns. This includes developing long-term relations with financial institutions in the private sector and negotiating a portfolio of investments and commercial loans that best suits the interest of the MFI.

**Monitoring and Evaluation System.** MFIs should establish and operationalize, on an ongoing basis, a monitoring and evaluation (M&E) system of their performance. The system adopted should provide for meaningful participation of MFI clients.

### Poverty Impact of Microfinance

It is widely presumed that microfinance is an effective tool for poverty alleviation. In fact, it is this presumption that has fueled much of the support for allocating increasing amounts of public resources to the microfinance sector. Hence, assessing and monitoring the impact of MFIs on the livelihood of the poor as well as examining its cost-effectiveness vis-à-vis other poverty-alleviation measures is of interest not only to policy analysts, but also to concerned investors and managers of microfinance. Empirical research so far points out—albeit not universally—to significant and sizable improvements in income and food expenditures, but documents little impact on other welfare indicators such as nutrition, education, and empowerment of women. Clarifying the relationship between poverty alleviation and microfinance

services has implications not only on a more meaningful discussion of subsidies and sustainability of institutions, but also on operational matters such as service targeting and product innovation. For this reason, more research is needed that leads to better impact assessment and also one that helps microfinance practitioners to operationalize poverty targeting and monitoring.

### Agricultural Finance

Most of the world's poor consist of microentrepreneurs who are engaged in agricultural production on small farms. But providing financial services to this diverse group has been challenging for several reasons: they are vastly spread geographically, making service delivery and information collection very costly; many of the farmers are illiterate; production is not only weather dependent and risky, but also rigidly cyclical. Yet MFIs risk bypassing the poorest if this group is not serviced adequately. Hence, efforts to develop effective and sustainable microfinance services for small agricultural producers deserve priority.

### Sustainability and Subsidy Issues

The issue of sustainability of institutions and the role of subsidies is a complex one. On the one hand, setting up institutions that are financially unsustainable distorts incentives, makes institutions hostage to uncertain donor or government financing, and, in some cases, leads to mistargeting as richer and powerful groups preempt services available at considerably below market prices. Further, as a number of empirical studies have shown, what is most valuable to the poor is access to services, as they are often willing to pay for services at full cost. The case for subsidies, on the other hand, can also be quite compelling. Simply put, if microfinance services are, dollar for dollar, more effective in achieving some objectives compared to alternative poverty alleviation programs (e.g., other transfer programs), then there is clearly a case for diverting public resources away from the latter into the microfinance sector.

Decisions on subsidies, ideally, have to be made on a case-by-case basis and with full accounting of all costs and benefits. But this is more easily said than done, since benefits and costs are notoriously difficult to pinpoint and measure.

Best use of subsidies is found in helping build institutions that are likely to attain sustainability in a clear time frame. Contributions to finance initial investments in physical infrastructure and human capital development have high sustainable returns in the future.

There also exists substantial scope for additional research in clarifying the nature of cost and benefits of microfinance services and using this knowledge to develop sustainable institutional formats. Researchers need to work closely with both practitioners and policy-makers for this effort to be successful. ■

### ABOUT IFPRI

IFPRI's mission is to identify and analyze strategies for meeting food needs of the developing world, with particular emphasis on low-income countries and the poor.

IFPRI is a member of the Consultative Group on International Agricultural Research (CGIAR).

-----  
*Any opinions expressed herein are those of the author(s) and do not necessarily reflect those of IFPRI.*  
-----

### CONTACT

Bonnie McClafferty  
Communications  
Specialist  
B.McClafferty@  
CGIAR.ORG