

Regional and Sustainable Development Department

A QUARTERLY NEWSLETTER OF THE
FOCAL POINT FOR MICROFINANCE

March 2004 · Volume 5 Number 1

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ADB

FINANCE for the POOR

Microfinance Outreach to the Poorest: A Realistic Objective?*

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Introduction

Perhaps no other development tool has attracted so much global attention in the history of poverty-focused development than microfinance. The attention is justifiable to some extent given the potential of microfinance to contribute to poverty reduction. United Nations Secretary-General Kofi Annan recently underscored the importance of microfinance as an integral part of the development community's efforts to meet the Millennium Development Goals (MDGs). According to Mark Malloch Brown, Administrator of the United Nations Development Programme, microfinance has become one of the key driving mechanisms toward meeting the MDGs, specifically the overarching target of halving extreme poverty and hunger by 2015.

However, recent experience shows a growing uneasiness among some promoters of microfinance about the pattern of growth of the microfinance industry, particularly its failure to reach the poorest—defined simply as those who are at

the bottom 50% below the poverty line—with microcredit and other financial services. The Consultative Group to Assist the Poor (CGAP) noted that “most microfinance clients today fall in a band around the poverty line and the extremely poor are rarely reached by microfinance” (CGAP 2003). Hulme and Mosely (1996) also came to a similar conclusion several years earlier. However, there does not seem to be a similar consensus on whether we should focus attention on reaching the poorest with financial services.

There are three camps of thought on the issue of financial services for the poorest. The first camp rejects the hypothesis that the poorest can be reached with financial services on a sustainable basis. The second camp advocates that the poorest of the poor can be reached not only on a sustainable basis but also on a large scale. The third camp recognizes that the potential for reaching the poorest on a sustainable and



* The author gratefully acknowledges the comments of Jay Maclean, Consultant, ADB.

Microfinance Outreach...

(continued from page 1)

a large-scale basis is limited but that the search for innovative approaches to expand the outreach to the poorest must be continued. The purpose of this article is to examine briefly the assumptions and arguments of each camp to clarify the issues surrounding the problem of reaching the poorest with financial services.

First, it is important to note that the intention to expand financial services to the bottom 50% below the poverty line is noble and laudable. While accepting this, one has to look closer into the core problem and ask whether the assumptions on which the three camps stand are valid. The core issue is whether it is realistic to expect that microfinance services can be provided to the poorest on a sustainable and large-scale basis.

Microfinance is more than microcredit

When most people argue that microfinance has not reached the poorest, what they often really mean is that microcredit has not reached the poorest. However, microfinance includes a range of financial services—savings, credit, money transfers, and insurance, among other things—for poor and low-income people. It is important to bear in mind this broad definition of the term microfinance when the issues relating to outreach are discussed.

First Camp: The poorest cannot be reached on a sustainable basis

Those who belong to this camp simply argue that the poorest cannot be reached with microfinance services on a sustainable basis. When credit is extended, the recipient should have an ability to service the debt, in addition to having an intention to do so. If the borrowers are unable to service the debt for some reason, credit becomes a burden. Credit is unlikely to help the poorest if they do not have the capacity to service the credit. As Robinson (2001, p.20) pointed out, “for example, extremely poor households living in small, isolated communities in areas that lack basic infrastructure and markets may be unable to use credit in any way that would enable them to repay loan principal and interest.” There are many such people in the poorest category. To address the needs of these people, other interventions—and not microcredit—are required. Robinson (ibid.) concludes that

“The poorest of the poor should not be the responsibility of the financial sector. The food, employment, and other basic requirements needed to overcome desperate poverty are appropriately financed by government and donor subsidies and grants. These tools are properly the responsibility of ministries of health, labor, social welfare, and others, as well as of donor agencies and private charities.”

This camp’s views are based on three interrelated assumptions. First is that there is very little effective demand for financial services among the poorest. Second, the cost of providing services to the poorest is too high. Third, the poorest cannot afford to pay the prices that sustainable microfinance service providers are likely to charge for their services.

Second Camp: the poorest can be reached on a sustainable and large-scale basis

This camp holds an opposite view from that of the first camp. First, it assumes there is a vast effective demand among the poorest for microfinance services, particularly microcredit. It is claimed that this enormous demand is evident from the reliance of the poorest on informal sources of credit. Second, it is argued that increasing numbers of microfinance institutions (MFIs) with a focus on the poorest have achieved successful results and the required knowledge on delivery mechanisms is widely available. According to this group, if funding agencies and MFIs target the poorest and if funding agencies make more funds available to these MFIs, outreach to the poorest can be rapidly increased.

Third Camp: potential for reaching the poorest on a sustainable and large-scale basis is limited

This camp does not totally reject the potential for reaching the poorest with microfinance services on a sustainable basis. However, it does not accept that there is a vast effective demand for microcredit among the poorest or that there is a great deal of existing knowledge about the requirements of sustainable microfinance for the poorest. As a result, this group does not consider that the major constraints to large-scale outreach to the poorest are the lack of support from the donor community and inadequate funds for the expansion of credit operations of MFIs. The third camp’s view is that the search for sustainable models to deliver financial services for the poorest must continue;

funding agencies have an important role to play in promoting innovations toward this end. However, mere increases in funds for onlending does not address the problem for various reasons. This camp also recognizes that subsidies have an important role to play in developing sustainable mechanisms to reach the poorest.

Are the assumptions realistic?

The assumption that there is no effective demand for microfinance services among the poorest does not seem to be realistic. Although the majority of clients in most sustainable MFIs—such as the Bangladesh Rural Advancement Committee (BRAC) and the Association for Social Advancement (ASA) in Bangladesh and the Share Microfin Ltd in India—are not the poorest, these institutions serve some clients at the bottom 50% below the poverty line. Also, the poorest households have an effective demand for safe de-

Credit should be a lubricant for the engine of feasible and profitable activities: if the lubricant is mistaken for the engine, the borrower may end up in a debt trap.

—Arjaan de Haan and Michael Lipton

posit facilities (Rutherford, 2000). While the amount of their deposits is small, this does not mean a lack of demand. With flexible deposit and loan products, SafeSave in Bangladesh has been able to reach some of the poorest households in Dhaka slums. Similarly, about 7% of Mibanco clients in Peru belong to the poorest category (Accion International, 2003). The poorest have an effective demand for different types of products and services and that this demand may be limited, depending on the context in which they operate.

The poorest need very small loans with flexible repayment schedules: they do not like to subject themselves to rigid installment amounts and schedules. They also need flexible deposit facilities: they would like to save any amount whenever they can and withdraw any amount whenever they need (Rutherford, 2000). Also, they have strong preferences for certain types of delivery mechanisms. Researchers have found that the poorest prefer individual loans, do not wish to participate in group-based programs, and do not like to attend regular meetings. Thus, to reach the poorest, different approaches are required. There are no effective delivery mechanisms that can provide such flexible services on a large scale to the poorest. For example, SafeSave in Bangladesh has been providing flexible services for the poorest for several years. However, it has so far not been able to achieve sustainability or reach a large number of clients.

Reaching the poorest is obviously much more expensive than reaching the poor—those who are around the poverty line. There are many reasons for this. First is the volume of lending. The poorest require smaller loan amounts and a lender will have to give more loans to achieve the required volume to break-even or make a profit. For instance, If the lender's margin is 2% and overheads are \$20,000 per year, a loan portfolio of \$1 million is required to cover the overheads. If an average loan size of \$50 is assumed, the lender has to make 20,000 loans to break even. Assuming a high productivity rate of 400 clients per loan officer, a lender needs 50 loan officers to handle 20,000 loans, in addition to other staff. The break-even portfolio would even be higher if the demand for loans is seasonal and defaults are greater than 0%.

It is also not realistic to assume that the risk factors for the poorest will be similar to those of the poor. By definition, the poorest operate in a much riskier environment than the poor. For example, they suffer much more severely than the poor from interlocking, multiple disadvantages. Therefore, their capacity to seize economic opportunities is also limited.

Given the nature of the demand, size of transactions, flexibility required to meet the demand, and risk factors associated with transactions with the poorest, operating costs of MFIs focusing on the poorest tend to be much higher. Thus, if the MFIs are to charge prices that would enable them to cover costs, those prices need to be much higher than what is necessary to serve the poor. However, it seems there are constraints coming primarily from the limited affordability of the poorest. It is not clear whether the widely

held assumption in the microfinance industry—that poor households can afford to pay high interest rates—is similarly applicable to the poorest. Although some people presume that the poorest also already pay very high interest rates for their loans from informal sources, there is no hard evidence to support the hypothesis that a large number of them do so. This tends to demonstrate the difficulties associated with serving the poorest on a sustainable basis.

The geographical location of the poorest and the broader environment in which they operate also make it more difficult to serve them. For example, while the poorest can be found in urban areas, most of the poorest in Asia are concentrated in rural areas where basic physical infrastructure is highly inadequate (Haan and Lipton 1998, p.155). The bulk of the poorest in India are in such states as Bihar (including Jharkhand), Uttar Pradesh (including Uttaranchal) and Madhya Pradesh (including Chhatisgarh) (Mehta and Shah 2003). These states have seen relatively very little institutional microfinance.

Some of these states need to improve not only their infrastructure but also their governance and law and order conditions. A case in point is Bihar (The Economist, 21 February 2004, p.19).

When physical infrastructure is limited and governance and law and order problems are severe, reaching even the middle class, let alone the poorest, with financial services on a sustainable basis is a serious problem. Financial services do not create economic opportunities; they only enable people to take advantage of the economic opportunities created through other interventions. This partly explains why about 70% of the microcredit outreach of India is in the two southern states of Andhra Pradesh and Tamil Nadu where infrastructure is better and the broader socio-economic environment is more conducive for the poor to take advantage of access to financial services. Even the self-help group scheme, the largest microcredit program, sponsored by the state-owned National Bank for Agriculture and Rural Development, has poor penetration in such states as Bihar and Uttar Pradesh and high penetration in both Andhra Pradesh and Tamil Nadu.

Microfinance, though an effective poverty alleviating instrument, is not suitable for all categories of the poor. For those trapped in chronic food insecurity with no asset base to protect themselves from the myriad web of shocks, microfinance can be ineffective and sometimes counterproductive.

—Imran Matin and David Hulme

What is needed to expand the outreach to the poorest?

There is no consensus among the promoters of microfinance on how to reach the poorest. Those in the second camp argue that the most severe constraint is limited

availability of funds. According to this group, if more funds are available for MFIs to lend, they can expand the outreach to the poorest on a sustainable basis. The third camp has different views. Based on the foregoing discussion, however, it is possible to highlight several requirements for expanding outreach to the poorest. These include more investments in social and physical infrastructure, strong retail institutions with a commitment to serve the poorest, and innovative approaches that combine livelihood protection with livelihood promotion. Note, however, that what is needed for serving the poorest in a given locality may depend on specific factors in that locality.

Investments in social and physical infrastructure are inadequate

A major constraint in reaching the poorest with financial services is the lack of investments in social and physical infrastructure. Unless sufficient investments are made to improve infrastructure, the majority of the poorest will remain outside the formal and semiformal network of financial services because they will have no viable economic opportunities. The institutions that wish to serve the poorest will continue to face both prohibitively high risks and transaction costs in this market segment. Even possibilities for cross-subsidization will be limited.

Strong institutions are needed

Another fundamental constraint to the rapid expansion of a wide range of microfinance services including microcredit to the poorest is the lack of retail institutional capacity. Availability of funds is one thing; effective delivery and recovery of the funds is an entirely different issue. The latter depends on the presence of strong retail institutions.

Building sustainable institutions that can provide demand-driven services and products is not only difficult but also time consuming. It also requires funds for capacity building. Giving more funds to MFIs that are not yet ready to effectively use the funds to reach the target clients will only undermine the objective.

However, if MFIs are to serve the poorest, they must be allowed to serve a broad spectrum of clients rather than exclusively focus on the poorest. Financial institutions need to diversify the risks they take and adopt an appropriate risk-return approach. MFIs with an eye on risk management may want the freedom and flexibility to spread risks geographically, across various economic activities, and also across clients in different socioeconomic categories. If MFIs concentrate their credit operations heavily on the poorest, they will undoubtedly be subjecting themselves to greater covariant risks and become more vulnerable to external shocks. Also, as noted earlier, the poorest clients most likely will take small loans and make small deposits involving high transaction costs for the service providers. Thus, concentrating the portfolio on such clients will make it virtually impossible for MFIs to achieve sustainability.

In addition, the potential market for microfinance includes a wide range of clients in low-income groups, not just the poorest. If MFIs exclude the vulnerable nonpoor from their services because of target-related or other reasons, this group may even fall into poverty, thus defeating the objective of poverty reduction. Also, providing credit to the vulnerable nonpoor can create employment opportunities for the poorest.

We cannot, however, put MFIs on an automatic gear and expect them to reach the poorest. Empirical evidence shows that appropriate products and services are effective ways of deepening the outreach to the poorest. MFIs must be provided with the right incentives and support to design appropriate products, particularly provide flexible deposit facilities, and extend their services to the poorest.

More emphasis on efficiency is needed

The poorest clearly have less capacity than the poor to afford cost-recovery interest rates on loans. The return on capital and labor for the poorest may be lower where infrastructure is poor. The poorest households also require credit for noninvestment purposes, such as for paying medical bills, school fees and books for children, and for emergencies such as funerals. Whether they can afford to pay high interest rates on loans for such purposes is highly doubtful.

It is possible that some of the poorest households have failed to access microcredit from MFIs partly because the price of microcredit has been too high. If microcredit is to reach the poorest, MFIs must focus on improving efficiency, bringing down high administrative costs in their operations, and, over time, passing on the benefits of efficiency to their clients through lower prices. MFIs must keep their costs at minimum levels through simple management structures and operational and delivery systems. Although scale is a factor that influences efficiency, delivery mechanisms and systems also play a key role. Therefore, it is necessary to continue to search for low-cost business models to serve not only the poor but also the poorest.

Innovative approaches

The poorest differ from the poor; they have lower asset levels, higher illiteracy level, fewer employment opportunities, greater consumption deficits, and greater vulnerability to periodic economic and social shocks. Innovative approaches are needed to serve them and improve their access to sustainable financial services. The Income Generation for Vulnerable Groups Development (IGVGD) program of BRAC is an outstanding example.

“Targeted towards destitute rural Bangladeshi women who have little or no income opportunities, the IGVGD program has provided food grain assistance and savings and credit services to nearly a million participants over a 10-year period. About 85% of IGVGD members also received training and support in poultry and livestock raising, vegetable gardening, agriculture, fishery production, or grocery business. Two thirds of these women have ‘graduated’ from absolute poverty to becoming microfinance clients, and have not slipped back into requiring government handouts” (CGAP, 2001. p.2).

BRAC provides smaller loans to IGVGD clients and these loans are cross-subsidized by its regular microcredit programs. BRAC’s subsidy for both credit and training services has been estimated at taka (Tk) 725 (about \$16) per client. If one were to add in the cost of the food grain provided by the World Food Programme, the total subsidy per each woman would amount to about Tk 6,275 (about \$135) (CGAP, 2001. p.11). However, BRAC keeps track of these subsidies through separate financial monitoring and accounting.

While the IGVGD Program has achieved impressive results by combining livelihood protection (food aid) with livelihood promotion (skills training and microfinance), it is important to note that “about a third of the women did not benefit significantly from the program in the long term. BRAC also excludes about 10% of the women receiving food grain from IGVGD for being too old or disabled” (CGAP, 2001, p.12). Thus, Matin and Hulme (2003, p.662) conclude:

“...the IGVGD experience confirms that programs combining elements of livelihood protection and livelihood promotion can reach deeper than purely promotional schemes and can benefit the chronic poor. Their relative success should not, however, lead us to think that they can totally replace programs of pure social protection—a small proportion of the population will always need more traditional ‘social welfare’ support to avoid persistent deprivation.”

ASA, the other giant MFI in Bangladesh, perhaps driven by the competitive pressures of the BRAC program and the desire to further improve its international reputation as a pro-poor MFI, has taken a bold and commendable step to reach the hard-core poor. ASA introduced a flexible product—business development services to improve capacity of the poorest to productively use credit—and a new service delivery system. ASA will establish 1,200 outposts in remote locations to facilitate hard-core poor households’ access to its products and services. The local staff responsible for the new flexible products will operate from these outposts. ASA expects to reach one million hard-core poor households by the end of 2006 through this innovative program (Fernando, 2003).

Conclusion

Contrary to the assertion of the first camp, there is an effective demand among the poorest for microfinance services. Though microfinance is not a magic bullet for poverty reduction, meeting this demand will help the poorest to reduce the severity of their poverty and improve their welfare. Hence, microfinance outreach to the poorest is a laudable objective. However, it is unrealistic to expect that the outreach of microfinance services to the poorest can be increased rapidly in the near future, as assumed by the second camp. The industry has not found an answer to the issue of how to expand the outreach to the poor, let alone the poorest, rapidly on a sustainable and large-scale basis.

To reach the poorest, it is necessary to design appropriate products and services and innovative programs and delivery mechanisms that can provide those products and services at affordable prices. This requires, among other things, recognizing the differences between the poor and the poorest. Also, it is necessary to build adequate retail institutional capacity and provide support and incentives to these institutions to reach the poorest. Directives did not lead to sustainable rural finance for the small farmers in the 1970s and 1980s, and there is no reason to believe that they will work for the poorest. It is also essential to address social and physical infrastructure issues to increase economic opportunities for both poor and the poorest, and improve their capacity to seize economic opportunities. Without significant increases in such investments, reaching the poorest on an increasing scale with sustainable microfinance will remain an illusive objective.

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The Stark Reality... and the Great Challenge

Sustainable access to microfinance helps alleviate poverty by generating income, creating jobs, allowing children to go to school, enabling families to obtain health care, and empowering people to make the choices that best serve their needs. The stark reality is that most poor people in the world still lack access to sustainable financial services, whether it is savings, credit or insurance. The great challenge before us is to address the constraints that exclude people from full participation in the financial sector.

UN Secretary-General Kofi Annan

The Asian Development Bank (ADB) approved in December 2003 a loan package totaling \$70 million to help Sri Lanka establish a sustainable rural finance system. It comprises a program loan of \$50 million to support policy and institutional reforms in the rural finance sector, and two project loans of \$10 million each to promote rural enterprise development and institutional strengthening.

Sri Lanka's formal rural finance sector is characterized by a diverse set of institutions comprising thrift and credit cooperative societies, cooperative rural banks, regional development banks, Samurdhi Banking Societies, commercial banks, and the national savings bank. Some of the institutions such as thrift and credit cooperative societies and cooperative rural banks, have a long operational history. Despite the diversity of institutions and the range of services they provide, the sector remains fragmented and most of the institutions suffer from weak governance, poor repayment rates, high transaction costs, weak supervision, and recurring losses. A majority of some 3 million households in rural areas continue to lack access to quality financial services to take advantage of economic opportunities and adequately manage their risks. The project aims to address the key issues in the policy framework,

financial infrastructure, and service delivery institutions to transform the existing rural financial system into a more dynamic and efficient one.

The program loan will promote policy changes that emphasize good governance and improve operations of rural finance institutions. It will help draw up a legal and regulatory framework including a rural finance sector development agency and institutional reforms in cooperative rural banks and regional development banks, among others, and expand rural finance in conflict-affected areas. It will also support the demand side of rural finance by involving rural communities in partnership with nongovernment organizations in identifying, planning, executing, and monitoring subprojects in expanding the rural finance market.

The project loans will strengthen key sector institutions—including the Center for Banking Studies of the Central Bank of Sri Lanka, cooperative rural banks, and regional development banks—to improve their outreach, quality, effectiveness, and efficiency of services.

Successive governments have adopted ad hoc and short-term measures for rural finance development. As a result, the government interventions have not resulted in a robust rural financial system. ADB's program is expected to help the Government to redirect its interventions to strengthen rural financial market development.

Securitization Enters the Microfinance Industry

Most microfinance experts consider the Asian microfinance industry in general to be far behind its counterpart in Latin America in terms of commercialization. But this is gradually changing. An increasing number of microfinance institutions (MFIs) in the region are paying more attention to developing commercial sources of funding to finance their growth. The sale of loan portfolios by two MFIs in India's Andhra Pradesh to a private commercial bank provides yet another example of these efforts to tap commercial sources of funding.

In November 2003, the Industrial Credit and Investment Corporation of India (ICICI) Bank bought Indian Rupees (Rs)42.1 million (about \$900,000) of the crop loan portfolio of Samruddhi, a microfinance nonbank finance company registered with the Reserve Bank of India and operating in Andhra Pradesh. Later, ICICI Bank also paid \$4.2 million equivalent in Indian rupees for a portfolio of 42,500 loans from Share Microfin Ltd., another leading regulated nonbank MFI in

Andhra Pradesh. This deal was facilitated by a collateral deposit of \$325,000 made available by the Grameen Foundation-USA.

Securitization of loan portfolios of financial institutions is not something that attracts any special attention because it is so widely practiced in the broader financial sector. But that is not the case with the microfinance industry. Until November 2003, no MFI has been able to securitize its loan portfolio and attract funds from a commercial entity. ICICI Bank's deals with Samruddhi and Share Microfin Ltd. changed this and demonstrated that the industry is gradually entering into another phase of commercialization. The fact that ICICI Bank is one of the largest private commercial banks in India adds another dimension to the picture in that it demonstrates that traditional financial institutions can be active players in the industry on a commercial basis. It was not an altruistic transaction by ICICI, a bank that has begun to tap the bottom of the pyramid financial market for profit.

Securitization allows the selling financial institution to receive instant cash while earning income through administration of the securitized loan portfolio. Also, it allows the selling institution to bring new loans into its portfolio. Above all, securitization is considered to be a relatively cheaper way of raising funds. For example, according to *The Economist* (7 February 2004), ICICI securitization has enabled the Share Microfin Ltd. to obtain funds "at a cost that is three to four percentage points cheaper than it pays for a bank loan." Udaia Kumar, Chief Executive Officer of Share Microfin Ltd. reckons that securitization will significantly facilitate his portfolio growth and microcredit outreach in the next few years.

The securitization transaction with Samruddhi covers loans maturing between 1 December 2003 and 31 August 2004, with no payments of principal and interest so far and no overdues.

The main features of the deal include the following:

- The seller, Samruddhi, assigns absolutely and irrevocably all receiv-

- ables along with all rights, titles, and interests in and to such receivables, to the ICICI Bank, the buyer.
- Purchase consideration of Rs42.1 million will be paid by the ICICI Bank.
- Samruddhi, as the collection agent, will ensure collection of the receivables from the borrowers and payment of the same to ICICI Bank on the predetermined pay-out dates (12th of every month, starting in January 2004).
- Samruddhi will provide a detailed report on each payment date regarding collections, shortfalls, and prepayments, if any, of the receivables during the period.
- The aggregate minimum amount to be received by ICICI Bank will be the purchase consideration of Rs42.1 million together with yield thereon at 8.5% per annum compounded monthly.
- The remaining 15.5% (24%-8.5%) will accrue to Samruddhi for the collection expenses and as service charges.
- Samruddhi, as the guarantor, will provide ICICI Bank with a first loss deficiency guarantee with respect to the due and timely performance by the borrowers of their obligations, and the aggregate liability of Samruddhi in this regard will not exceed 15% of the aggregate amount of the receivables.

Sources: CEO, Bhartiya Samruddhi Finance Ltd., India and *The Economist* (7 February 2004).

Weather or Not to Insure

Big companies, rich farmers, and an increasing number of medium-sized companies in developed countries use weather risk management products and services that mitigate the financial impact of bad weather. Transactions are structured in the form of derivatives or insurance for this purpose. The menu of weather-related financial instruments is also increasing. Last year ABN Amro offered its Dutch clients a weather-linked 3-month deposit product, for example. The account called, Weergaloos Sparen, offered an interest rate of 7.5% if the weather over July, August, and September was particularly unseasonal, compared with the going rate of 3.3%. If the weather was good, the account paid only 2%.

Rich farmers, large- and medium-sized companies, and enterprises in developed countries have access to these expanding new products and services. But what do these developments mean for the small farmers and poor households in developing countries? In Asia, much of agriculture is still dominated by small farmers, with few exceptions. The welfare of millions of farmers involved in agriculture and their household members is highly dependent on weather conditions. Excessive rain and drought often make their lives miserable. Are they likely to benefit from emerging weather risk instruments?

It seems that weather-related financial instruments are spreading into potential clients in low-income groups in developing countries. Last year, the World Bank introduced a pilot weather insurance program in Mahabubnagar district at the eastern end of Andhra Pradesh, bordering Karnataka in India in association with the Indian insurer ICICI Lombard General Insurance Company. Krishna Bhima Samruddhi (KBS) Local Area Bank, a wholly owned subsidiary of Basics Ltd, bought a bulk insurance policy from ICICI Lombard and sold individual insurance policies to over 200 groundnut and castor farmers. (This shows that rural financial institutions can be active partners in this emerging industry). Additionally, weather insurance has also been extended to 50 soya farmers in Madhya Pradesh through Pradan, a nongovernment organization and some paddy farmers in Aligarh in Uttar Pradesh through an agribusiness company.

The World Bank and the Indian partners expect that the pilot projects will make weather insurance more popular in India and other countries because most small farmers can easily understand the characteristics and value of weather insurance products. The concept of weather insurance is a simple one. A weather insurance policy provides cover against defined deviations from the normal expected weather conditions, not just against the extreme conditions like severe drought or flood. The expected normal weather condition is estimated on the basis of the data for the past 2 to 4 decades. The amount of payout is linked to

the level of deviation from the expected normal weather condition.

Weather insurance is far superior to traditional crop insurance schemes for several reasons. According to Panos Varangis, Lead Economist for the World Bank's Agriculture and Rural Development Department, "weather insurance does not suffer from the usual moral hazard and adverse selection and high administration cost problems of traditional crop insurance, and it is therefore better suited to small farmers in rainfall-dependent countries such as India." The policyholders cannot influence the weather. The insurer does not have to check claims because the sole trigger of payouts is weather data. This lowers the administrative costs. In addition, weather insurance schemes can eliminate room for corruption that is rampant in most crop insurance schemes in developing countries because, in the case of weather insurance policies, payouts are based on objective data from independent sources. In the case of typical crop insurance programs, payouts are based on assessment of losses, and this leaves room for rent-seeking by those who are responsible for the loss assessments. Also, loss assessments are time consuming and the policyholders are unable to obtain payments quickly.

In the case of weather-based insurance programs, payouts can be made promptly, because information on weather conditions is, or can be made, readily available. Also, the policyholders are not required to file the claims. The insurer will compensate the policyholders at the end of the crop season for any deviations from the expected normal weather conditions. In the case of the ICICI Lombard-KBS pilot program, the claims for the policies have been settled within 15 days of the end of the cover period.

Weather insurance not only can protect farmers' income but also enable the financial institutions that provide credit to farmers to mitigate the risk inherent in lending to weather-sensitive economic activities. This will in turn contribute to an expansion of the supply of credit to those who are involved in such activities. Weather insurance can also be extended to a wide array of small and medium enterprises whose income is vulnerable to fluctuations of weather. Thus, there are incentives for the governments, funding agencies, insurance companies, and rural financial institutions to promote weather insurance. At the initial stage of market development, however, Say's Law of "supply creates its own demand" seems to apply.

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