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CAPS ON INTEREST RATES

Governments in developing countries often impose caps on interest rates charged on loans for the poor. Despite their popular appeal, such caps undermine the profitability of lending and thus reduce the supply of loans.

Source: *The Economist*, The Hidden Wealth of the Poor. 5 November 2005, p. 3.

Smart Subsidy for SUSTAINABLE MICROFINANCE*

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INTRODUCTION

"Smart subsidy" might seem like a contradiction in terms to many microfinance experts. Worries about the dangers of excessive subsidization have driven microfinance conversations since the movement first gained steam in the 1980s. From then on, the goal of serving the poor has been twinned with the goal of long-term financial self-sufficiency on the part of micro banks: aiming for profitability became part of what it means to practice good microfinance.

Much of the excitement around microfinance stems from the possibility of achieving massive scale through highly efficient operations. And one of the fears of relying on subsidies is that it can undercut both scale and efficiency. So, a beginning point in considering smart subsidies is recognizing that the same forces driving efficient outcomes in free markets—i.e., hard budget constraints, clear bottom lines, and competitive pressure—can also be deployed in contexts with subsidies. If deployed well, there are circumstances in which subsidies can increase the scale of microfinance outreach, access to commercial finance, and depth of outreach to the poor. To make this happen, donors and recipients need to

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be aware of the opportunities and constraints. By the same token, overreliance on subsidies and poorly designed subsidies can limit scale and undermine incentives critical to building strong institutions.

Smart subsidies maximize social benefits while minimizing distortions and mistargeting

The idea of “smart subsidy” springs from the premise that subsidies are neither inherently useful nor inherently flawed. Rather, their effectiveness depends on design and implementation. Smart subsidies maximize social benefits while minimizing distortions and mistargeting. The discussion below emphasizes the way well-designed subsidies can potentially “crowd in” other donor funds. Particular emphasis is put on subsidies that are (1) transparent, (2) rule-bound, and (3) time-limited. One further step is to institute regular, rigorous statistical evaluations of program impacts. Only then can donors evaluate the social returns on their investments—and have the information to improve impacts.

The essay focuses on possibilities, not new guidelines. Ultimately, the push for profitability will continue to be critical for microfinance. The question is whether a subset of institutions can benefit from using subsidy strategically to promote social objectives not otherwise possible. And if so, how?

OPENING CONVERSATIONS

Long-term sustainability is critical for microfinance. The desire to escape ongoing subsidization spurs institutions to innovate, cut costs, and improve products and services. The push for profitability attracts new investors into the sector, reinforcing calls for professionalism, transparency, and good governance. None of this is likely in settings dominated by subsidy.

The recently reformulated set of donor guidelines of the Consultative Group to Assist the Poor (CGAP) on “good practice in microfinance”[1] begins with the idea that “microfinance can pay for itself, and must do so if it is to reach very large numbers of people.” The guidelines push the point further: “Unless microfinance providers charge enough to cover their costs, they will always be limited by the scarce and uncertain supply of subsidies from donors and governments” (CGAP, 2004, p.1). The appropriate role of subsidies is thus minimal according to the guidelines. For the most part, subsidies are to be limited to start-up funding of new institutions, after which they should be withdrawn. As the guidelines put it: “Donor subsidies should be temporary start-up support designed to get an institution to the point where it can tap private funding sources, such as deposits.” (CGAP, 2004, p.1).

We have to be careful, then, in opening conversations about broader uses of subsidy—uses that may go substantially beyond “temporary start-up” support. But the risks of not discussing subsidy openly can be large too. For one thing, using subsidy continues as an ongoing part of the financial strategies of many microfinance institutions (MFIs), even institutions well beyond their “temporary start-up” phase. The *Microbanking Bulletin* of July 2003, for example, shows that 66 out of 124 micro lenders surveyed were financially sustainable, a rate just over half. For micro lenders focusing on the low-end, just 18 of 49 were financially sustainable as of the July 2003 accounting, a 37% rate. On one hand, the data show that even programs reaching poorer clients can do so while covering the full costs of transactions. On the other hand, the norm remains subsidization, particularly for those programs working in remote areas and seeking to reach the poorest households.[2]

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Another reason for opening conversations is that subsidization is not likely to end soon. “Social investors” are starting to make their mark in the sector, for example, and many are driven by the possibility of trading off profit for demonstrated social impact. Philanthropic foundations work on the same premise. Many social investors hope to strengthen microfinance as a poverty reduction tool, and some MFIs have made a conscious effort to reach the "very poor" individuals highlighted, for example, by the UN Millennium Development Goals (MDGs). Recent studies show that microfinance mainly serves moderately poor and low-income households, though with weaker outreach to the very poor. Studies completed as part of legislation mandated by the US Congress, for example, show that in Peru, Kazakhstan, and Uganda, roughly 15% of microfinance customers were among the "poorest half" of the poor, as defined by the official poverty lines in their countries. In Bangladesh, 44% were found to be among the "poorest," a figure lower than expected. Not everyone is equally concerned about the plight of the poorest (or agrees that microfinance is the best tool to reach the poorest), but the failure to achieve deeper outreach is a growing policy concern, especially in the UN system.[3] One question raised is whether (smart) subsidies can help in achieving social goals, including poverty reduction and improvements in levels of health and education alongside better finance.

A third reason for an opening to broader deployments of subsidies arises from analytical concerns. The propositions put forward against subsidies are best seen as rules of thumb and, as time passes, the need for analytical nuance becomes clearer. With greater analytical clarity, the limits and possibilities for efficient subsidization have emerged. In particular, four important lessons have been learned:

1. Subsidized credit does not equal "cheap credit" (meaning, credit at interest rates well below rates available elsewhere in the local credit market) and the poor incentives that ensue. The early attacks on subsidized state banks centered justifiably on their "cheap credit" policies—interest rates on loans that were sometimes negative in inflation-adjusted terms and small if positive. But the jump from criticizing "cheap credit" to criticizing other kinds of subsidies has been recognized as being too great a leap. Today, cheap credit is a well-understood problem, and a first principle of smart subsidies is to avoid cheap credit.

2. Profitability does not equal efficiency. New data show that efficiency (lean management structures, low unit loan costs, and high numbers of loans per staff member) depends largely on giving staff the right incentives and using information well. The *Microbanking Bulletin*, for example, shows highly efficient institutions that are subsidized, as well as some that are profit-making. It also shows profit-making institutions that are not particularly efficient. Consider, ASA in Bangladesh, for example. ASA has implemented innovative cost-cutting management practices that have made it among the most efficient lenders in the world. But ASA achieved the cost reductions during a period in which it was also receiving soft loans from Palli Karma-Sahayak Foundation (PKSF) a local apex organ-ization. It was (modestly) subsidized but highly efficient.[4]

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3. Profitability does not equal sustainability (as judged by the ability to survive over time). Consider a program that enjoys a temporary monopoly, charges high rates, and posts profits. It will be "financially sustainable" according to the standard measures. But the bank is vulnerable to new entrants who may skim off good clients and undermine the long-term viability of the business. In comparison, a well-run but subsidized micro bank may well be more viable over the long-term. A realistic long-term strategy is what matters most, and this is not reflected in snapshot measures of current profitability.

4. Profitability does not guarantee access to commercial finance, nor does lack of profitability necessarily foreclose such access. Profitability does not guarantee large scale, nor does subsidization necessarily limit it. In the United States, for example, most universities and hospitals operate

on a not-for-profit basis, but many obtain commercial financing for parts of their operations. Similarly, MFIs routinely mix funding sources—some subsidized, some at commercial rates.

While these arguments point to the possibility for a broader consideration of subsidy, how and when should it be done?

"CROWDING IN" AND "CROWDING OUT"

Donor funds typically constitute just one part of overall financing for a development finance institution. Given this context, donors use their resources most effectively when they act as catalysts for additional resources or social impacts. One important idea is that smart subsidies should "crowd in" funding where possible, rather than crowd it out.

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Providing guarantees is a good example (or offering subordinated debt in which the donor is willing to be repaid after other lenders are repaid). Consider the case of a recent securitization deal between India's largest private bank, ICICI, and the micro lender, SHARE Microfin Ltd.[5] For ICICI to agree to pay for a portfolio of 42,500 loans served by SHARE (SHARE continues to service the loans, but interest and principal go to ICICI), ICICI required protection against unexpected loan losses. ICICI demanded an 8% first-loss guarantee. If customers refused to repay SHARE, ICICI did not want to be left vulnerable. The eventual deal emerged when the Grameen Foundation funded most of the required guarantee by giving SHARE $325,000 in capital. SHARE, for its part, contributed about $20,000. The loan portfolio was valued at $4.3 million, so the guarantee amounted to $344,000 or 8%.

The Grameen Foundation's $325,000 was thus used to "crowd in" an additional $4.3 million from ICICI. While ICICI receives the profit from its shares, SHARE gains by spreading its risk and getting an immediate capital infusion. In this case, the subsidy (in the form of a loan guarantee) helped attract commercial capital; not only that, it helped finalize the deal. The experience undercuts the simple idea that subsidization and commercial capital are at odds. Here, in fact, they are complementary.

Guarantees are powerful not just because they reduce risk for other potential investors. They can also be powerful when they signal information about the recipient's strength and efficiency. Presumably, the Grameen Foundation went into the deal with SHARE and ICICI after reckoning that the risks were modest. By putting their money behind that belief, the Grameen Foundation could signal to outsiders that SHARE was an institution in which it is worth investing.

Similarly, making a substantial loan to an institution can signal a belief in the strength of that institution, and being willing to accept subordinated debt status goes even further. In the decision to make a grant versus a loan or guarantee, the two latter options mean bearing risk. Rather than avoiding risk, the donor can signal their belief in the strength of the institution by deliberately accepting risk—and that signal may help attract commercial investors.

The other way that donors crowd in other investors is by providing broad oversight (and perhaps even joining the board) of the recipient institution. If the donors have a strong reputation for prudent leadership and oversight, their involvement can provide additional incentives for other investors, even commercial investors, to participate. Again, the donors not only bring their own resources but also the possibility of attracting other investors.

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START-UP SUBSIDIES FOR INSTITUTIONS

The CGAP's donor guidelines on good practice in microfinance privileges start-up subsidies for institutions, limited to the first 5–10 years of operation. Start-up subsidies have the advantage of being time-limited and relatively transparent. By restricting the subsidies to a limited period, the fear of dependency is diminished. This rule-based aspect of the subsidy reduces the weak incentives created by soft budget constraints—i.e., that recipients will not face the consequence of failing to achieve financial targets. Here, instead, the donor makes clear that the subsidies are only available for a short time, after which the institution is expected to become self-sufficient.

A common goal is that the subsidy allows institutions to immediately charge customers fees and interest rates at levels that will become feasible only once the institution reaches a larger scale. In the start-up stage, the subsidies make up the shortfalls—and thus prevent the full costs of the operation from being passed on to customers in the form of higher fees and interest rates.

The logic is clear. But if "start-up" subsidies are appropriate when an institution is just building its first branches, why would they be less appropriate when the institution chooses to expand to a wholly new area where it has to build up, in large part, from scratch? In the very beginning, when building the first branch, much learning-by-doing must, of course, be done, and the subsidies are particularly helpful. Later expansion should be easier and a prudent institution will put aside a part of current earnings to fund future expansion. All the same, a donor may be able to hasten the expansion process by broadening the notion of "start-up" subsidy to cover major expansions—even after the first 5–10 years of an institution's existence—without creating ongoing incentive problems.

START-UP SUBSIDIES FOR CUSTOMERS

One of the reasons start-up subsidies are justified is that an institution takes time to achieve scale economies. To a degree, this is true when working with new clients, too—at any stage in the life of an institution. New clients generally start with the smallest loans, and such loans tend to have high transactions costs per unit.

At BRAC in Bangladesh, for example, a study several years ago showed that initial loans to new customers were so small—just taka (Tk) 2,500—that BRAC lost money servicing them at the given interest rate (15% charged on a flat basis, roughly equivalent to a 30% per year effective interest rate). At loan sizes of Tk4,000 and more, BRAC recovered costs with interest earnings, but not at Tk2,500. BRAC calculated that it cross-subsidized at a rate of Tk225 on a Tk2,500 loan, suggesting that BRAC would have needed to raise effective interest rates by about 9 percentage points for small loans. BRAC's management, though, feared that effective interest rates of 40% would be unaffordable for the poorest borrowers and could undermine social goals.

The subsidies (actually "cross-subsidies" in this case) were not associated with "cheap credit" and all of the negative trappings that entails. Instead, they were strategically deployed and targeted to aid the poorest customers. They allowed the customers to begin the first stages of a relationship that ultimately was sustainable.

BRAC's IGVGD Program subsidized potential clients who were not yet ready to borrow from micro lenders at "market" interest rates

BRAC took the idea a large step further in its Income Generation for Vulnerable Group Development (IGVGD) Program which subsidized potential clients who were not yet ready to borrow from micro lenders at "market" interest rates. First, BRAC argued, these customers can benefit from an intensive period of training and time to build businesses to a minimum scale. The IGVGD Program was built around a food aid program that the World Food Programme sponsored. The resources of the food aid program were integrated into a program that provided both 18 months of food subsidies and half a year of skills training, with the aim of developing new livelihoods for the chronically poor. Participants were also expected to start saving regularly to build discipline and an initial capital base. When the training program was completed, households were expected to be able to "graduate" into BRAC's regular programs.

The program focused on households headed by women or "abandoned" women who own less than a half acre of land and that earn less than Tk300 ($6) per month. The training included

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skills like livestock raising, vegetable cultivation, and fishery management. After an 80% success rate in a pilot program with 750 households, BRAC rolled out the program throughout Bangladesh, and IGVGD had served 1.2 million households by 2000.[6]

The subsidies at BRAC are not large in the scheme of things. Taken together, Hashemi (2001) estimates that IGVGD subsidies amount to about Tk6,725 (about $135 in 2001) per participant. The largest component is Tk6,000 for the food subsidy (provided by the World Food Programme), and the remainder is about Tk500 for training costs and Tk225 to support making small initial loans to participants (the first loans are typically about $50). For $135 per participant, BRAC aims to forever remove the need for participants to require future handouts. To achieve that aim, efforts to ensure sustainable impacts must be implemented and success rates improved. But even as it stands, the IGVGD is an important model for other programs. BRAC has launched a new initiative, Targeting the Ultra Poor, that builds on the IGVGD and combines training and subsidy for the very poor. The question ultimately is whether this deployment of subsidies generates sufficient social value for the cost. And does it generate more social value than alternative social investments?

PROVIDING COMPLEMENTARY INPUTS

The IGVGD began with the recognition that the problems and constraints faced by poor households are often multiple and overlapping, including the lack of access to adequate health care, skills, and education.

A different kind of time-limited, transparent, rule-bound intervention involves the delivery of nonfinancial services to current customers. Consider Pro Mujer, a micro lender in Latin America that is committed to improving the health and economic opportunities of poor women and their families. Based on feedback from their clients, Pro Mujer's branch in Nicaragua introduced an array of health services including gynecological exams, with a focus on cancer prevention and detection; self-help groups aimed at combating family violence; and health counseling by clients trained as health promoters. In 2005, Pro Mujer, Nicaragua began an innovative strategy to take health services straight to customers' communities. Health educators now travel by motorcycle to communities, offering pap smears and consultation services. In 2004 alone, 199 cases of cancer were detected among Pro Mujer's customers in Nicaragua, and the women were linked to treatment.

Such integrated models of banking coupled with social services (or other services) are not appropriate for every MFI or every location—or even most institutions and locations. Nor are they simple to implement. But Pro Mujer has demonstrated that they are possible to implement well and that they are meaningful for clients. There is no reason that customers cannot pay for most of the health services on their own (Pro Mujer is strongly committed to financial self-sufficiency), but where full costrecovery is impossible, strategic subsidization can improve health service quality and quantity for customers, without distorting financial mechanisms.

DEMONSTRATING IMPACT

In general, subsidies should be time-limited and rule-bound. Practitioners know that the availability of subsidies can be uncertain and unreliable. Depending on ongoing flows of subsidy is not likely to be a viable long-term proposition. But that still leaves many places where smart subsidy may help philanthropic individuals and donors achieve social objectives that are not readily achievable when working through strictly for-profit institutions.

Deploying subsidies though raises the bar on evaluations. The microfinance industry has made great strides by developing—and insisting on the use of—clear, rigorous financial measures. The same must be true for subsidies. If smart subsidies are deployed in the hope of producing demonstrable social impacts, those impacts should be measured using rigorous statistical analyses—with solid control and treatment groups and attention to measuring causal relationships. Every intervention need not be rigorously evaluated, but at present there is almost no careful evaluation (i.e., with appropriate control groups), and it is time to shift the balance.

Microfinance experts have worried, justifiably, that badly designed subsidies not only undermine the financial performance of micro lenders but can also undermine social impacts by limiting scale and the quality of services. If subsidies are deployed in the name of improved social impacts, donors should make it a priority to measure the degree to which they generate important net impacts for customers.

ENDNOTES

1 The guidelines incorporate the views of a broad range of donor staff working to support inclusive financial systems (CGAP, 2004).

2 Definitions of low-end vary. The *MicroBanking Bulletin*'s definition of institutions reaching the low-end of the population includes those with an average loan size of less than 20% of GNP per capita or less than $150. Some of the programs in the bulletin are young and in their start-up phase, but even established programs use subsidies.

3 Data are from Morduch (2005). Some current microfinance customers likely started out among the very poor and have since grown less poor. Data on incoming microfinance customers (rather than current customers in aggregate) would show higher levels of poverty if that is true. Also note that these data are from just four countries and pertain to relatively small samples.

4 For more on ASA's innovations, see Nimal Fernando and Richard Meyer (2002).

5 Details are taken from Chowdhry, et al (2005).

6 The data and follow-up study reported here are from research in Imran Matin and David Hulme (2003).

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