Implementing the Microenterprise Results and Accountability Act of 2004

Testimony for the House International Relations Committee
Subcommittee on Africa, Global Human Rights and International Operations

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Chairman Smith, Members of the House International Relations Subcommittee on Africa, Global Human Rights and International Operations, thank you for this opportunity to appear before your committee. I want to take this opportunity to thank the chairman, and the committee, for the continuing efforts to work toward a world with less poverty, greater opportunity, and stronger accountability for foreign aid spending.

I am honored to be here to discuss the important legislative efforts to promote microfinance and microenterprise. I would like to ask that my full testimony be entered as part of the record, and I will then briefly summarize my major points.

My comments today reflect over fifteen years of research on both microfinance and poverty measurement. In addition to my faculty position at the NYU Wagner School, I have the privilege of serving as chair of the United Nations Expert Group on Poverty Statistics, a group of international experts and practitioners working to improve the measurement and understanding of global poverty. I am also a member of the expert advisory committee for the University of Maryland IRIS Center project to implement the poverty assessment component of the legislation under review today.

Advocates of various stripes have brought passion, new evidence, and new ways of thinking to make microfinance a global phenomenon. In the process, decades of pessimism and misinformation have been pushed back. Microfinance stands as one of the most promising and cost-effective tools in the fight against global poverty. Microbanks like the Jamii Bora Trust now give hope to residents of the sprawling slum of Kibera, Kenya, one of world's largest and bleakest slums. I have visited successful microfinance customers living in make-shift huts built on stilts over fetid water in the slums of Bangladesh, and heard customers excitedly tell of their new businesses in poor villages in South India. Thanks to hard-fought campaigns, microbanks now serve tens of millions of poor and low-income customers in Kosovo, in Afghanistan, throughout sub-Saharan Africa, and in many other parts of the world. Accion New York even serves over 6,000 customers in the New York metropolitan area.[1]

[1] Correction (November 2005): Accion serves over 2,000 customers in New York.

In pushing to make all this happen, the rhetoric has sometimes been heavy and the hopes extremely high. Now, with microfinance firmly established--marked with a special UN International Year of Microcredit in 2005--it is the right time to step back and discuss what we've learned so far, what we would like to know better, and how we can move forward together.

The present legislation, in creating a mandate to collect data on who microbanks serve today, has already proved extremely valuable. And the effort will be even more valuable as additional data are collected and analyses push ahead.

I want to focus on four points this afternoon:

First, there is clear evidence that microfinance can work for the very poor. Many among the very poor actively seek better ways to borrow, save, and purchase insurance—but find themselves too often rebuffed by state banks or traditional commercial institutions. Not all would make reliable customers, but microfinance practitioners have demonstrated that it is possible to serve large numbers of the very poor. The present legislation underscores the importance of trying to better reach this population.

Second, microfinance can be powerful and cost-effective, but it is not a panacea. The World Bank finds that over one sixth of our planet live on income less than $1 per person per day. It is easy to lose sight of the human struggles that lie beneath these numbers—struggles complicated by poor health, inadequate nutrition, limited education, and vulnerability to shifting economic, political, and environmental conditions. Microfinance cannot fix all of these problems. Microfinance can be a powerful and cost-effective strategy that complements other interventions, but it is not a miracle cure. Setting expectations too high risks undermining the genuine contributions that access to finance can bring.

Third, preliminary evidence so far suggests that reaching the targets set by the legislation will be a challenge—specifically the target of spending half of the USAID microenterprise budget on the very poor. I say this without specific knowledge about USAID's disbursements. My prediction stems only from preliminary (and limited) evidence that few existing microfinance institutions currently serve customer populations that are predominately drawn from the very poor as defined by the legislation. These patterns are unlikely to change in the short-term. Of course, if meeting targets was easy, there would be little gained by legislating targets, and part of the intent of the legislation, as I understand it, is to encourage the development of new ways to reach the very poor with financial services. The findings, if confirmed by subsequent data collection, underscore the continuing importance of pro-poor innovation.

Fourth, international donors like USAID have a crucial role to play at this juncture, even when the push toward commercialization suggests that donors should become less relevant. Donors can and should play a key role in continuing to spur innovation for those still poorly-served, enabling a strong macroeconomic and policy environment, supporting basic research questions relevant to policy and practice, and directly supporting microfinance practitioners who work with the poor and very poor.

I. Microfinance can work for the very poor.

Debates continue around which customers can best take advantage of microfinance. Fortunately, the answer is that a wide variety of groups can do so in different ways. Financial markets in poor communities still have too many gaps, and a broad range of people are eager to become microfinance customers, both among the poor and non-poor. Most microfinance customers today live on incomes that put them a few notches above their national poverty lines or just below the lines—not the very poor as defined by the legislation. These are low-income households struggling to establish a firm economic foothold, and they are often a vital (and large) part of economies.

The Microenterprise Results and Accountability Act recognizes the broad scope for microfinance by not targeting 100 percent of microenterprise funds to the very poor. Instead, the legislation targets half of funds toward the very poor. Some microfinance experts have wondered, though, whether the very poor can be reliable clients at all. Evidence from India and Bangladesh, where many microfinance customers are very poor according to the legislation's definition, show that the answer is definitely yes. Evidence from other countries is less clear, in part because microbanks seldom collect complete data on the income levels of clients and in part because the "very poor" segment of the market is often small and not yet served extensively by microfinance.

Lessons from Indonesia: many un-served customers may still be "feasible" borrowers.
Several years ago I advised a project that attempted to address these questions head on. In August 2002, Bank Rakyat Indonesia (BRI), a pioneering microfinance provider, now serving over 30 million customers, undertook a survey in part to gauge whether the very poor could be feasible customers. The survey covered 1438 households in six provinces. At the time of the survey, nearly all of BRI's customers were close to the poverty line or above it. BRI initiated the survey in part to better understand possibilities for working with clients poorer than their existing base.

The survey had one unusual feature. Instead of hiring an outside survey firm, BRI looked in-house for survey enumerators—the people who would go door-to-door asking questions of the 1438 households in the sample. The enumerators were thus mostly BRI loan officers or book-keepers, and most in this group had extensive professional experience judging credit applications.

The survey included detailed information on the households' credit, assets, savings, household businesses, and economic and social changes. The use of loan officers and book-keepers as enumerators provided a unique opportunity to assess the creditworthiness of both customers and non-customers using the standard procedures applied by the bank. At the end of each survey, the enumerators were asked to give their professional assessments of the creditworthiness of each household, whether or not someone in the household was presently borrowing (or even interested in borrowing).

The poverty line in Indonesia at the time was roughly 36 cents per person per day in rural areas, and 48 cent per person per day in urban areas (converted at official exchange rates). The enumerators reported back that roughly half of the poor households surveyed would, in their professional judgment, be appropriate for a BRI loan. Moreover, roughly half of the households living on income equivalent to *half* of the official poverty line or less (i.e., on under 18 cents per person per day in rural areas) were also judged to be feasible BRI borrowers. Few were currently microfinance borrowers, though. Thus, in Indonesia there appeared to be a large group among the very poor who were under-served by microbanks but who were nevertheless potentially reliable customers—as judged by BRI professionals themselves.

Trade-offs in serving the very poor: reaching the very poor is costly but viable. The enumerators in the Indonesia survey described above were judging whether the households seemed reliable, able to repay loans on time, and able to pay the same interest rates as existing customers of BRI, a leading commercial bank. The enumerators found many very poor households that qualified.

It is another thing to ask whether the bank would have been able to profit while serving these very poor customers. Since the scale of lending is typically smaller when serving the very poor, profits can be difficult to squeeze out. In addition, to reach the "feasible" half of the poor population, BRI staff would have to find inexpensive ways to determine who was in the half that was deemed a good prospect for repaying loans, and who was not. BRI is experimenting with ways to achieve these goals cost-effectively.

We can step back and ask a broader question: across successful microfinance institutions world-wide, is there evidence of a clear trade-off between profitability and the ability to reach the poor?

The answer is mixed, but hopeful. With two co-authors in the research department at the World Bank, I have been investigating a data set with unusually high-quality financial information on 124 microfinance institutions in 49 countries. These institutions are united by claiming strong commitments to achieving financial self-sufficiency and a willingness to open their accounts to careful scrutiny. The institutions thus represent some of the best hopes for achieving poverty reduction with profit (or at least without ongoing subsidy).

The data set does not include information on how many clients of each institution are "very poor" as defined by the present legislation, so proxies for poverty levels are used instead, mainly based on average loan size.

We find several interesting results here. First, the survey shows little correlation overall between profitability and average loan size. Average loan size is taken as a rough proxy for the average poverty level of customers, so this finding suggests the possibility of serving the very poor on a financially viable basis.

The survey allows us to dig a bit deeper. We start by noting clear differences across institutions associated with their lending methods. For example, microbanks using a "village banking" model pioneered by FINCA make the smallest loans ($149 per borrower in 2003). (These are not all affiliates of FINCA and their specific lending methods may vary.) Microbanks in the sample that use "individual lending" methods, similar to standard commercial bank practices in the United States, make much larger loans on average ($1220 on average). These are still small loans, of course, relative to the size of loans made by typical banks.

The survey shows that the village banks, not surprisingly, face high costs per dollar lent. This is in large part because banks that make the smallest loans run into limits in the economies of scale that can be reaped.

The "individual lending" group is profitable on average, with revenues covering 111 percent of their total costs (over 100 percent indicates profitability). The "individual lending" group demonstrates the possibility of financially sustainable microfinance. The high costs faced by the village banks as a group mean that they were covering just 95 percent of their total costs—which is still impressive but not yet fully profitable.

These are averages, and they cover up that some village banks are already profit-making while others are not. Taken as a whole, most of the microbanks in the sample have steadily improved their financial positions over time, and the financial performances can be expected to improve in future years for everyone. The data suggest that reaching the very poor while making profits is within sight—but it is not easy and takes time, even for this group of industry leaders. This is one reason that continuing support from international donors can be pivotal.

II. Microfinance is not a panacea.
Many social and economic interventions lack a broad range of rigorous evaluations with high statistical standards. The lack of serious evaluations is common in the health and education sectors, for example, and the microfinance sector is no exception.

We have many compelling stories about transformations brought by microfinance, and good theoretical reasons to expect that microfinance is a powerful intervention in practice. Recent evidence based on large comprehensive surveys in Bangladesh, for example, show microfinance's promise, particularly in reducing extreme poverty. We still await rigorous evidence on microfinance impacts from a broad range of countries, and international donors have a potentially pivotal role to play here as well.

When better surveys are completed, I expect that we will find that credit alone is not a panacea that can eliminate all of the constraints faced by the very poor. Those problems and constraints are often multiple and overlapping, including lack of access to adequate healthcare, sanitation, and drinking water.

But microfinance can be an important part of solutions. It can be a way to help finance health needs, for example—through savings accounts, through loans, and, most recently, through health insurance programs. Microfinance practitioners like Freedom from Hunger explicitly bundle credit provision with cost-effective education on good health practices, and they have demonstrated improvements in their customers' health as well as wealth.

Pro Mujer, an innovative microlender in Latin America, is an example of an instution that has gone one step further. Based on feedback from their clients, Pro Mujer 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. Last year 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 microfinance institution or every location—or even most institutions and locations. Nor are they simple to implement. But they show considerable promise when focusing on the poorest.

III. Reaching the legislated targets may prove to be a challenge.

The Microenterprise Results and Accountability Act of 2004 establishes an effort to collect data on the poverty levels of microentrepreneurs served with USAID funds. The initiative is a major step forward, both for the microfinance community and for taxpayers who deserve accountability about the social impact of government spending.

I have been involved, as a member of the advisory committee, in the effort to create simple methods for assessing the poverty of microfinance customers. Real progress has been made by the team based at the University of Maryland IRIS Center, and it has been a privilege to be part of the process. In many of the countries where the methods are being developed, the poverty assessment tools so far have quite good levels of accuracy.

Looking ahead, at least two issues are being kept in mind. The first has to do with ongoing technical debates around poverty measurement methods—issues that are general and not specific to microfinance. The second has to do with the preliminary results on the poverty levels of existing microfinance customers.

A. Technical debates about poverty measurement.

Most countries measure poverty according to their own methods, reflecting their own policy concerns and national conditions. The legislation being discussed today identifies very poor people according to two specific criteria: either people living under the "international poverty line" of $1 per day per person, or people in the bottom half of their country's own poverty distribution—literally, the poorest of the poor.

The specificity around the notion of the "very poor" is very helpful. The definitions reflect the aspirations of many in the community of microfinance practitioners and policymakers, and it is unlikely that wide-scale pro-poor innovation will occur without concrete steps like this.

From a purely technical standpoint, things are seldom as simple as they seem at first crack, though, and I highlight two hurdles considered so far in implementing the legislation. Fortunately, neither hurdle is insurmountable, but they suggest how implementing the legislation may require extended support from experts skilled in survey design and poverty analysis. I preface these views by noting that these are my personal opinions, and they may not be shared with others involved in the project.

Issues with the $1/day poverty lines. The international poverty line is a simple metric that has generated a wide consensus. But it has also been subject to some debate among practitioners and academics. One of the main tensions centers on the method of translating "$1/day" into the local currencies of countries in question. The method used is the "purchasing power parity" (PPP) exchange rates that were developed to put the value of GNPs across the globe onto comparable scales. Because official exchange rates are often distorted by policy or other interventions, the PPP exchange rates can give a clearer view of the standards of living in different countries. For this reason, they are increasingly used in making worldwide comparisons.

The PPP exchange rates were not specifically designed for comparing poverty levels, though. They are preferred in this setting over using official exchange rates, but they have limits. The most important limit here is that the PPP exchange rates do not reflect the kinds of goods and services typically consumed by the poor and very poor. They exchange rates tend to put too little weight on basic staple foods and too much weight on luxury goods and items like cars and color televisions. Efforts are underway to refine the PPP exchange rates with poverty comparisons in mind, and preliminary evidence from India and Indonesia suggests that the refinements may make a considerable difference in who is judged poor and who not.

The legislation is based, rightly, on using the best-available methods, but it is worth noting that the methods are still being developed, and I hope that a more reliable set of numbers will emerge within five years.

Issues with the "poorest of the poor" criterion. The idea is to define the very poor as those households in the bottom half of the distribution of poverty in a given country. In statistical terms, the idea is to distinguish between households above the median income (the middle point of the distribution) and those below the median income of all poor households. In some countries the median income of poor households is easy to obtain or approximate. Where nationally-representative surveys of incomes are available, it is an easy number to calculate.

A tension, from a purely practical angle, is that relatively few countries (particularly among the poorer countries) make nationally-representative surveys available on a routine basis. The surveys are often hard to obtain even on a non-routine basis.

The median income of the poor is also seldom published in official tables. In my role with the United Nations committee on poverty measurement, I have come to see the value of broader access to data and of publishing a wider array of poverty statistics (including median incomes). But neither is the case today, and researchers will have to take creative steps to approximate where the appropriate cut-offs are in places where the relevant data are unavailable.

Again, the hurdle is surmountable and the University of Maryland IRIS Center team has done an excellent job in showing how. Extending the process to other countries will require expertise and resources, and USAID should be prepared for this possibility.

B. Who is being served today?

In the course of their work, the team from the University of Maryland has collected data on the poverty levels of microfinance customers in four countries: Bangladesh, Peru, Kazakhstan, and Uganda. The lessons learned so far are revealing in themselves – and have emerged thanks to the provisions of the legislation.

The results are preliminary and based on relatively small samples, but I want to highlight a few findings. The microfinance institutions surveyed reach poor and low-income customers who can benefit from the services provided.

At this point, though, relatively few current microfinance customers in the survey (in these three countries) are below the established cut-offs for being "very poor."

In Bangladesh, nearly 350 current microfinance clients were surveyed, and 44 percent were found to be under the relevant cut-off.

In Peru, nearly 1200 microfinance customers were surveyed, and none were below the $1/day international poverty line. Between 4 and 17 percent fell below the second cut-off, being in the bottom half of the income distribution.

In Kazakhstan, an even smaller group of customers was found to be below the established cut-offs, which is understandable in part given the relatively low poverty rate in the country (16% in 2004).

In Uganda, in a sample of 788 households, 40 percent were identified as current microfinance customers. Of these, 15 percent would be designated as "very poor" according to the cut-offs in the legislation.

Caveats and comments. In Bangladesh many current microfinance customers likely started out among the very poor and have since grown less poor. To some extent, this is also likely elsewhere. Data on incoming microfinance customers (rather than current customers in aggregate) should show higher levels of poverty if that is true, but at this point I can only speculate.

Also, again, these data are just from four countries and pertain to relatively small samples.

If the patterns hold up, though, it will be a challenge to reach the targets set by the legislation. Of course, if meeting targets was easy, there would be little gained by legislating targets. The most important lesson I take from the findings (if they are confirmed by future data collection) is that pro-poor innovation continues to be important for microfinance—and suggests an important ongoing role for USAID.

IV. USAID's role.

The emerging successes of commercially-oriented microfinance might suggest that international donors should play a smaller role in this sector. The evidence so far, though, suggests that microfinance is still not reaching the target population of "very poor" customers highlighted by the legislation. To reach this goal, several activities seem critical, and international donors like USAID can take the lead in:

1. **Helping establishing sound macroeconomic and regulatory environments** in which microfinance can grow.

2. **Spurring pro-poor innovation** through challenge grants, and helping to get innovations to a wide scale.

3. **Supporting basic research questions relevant to policy and practice.** Rigorous evaluations are "public goods" and tend to be under-provided. They also can require financial and technical support beyond the capacity of microfinance providers focused on the very poor. A range of other basic questions about pricing and policy remain relatively unexamined. International donors like USAID have the position to play a leading role in helping institutions (and the broader industry) learn from successes and challenges.

4. **Directly supporting microfinance practitioners who work with the poor and very poor.** The support from international donors has been essential for microfinance institutions as they have pushed to reach new markets, tried new and better products and processes, and reached scale. The growth of microfinance is a testimony to the power of those investments. Established providers that are entering new markets and seeking to serve difficult-to-reach customers continue to need support in order to reach the full promise of microfinance.

Thank you very much for allowing me to share my views on these important topics.