# Focus

No. 17
May 2000

## Microfinance and Risk Management:
A Client Perspective

The Focus Series is CGAP's primary vehicle for dissemination to governments,donors, and private and financial institutions on best practices in microenterprise finance.

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As the microfinance industry matures, service providers are increasingly concerned with developing new and better products. This focus on new product development is a response to growing competition in the microfinance market, the search for more defined market niches, and some anxiety about dropout rates.

To design successful products, the first step entails understanding the financial needs of clients (and potential clients) and how financial services fit into their money management strategies. Understanding clients requires an awareness of the economic goals of poor households, how people manage resources and activities, and how they deal with risk in their day-to-day lives. Such a framework can be a useful starting point to better understand financial service preferences of poor households.

Recent research commissioned as a contribution for the forthcoming *World Development Report 2000/1(WDR)*[1] on poverty highlights the importance of focusing on risk and vulnerability as a way of understanding the possibilities and limitations of the interface between poverty and microfinance. The research focused on selected non-income dimensions of poverty, specifically how people use microfinance services to build physical, financial, human and social assets, mitigate risk, and reduce vulnerability.

The study addressed four main questions:

- Whom do microfinance programs reach?
- What is the nature of risks facing clients?
- What strategies do clients use to deal with risks they face?
- What is the role of microfinance services in this process?

The field studies involved seven microfinance institutions (MFIs) in four countries including Bolivia, Bangladesh, Uganda and the Philippines. Using low cost methods, the researchers gathered a mix of primary qualitative and quantitative data on clients and non-clients. In total, the study drew on data from field interviews with some 1,500 microfinance clients in the four countries. The field findings were supplemented with secondary information and findings from other recent impact studies.

### *Findings from the WDR research*

#### Whom do programs reach?

Wealth ranking by household poverty level shows that microfinance clients in the study programs are heterogeneous. Clients defined themselves relative to poverty categories that included destitute, extreme poor, moderate poor (roughly just below the poverty line), and vulnerable non-poor (just above the poverty line). As shown in Table 1, the WDR research, complemented with the findings from other impact studies, suggests that:

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**Table 1: Whom do MFIs reach?***

| | **Philippines** (CARD) | **Uganda** (UWFT) | **Bolivia** (four programs) | **Bangladesh** (BRAC) |
|---|---|---|---|---|
| *Destitute* | negligible | negligible | negligible | negligible |
| *Extreme poor* | some | few | almost none | ~40% |
| *Moderate poor* | many | many | many | ~35% |
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Estimates made by field research teams based on available information, including findings from secondary research, individual interviews with staff and clients, and focus group interviews.

- clients from extreme-poor households participate in microfinance programs but are not in the majority. Programs that explicitly target poorer segments of the population generally have a greater percentage of clients from extreme-poor households; and
- destitute households are outside the reach of microfinance programs.

The vulnerable non-poor comprise a significant segment of the clientele of many MFIs. This group of clients lack insurance or social security and can easily fall back into poverty as a result of a shock (see Box 1).

Given the poverty alleviation objectives of many microfinance programs, these findings suggest a strong case for innovations—improving the design of products and services—to better meet the needs of clients from a broader range of households, namely both the extreme poor and the vulnerable non-poor. Such innovations, if they are to improve the depth of poverty outreach, should take risk and vulnerability faced by the poor seriously.

**Box 1: Yesterday's Non-Poor ... Today's Poor**

Unlike most microfinance clients, Mrs. Muwanga had limited experience working in the informal sector when she received her first Uganda Women's Finance Trust (UWFT) loan. Mrs. Muwanga's family was relatively well-off. Her husband was a lawyer and their children were enrolled in boarding schools and Makerere University. They lived comfortably in a five-room house. However, her husband suffered a stroke in April 1997 and since then has been unable to work. Because of the sudden loss of income, Mrs. Muwanga finds herself the major contributor to the household and the children have been withdrawn from school and university. Her first business venture was the baking and sale of cakes. She made a small profit on her first loan of around $150. During the second loan cycle, she was less lucky. She purchased some bad flour and had to withdraw her savings and sell off her cooker to repay the loan. After this experience, she leased school canteen space and has begun a new business providing food and snacks to the children and their teachers. Mrs. Muwanga's story illustrates the ups and downs of income generation and the dynamic characteristics of poverty.

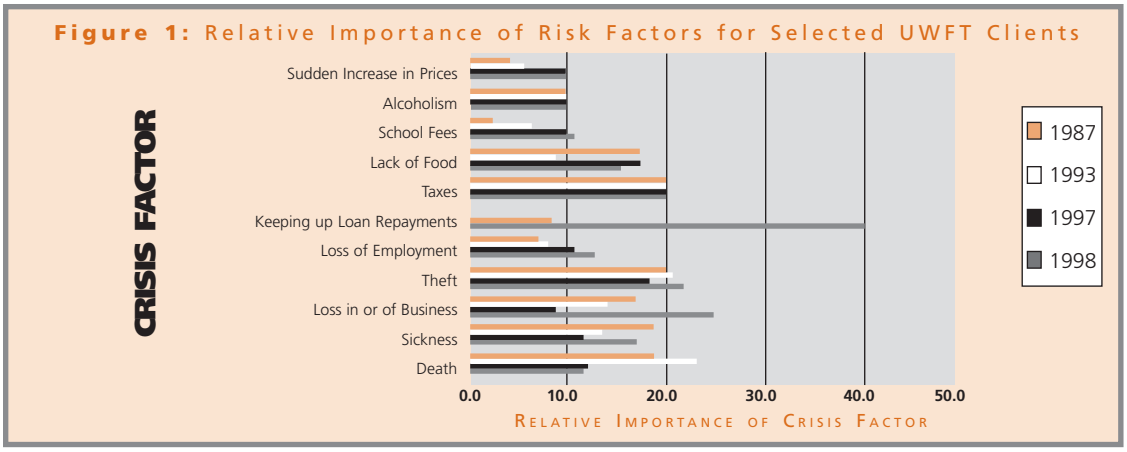
## What is the nature of the risks facing clients?

Microfinance clients at all poverty levels face frequent and wide-ranging risks. This reality is best summed up by a CARD Bank client from the Philippines, "... life for the poor is one long risk." There are many sources of risk: *structural factors* such as seasonality, inflation, or the vagaries of weather; unexpected *emergencies* such as sickness or unexpected death of a family member, loss of employment, fires and theft; and the high costs associated with *life cycle events* such as marriage, funerals, and educating children. There are risks associated with *operating an enterprise* or *taking a loan* as well.

The clients interviewed cited illness as the most prominent source of risk, followed by the death of a family member and accidents. Enterprise risk was frequently mentioned in Bolivia and the Philippines, countries that have experienced large and rapid structural changes in their economies. The risk of taking a loan was mentioned, especially among first-time borrowers and older clients with larger loan sizes. The risk of default and losing access to a valued financial service can be compounded by the loss of self-esteem, confidence, and social assets. Figure 1 shows the relative importance of crisis factors for clients of the Uganda Women's Finance Trust.

## The role of financial services in dealing with risk

In discussing the role of microfinance services in helping clients manage risk, Rutherford considers risk in terms of shocks and economic stress events that require people to spend lump sums of money not readily available.[2] The WDR research identified clients vulnerability to shocks as a core aspect of poverty. Financial services provide the means




for poor households to transform small sums of savings into usefully large lump sums, and therefore can go a long way in decreasing vulnerability. The study found that MFIs play more of a role in helping clients protect against risks ahead of time than cope with shocks after they occur.

*The role of financial services in protecting against risks ahead of time*. The field research shows several strategies that individuals and households use ahead of time to protect against risk. These strategies include diversifying income sources, building up physical, financial, human and social assets, and focusing on good money management.

Financial services play an important role in this process. Loans enable clients to take advantage of opportunities to build and diversify all kinds of assets that can be drawn upon in times of need. Clients use loans to diversify their sources of household income and smooth income flows and consumption. They invest in enterprise fixed assets, financial assets, and physical assets, particularly housing (see Box 2). Microfinance is also used by clients to build human assets, particularly the education of children and health care.

Participation in microfinance programs provides women access to knowledge and information that helps them to interact in the outside world and permits the building and strengthening of social networks. Women value group memberships, a component of social assets, in protecting against risk (see Box 3). By increasing women's economic contributions to the household, participation in a microfinance program can help improve their sense of self-esteem and control over assets. All of these assets increase the options and resources available to households in the event of a shock or stress event.

**Box 2: My Home is my Castle.... And Workplace and Rental Unit**

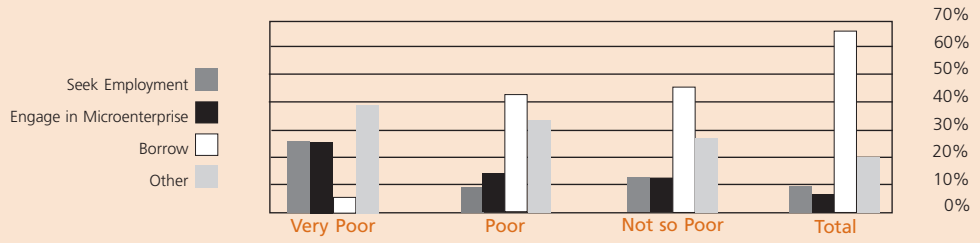
Multiple use of housing is especially prevalent among households experiencing crisis. In Uganda there were many cases of clients who had sub-divided their houses into rental units to generate additional income, and other situations where houses were put to different uses at different times of the day. A striking example of the latter was a house that was used as a hair salon during the day, as a bar in the evening and as a place to sleep at night.

In other instances business premises were used as residences at night as a strategy to cope with a crisis. One of the clients had the following experience: "Enforcement authorities locked my room, when I was away at work, saying it was an illegal structure. While I am looking around for a new room I can afford for my family of fifteen people, at night some of them stay in the bar which my wife runs, and the others stay in the kiosk which I run."

**Box 3: Munno Mukabi: Indigenous Insurance in Uganda**

The most popular type of self-help groups is known as *Munno Mukabi* (which translates to Friend In Need Associations). Many clients of the UWFT belong to one of these. How does a typical *Munno Mukabi* operate? At the inception a budget is agreed on and split equally among the members. The proceeds are used to purchase such assets as are required for most household social functions that draw large *Munno Mukabi* numbers of people. These items include large saucepans, dishes, lanterns, canvas, etc. The functions include burials, weddings, children's graduations, baptismal parties, etc. After the initial capital investment is made, members attend weekly or monthly meetings at which a collection is made. One group for example, collects USh200 per head per sitting; others collect up to USh5,000. This money is kept and lent out whenever a crisis strikes. Members also pledge to make their labor available whenever a member faces a crisis or holds a celebration.[3]

**Figure 2:** Coping Strategies of CARD Bay FGD Participants by Poverty Level




Maintaining access to MFI program credit, in itself, is a protectional risk management strategy for many clients (see Box 4). They go to great lengths to ensure repayment, particularly when confronted with a crisis or shock, often by mobilizing informal sources of finance to ensure repayment. Repayment means access to a new loan to start back on the road to recovery, to restock a microenterprise, to rebuild a house, to pay school fees.

**Box 4:** Maintaining Access to Pro Mujer Credit in Bolivia

Lupe has two businesses: snack food sales and the production of hem decorations. In 1996, she obtained her first Pro Mujer loan and by the time of her fifth loan, her business was generating a steady profit. She then suffered two major crises—her son, who helped in the business, died and her husband, a wage earner, was paralyzed—which forced her to decapitalize her business. Rather than leave the program, she withdrew funds from her savings to pay off her loan balance. Six months later, clear of debt, her Pro Mujer group gave her a second chance to get back on her feet. Slowly Lupe is rebuilding her business. Maintaining the relationship with Pro Mujer allowed Lupe to deal with the shock once it came.

*The role of financial services in coping with shocks or economic stress events afterwards.* Once a shock or stress event occurs, people use various coping strategies: they modify consumption, raise income by mobilizing labor or selling assets, they draw on informal and formal savings, and draw down claims on informal group-based insurance mechanisms.

The WDR field studies suggest that clients generally use low to medium stress strategies in coping with loss – modified consumption, labor mobilization and informal borrowing from friends and relatives. They seek to conserve productive assets and thus maintain income-earning potential when possible. Across countries, clients were reluctant to withdraw children from school, cash in savings, or sell productive assets.

In general, clients tend to use informal sources of credit more often than MFI credit to cope with losses following a shock. When they were used, MFI services were only accessed when other sources were exhausted or failed. Clients reported using MFI loans following shocks to recover lost stock, make repairs on premises or equipment, or start alternative or additional business activities. In some cases they cited using their loans directly to smooth consumption but less frequently than expected. In the Philippines, coping strategies tend to differ according to poverty levels, with poorer clients less likely to rely on borrowing (Figure 2).

Why don't clients use MFI credit to cope with shocks when they occur? The answer to this question is complex; whether it reflects a true choice or constraint depends to a large degree on the design of the MFI loans, the timeliness and flexibility of MFI credit in relation to other sources, the type of shock, and alternative options available.

## The Challenge: MFI product design

The primary product design challenge emerging from this research is the need to design products beyond credit that can help a broad spectrum of clients mitigate the various types of risks they face and cope with crises after they have occurred. Flexible savings and insurance, and housing, education, and emergency loans are examples of potential products that could improve clients' ability to deal with risk. The microfinance industry should focus on improving upon existing loan products and finding ways of introducing a broad array of products that enables clients to reduce their vulnerability to risk.

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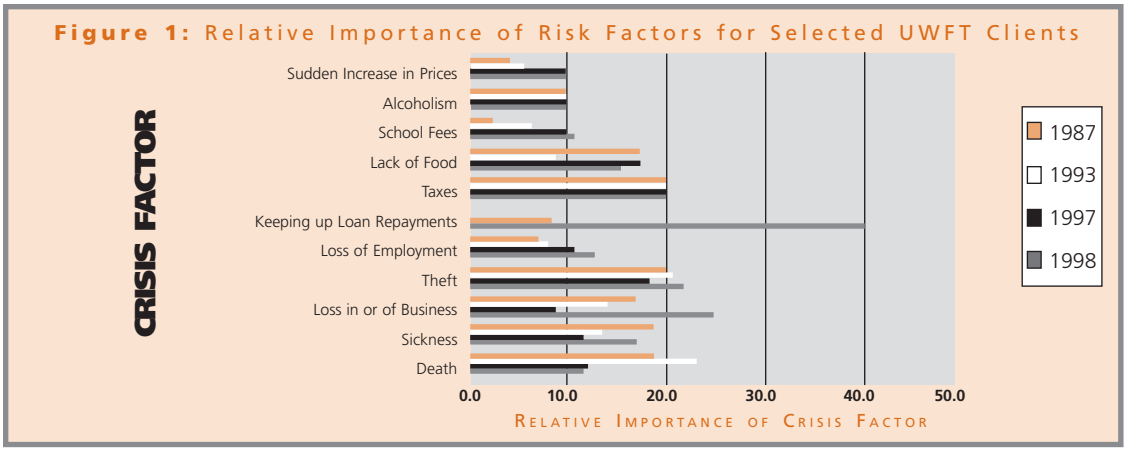


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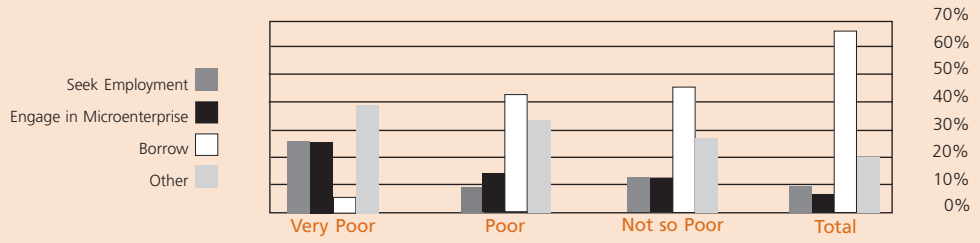


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