

Financial Services That Clients Need: The 3.0 Business Models, Reconciling Outreach with Sustainability

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1 Introduction

Formal financial services hold the potential to improve the lives of the general population, including low-income families, as well as contribute to general economic progress. The development of the finance function in an economy is linked to overall economic growth.¹ Countries with more private lending to private enterprises and liquid stock exchanges grow faster than countries with less developed banking systems.² Well functioning financial systems ease financial constraints that hold back development of industries and productive sectors.³

Lendol Calder argues convincingly that the development of the consumer finance industry in the twentieth century has shaped the behavior of the North American middle class. Entering into credit arrangements means borrower typically forgo some present consumption to repay installment credit, become more disciplined with respect to which consumables they purchase, and end up working harder to achieve their material satisfaction.⁴ Consumer credit has become an important driver of economic growth and governments take great pains during economic recessions to keep the cost of credit low for consumers and home purchasers.

Globally, microfinance has contributed to the lives of poor families by supporting their income generating opportunities, smoothing their consumption, and help-

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¹ Gurley, J.G. and Shaw, E.S. "Financial Aspects of Economic Development." *American Economic Review* 45, pp. 515-538. 1955

² Levine, R. Loayza, N. and Beck, T. "Financial Intermediation and Growth: Causality and Causes." *Journal of Monetary Economics* 46, 31-77. 2000

³ Demirguc-Kunt, A. and Levine, R. "Finance, Financial Sector Policies, and Long Run Growth." Policy Research Working Paper 4469. The World Bank Group. January 2008

⁴ Calder, L. *Financing the American Dream: A cultural History of consumer credit*. Princeton University Press. 1999

ing them meet important family goals like education, shelter, and old-age income security.⁵ In a number of countries, the progress of microfinance has contributed to financial deepening and overall economic progress; this has been clearly documented in Bolivia where private micro-credit is now worth 11 percent of GNP, and one third of total private bank credit in the economy.⁶

While the early development finance literature blamed the lack of credit on unwilling bankers and immoral, ignorant poor clients, the fact has always been that providing formal financial services to low-income families is a hard business. Banks have not known how to provide these services, and as a result don't imagine how they can be provided profitably. Poor families look at the current offering of banking services and don't see how they make sense for their own circumstances. This reinforces the perception in the traditional retail banking community that the poor don't save and are high credit risks; that they are not a profitable market segment.

Transaction costs are, and always will be a significantly higher proportion of the value of a financial service for the poor. The math is clear. Whether it costs a bank one dollar to have a client withdraw cash at a teller window, or 35 cents for that same client go to an ATM, or ultimately, 15 cents to transact over a mobile money network – those costs are proportionately higher for smaller transactions.⁷ Until now, the poor have lived further from connection points of the national financial system than their middle class compatriots. Even with the advent of agent-banking, which will undoubtedly bring connection points far closer to the poor, they will also bring many more points closer to the emerging salaried middle class that is expected to be their primary beneficiary. It is likely that the poor will always experience higher costs to get to and transact on any system, especially as a proportion of the amount they are moving. They will still need to pay or take a longer time to get to the connection point, and they will have to pay the fees these connection points will charge to handle cash. We are still a long way from a fully digitalized economy where those costs might be rendered irrelevant.⁸

The riskiness of lives led by the poor provides an extra challenge to any provider of formal financial services. Their income is highly variable, their overall financial situation can change quite quickly and dramatically, and, as a result, they have a relatively short planning horizon. A large number of poor pull themselves out of poverty in any given year, and yet, the loss of a job, a health crisis, or some other catastrophic event pushes a significant number of others below the poverty line. While access to basic formal financial services can help families cope with

⁵ Sebstad, J and Cohen, M. "Microfinance, Risk Management and Poverty." Pact Publications, 2001.

⁶ Gonzalez Vega, C.

⁷ Westley, G. "Is there a case for small savers?" CGAP. 2011.

⁸ CGAP "Branchless Banking Agents in Brazil Building Viable Networks" 2010.

this variability, the variability makes it harder for the financial institution to design and deliver products that contribute to the bottom line.⁹

On the credit side, variability of income complicates the work of a lender. Due to the asymmetry of information about household income and cash flows and the extent to which a potential client fulfills his or her financial obligations, the lender has a difficult time assessing credit-worthiness. And, once a credit relationship is established, the variability in income and cash flows over the course of their agreement can create moments where repayment is threatened.¹⁰

On the savings side, the variability of income and cash flows can make it difficult to accumulate significant balances in accounts. It is both difficult to get funds into the account on a regular basis, given the inability to make direct electronic deposits of a salary (for example), and, it can be difficult to sustain balances in the face of sudden demands in the household.

On the insurance side, while higher levels of risk faced by poor families would seem to make them ideal targets for micro-insurance, they are generally unwilling to purchase the intangible ‘benefit’ of a payout at some distant, unpredictable future, for an uncertain (though somewhat likely, event). Large numbers of poor families have not yet been able to experience the concrete benefit of micro-insurance.

For those who support a financial inclusion agenda, these basic challenges inherent in the nature of their poor and their transactions must also be set in the broader context of the set of other opportunities in retail banking. Especially where there is a significant emerging middle (salaried) class, consumer finance, automobile and housing finance, bill payments, and currency operations can all generate more profits, more quickly, without the deep institutional transformation that is necessary to successfully serve the poor. The opportunity cost for entering into the low-income markets can be quite steep, unless they are an extension of services that are already provided to salaried workers in those same communities. This seems to be particularly true for those middle and lower middle-income countries where salaried wage earners compose a significant portion of the population.

Present micro-lending techniques require the hiring of a very large number of specialized loan officers that can quickly become an important portion of the total number of staff in a retail bank. Given the power of banking labor unions in many environments, senior managers are reluctant to get into this labor intensive line of products. Bank staff is also relatively well paid. There is often a problem when absorbing less well-paid micro-lending loan officers into the bank in terms of internal equity. Often microcredit loan officers are paid with a much higher proportion of variable incentive-based pay than bank officers, further complicating the absorption of the microcredit model into commercial financial institutions.

⁹ Sebsted & Cohen. 2000.

¹⁰ Stiglitz, J. and Weiss, A. Asymmetric Information in “Credit Markets and Its Implications for Macro-economics” Oxford Economic Paper, New Series, Vol 44, No 4. Special Issue on Financial Markets, Institutions and Policy (October, 1992), 694-724.

As financial markets develop, and especially if local capital markets grow, microfinance organizations can access funds more easily. Often, it seems they can obtain funds more easily from national and international capital markets than if they were to try and capture savings in the communities where they make their loans. The up-front infrastructure cost of setting up the deposit mobilizing branch or agent network is substantial.

Micro-insurance has had mixed results. Credit-life insurance is broadly accepted and has been sold on the back of microcredit arrangements; it is viewed by many MFIs as a major revenue generator. Yet the idea of insurance has not caught on much with clients. Perhaps, too few clients have experienced the benefits of holding an insurance policy and therefore do not perceive this financial serve as one that provides concrete value, especially if they are being asked to pay monthly premiums. Perhaps, the current suite of products so not really meet important client needs, and rather, are simply an extension of products that were developed for other, quite different market segments. Early experience with micro-insurance products suggests that we have a long way to go before the poor consider them to be a standard component of their portfolio.

2 Re-focus on the Clients – Is There Real Need and Opportunity?

By 1985, the principle loan products and delivery methods of microcredit were set. Individual loans, solidarity group lending and village banking were all being replicated in numerous relatively small organizations around the globe. Some years later, village savings and loans groups were developed independently in Asia and then in Africa. The four approaches are all highly standardized in their operational mechanisms and target fairly well defined client segments. Organizations that use ‘village banking’ or ‘savings and loans groups’ approaches generally target the poorest clients, while those using ‘individual loans’ approaches target the less poor. Since the late 1980s, the organizations that have focused on the original three lending methods have concentrated on building stronger institutions that have the greatest potential to grow to scale and include hundreds of thousands and even, millions of microcredit clients. After twenty years of robust growth, a series of questions that have been raised about the effectiveness of micro-credit to lift the poor out of poverty (which many in the general public thought it was promising to do). And a series of events such as the IPOs, competitive behavior, and even, occasional predatory practices, that have revealed the commercial nature of specific organizations. As a result, we are now seeing a desire to re-focus on clients.

For many, this means introducing elements into the conversation about the qualitative nature of the financial services being offered. They are raising questions as to whether the loans are good for clients, whether they are being given in an ethical manner, and whether interest rates, solidarity methods, and collections procedures follow the principles of ‘responsible finance’. These issues are NOT

the subject of this chapter; though the author views these as necessary conversations in a fast developing field and as a particularly useful way for the organizations that are supported by the development community to differentiate themselves from consumer finance more generally in the minds of the general public.

Instead, this paper postulates that it is time to re-focus our efforts on providing a more complete suite of formal financial services that are easier to use, safer, and more affordable for poor clients. Can we address the core, eternal challenges we have always faced and only partly solved, for serving the poor? Can we figure out new delivery channels, products, and business models that produce step-changes in the supply of financial alternatives to informal finance? Are there client segments that we could reach, but do not? Are there life-cycle events in families that we could design products for that would keep families from dropping into poverty.

These are the questions that should concern anyone who believes that financial inclusion is an important part of the development of national banking systems. These are the questions that will drive the quest for the innovation that will be required to reach the hundreds of millions of unbanked in lower income countries. These are the questions that drive the remainder of this chapter.

Market Segments: There are a significant number of segments of families that live on less than a dollar a day (per capita) that are not well served by micro-credit, and even less well by other, non-credit financial services. In a survey of the market for formal financial services done by Oliver Wyman for the Bill and Melinda Gates Foundation in 2008 and 2009, the significant majority of these poor earned their wages primarily in farming and in casual (day) labor or as low-income salaried workers (domestics, and labor in small and microenterprises). Most micro-credit programs do not explicitly target, these groups, though some individuals are certainly incorporated into solidarity groups in many countries.¹¹ Microcredit remains biased toward those members of the informal sector that carry out ‘urban-based’ independent economic activities (even if these occur in small towns in rural areas), and NOT toward the educational, health, shelter, and consumption needs of farmers, low level salaried workers, and casual labor who actually dominate the informal workforce of most low income countries.

Too Poor for Credit: In many countries, even poorer informal sector workers are not attended to by mainstream microfinance. The incomes earned by the bottom quintile of the income distribution are too variable to support credit relationships and are potentially better served with some sort of approach like BRAC’s “ultra-poor” graduation program that combines in-kind income support with a savings product that, over time, builds the capacity to repay tiny loans through newly developed income earning activities.

In recent years, many middle income countries are putting conditional cash transfer programs in place to support the poorest families, and increasingly, think-

¹¹ (Oliver Wyman 2008, 2009)

ing about how to channel these cash flows into bank accounts. This connects these families with the national financial system and to transactions networks that allow them to benefit from other government and financial services. These programs may have a more direct poverty alleviation effect than microfinance, especially for those families that do not operate a microenterprises.

Regional Disparities: Some areas, like Latin America, and South Asia have achieved significant market penetration in the traditional ‘targeted’ client base. Other regions have lagged, though there are exceptions in certain countries where microfinance has had a long and strong tradition such as Morocco, Bosnia, Uganda, Ghana, and Indonesia. Microfinance has yet to ‘take off’ in Sub-Saharan Africa like it has in either of the pioneering regions. Programs across South Asia have had a ‘rural’ bias, concentrating their loans in small towns and villages while in Latin America, micro-credit has largely been an urban and peri-urban phenomenon.

Classes of Clients: That said, even in the countries with the strongest market penetration, there are significant relatively poor populations that are not well attended. For example the Bangladeshi equivalent of the Latin American microenterprise (a small scale furniture maker) was never the objective of the myriad solidarity group programs of Grameen, BRAC, ASA, Proshika, or others. And, with notable exceptions such as Mexican clients of Compartamos and the Bolivian clients of Crecer and Promujer, the very poor, female inhabitant of rural areas of Latin America, are relatively less-extensively served.

SMEs: Recently, a great concern has arisen about a gap in the financing of small enterprises that are important engines of employment generation and of economic progress the world over. The IFC recently estimated that the about half of SMEs do not have a loan or overdraft line-of-credit that it needs for business purposes.¹² They catalogued the barriers to SME finance as a higher degree of default risk due to asymmetry of information, lack of credit bureaus, poor loan origination capability (analytical techniques), poor legal frameworks for enforcing loan contracts, lack of policy support, and high transactions cost, among other causes. These barriers are particularly more significant for small, as compared with medium-sized businesses. Small businesses are generally family run; they still mix personal with businesses finances. They are less formal, especially with respect to how completely financial transactions are accounted for in bookkeeping and financial statements, which for the basis of bank credit. They are less consolidated and more exposed to business risk related to the principal owner/operators. The IFC has identified over 150 models for making loans to SMEs and it is currently in the process of figuring out how to coordinate the efforts of development finance institutions in this area through the G20’s Global Partnership for Financial Inclusion (GPI).

¹² IFC. “Scaling Up SME Access for Financial Services in the Developing World.” 2010

Small Farmers: The single largest group in the Oliver Wyman study of underserved clients living on less than 2 dollars a day was composed of 600 million farmers. Greater access to financial services and appropriately designed products can have a pronounced effect not only on poor rural households, but also on overall growth in poorer countries. A 1% growth in GDP associated with agriculture, for example, increase the expenditures of the poorest 30% of the population approximately 2.5 times more than growth initiated in any other sector. Similarly, estimates suggest that growth in agriculture is approximately 3.2 times more effective at reducing the poverty of people living on less than USD 1 per day than non-agricultural growth.¹³ From a gender perspective, research suggests that if women in developing countries had the same access to productive agricultural resources as men, then farm yields would increase an estimated 20–30%, and would in turn boost national agricultural output by 2.5–4.0%.¹⁴ Yet rural households report very little access to formal financial services of any sort.¹⁵

Casual Laborers and Low-Wage Salaried Workers: The second largest group in the Oliver Wyman study of underserved clients were not microenterprises, but rather, day laborers and low-wage employees. There are almost as many individuals living on less than 2 dollars a day in these two categories as small farmers. And, they are not the subject of most microlending operations; their income is either very irregular, or, they have salaries. Most of these workers are the employees of micro and small businesses, domestics working in homes, and day laborers on farms or construction sites. Except for remittances, they do not have access to formal financial services. The chief barrier to their access is the irregularity of their incomes, either because it varies day to day or season to season (casual laborers) or because of job instability (employees).

Life-Cycle Events: While there are a number of client segments that are not currently well served with a full set of formal financial services, even those who do have some access usually have access to only one, very rigid and highly standardized product that primarily serves as an additional source of general finance into the household. In order to build sustainable, scalable financial institutions to serve the poor, organizations concentrated on attaining volume as quickly as possible. This meant a one-size-fits-all approach to products. Yet, all of us, the poor included, require different financial products and services at different points in our life to accomplish our multiple family goals.

Young families need financing to get married, set up a household or business, and to take on the medical costs associated with bringing young children into the world. Later on, they need to save for children's education, marriage, and provide

¹³ Ibid.

¹⁴ UN Women (2011).

¹⁵ Christen, R. and Anderson, J. "Financing Agriculturally Dependent Households." CGAP Forthcoming

for their own later years when they will not be as productive. Toward the end of their lives, they often need to rely on funds they receive from their children, rents from properties they own, payments from government, and their own savings. At life's end, funeral expenses can be substantial.

Along the way, low-income families have a variety of specific financial needs that may not be well served with current microfinance products that were designed to finance working capital for productive and trading activities. While both loan and savings products are useful for general short term purposes they may not be particularly well suited to the cash flows associated with some of the longer term activities poor households manage. Neither are they flexible enough to match the precise cash flows associated with household financial goals. Borrowers find themselves borrowing from other sources to repay microcredit because their repayment schedules do not match household cash flows.

Investments in Productive Assets: Often families must purchase major assets such as a water buffalo, an over-lock machine, or a freezer whose repayment schedule would most beneficially be drawn out for a far longer period than is common in microcredit. While these assets contribute to the family's income, they do at a slow rate. When MFIs force repayment in 4–6 months, as is often the case, servicing this loan would use up the entire household's repayment capacity, driving out any other financing for other needs like education, working capital, or to meet an emergency.

Emergencies and/or Catastrophic Events: All families have sudden emergencies. Someone loses a job, gets sick, or there is a death in the family. There are also any number of smaller, less dramatic events that strain a family's budget and require immediate attention. Many "savings and loans" groups and village banks do have an emergency loan feature, but with some exceptions, most MFIs do not make funds available immediately upon request to attend to such emergencies. Very few MFIs can take deposits; these could be available for emergencies, and at a far lower cost to the client than borrowing.

And, on occasion, families suffer from catastrophic weather, civil, or events that can wipe out the entire family asset base. At present, the principal micro-insurance that is widely available is 'credit-life' which covers the outstanding balance of the loan, and in many cases enough to cover part of the cost of the borrower's funeral. Index-based insurance that would protect assets in the case of weather related loss has not yet gained a strong track record, in part due to the poor condition of weather stations and their historic data.

Home Improvements: Most poor families must accumulate building materials little by little to add to or to improve their homes. This sort of saving is best accomplished when families 'have a little extra' they can set aside. The purchase of building supplies is a way to turn cash into a less liquid asset that keeps its value. These materials are exposed to theft, loss, and degrading due to weather conditions – increasing the cost of building wealth.

Education, Weddings, and Other Major Expenditures: All families have particular moments when major expenditures completely overwhelm month to month budgets; so they require funds from outside the normal flows. Classic cases are saving for annual holiday/festival celebrations, coming of age festivities, funerals, school fees, planned surgery, means of transportation, or marriage. Normally, the timing of these major expenditures does not align with the highly structured microfinance products that may be available in the community. And, most microfinance continues to be in the form of loans, when most of these goals could be met with programmed commitment savings accounts at a far lower cost to the poor, if these were available.

There are a large number of client segments and major life cycle events that happen in families that drive a potential demand for well-designed and delivered financial services that is not currently being met. An effort to re-focus on clients should be built around a suite of products that are safe, affordable, and easy to use that addresses a significantly broader range of goals, cash flows, and behavioral considerations. Perhaps the most interesting area for further exploration is related to the design elements that help poor families balance:

- their preference for illiquidity (to encourage accumulation of savings);
- for immediate availability (to address emergency situations),

with

- the need for disciplining mechanisms (to both save and repay loans – as a means for accumulating large assets),
- the need to make deposit services available at the moment and place where extra cash occurs (to both keep costs down and to help resist the temptation to spend elsewhere).

If we can overcome these design challenges, we can help low-income families better achieve their most important goals, and bring them more fully into the formal economy. Further understanding clients, their goals, and their financial requirements is the key to building and deploying higher impact products and services that make sense for their providers, and to full financial inclusion.

3 Client Centered Innovations That Build on Core Products and Delivery Channels

Rather than talking in abstract terms about designing products and services that are more tailored to client's financial lives, we should try and see just how these might be different than is what is available today. After all, it's clear that the poor use current products for a full range of goals and situations; so what's so special that results from re-focusing on clients?

The following section relates a number of innovative products or services that represent Version 3.0 of microfinance, as we are defining it here in this chapter. They use the lessons we have learned about what works for the poor and adds in special features that tailor the relationship around behavioral characteristics that help in the achievement of family goals and that take into account family cash flows. These products have been chosen for their illustrative capability, not because they have been wildly successful. Time will tell whether these particular innovations will last and be useful. Together, they suggest the nature of future developments that are more client-centric.

Specialized Micro-credit: Agricultural microfinance is an example of a particularly important adaptation of micro-credit principles to a new target group that requires products that respond to a quite different cash flow. Traditional micro-lenders in Latin America have adapted their techniques in order to make loans in direct support of agricultural production activities. AgroAmigo, PRODEM, Caja Los Andes, and PROCREDIT El Salvador have all hired loan officers with agronomic training who make loans to farmers with terms and conditions that have been adapted to the crop cycle. For example, loans are made with balloon payments due at harvest time and disbursements that are staggered to accommodate major moments in the investment cycle around soil preparation and planting.

A number of urban MFIs have used a value chain approach to lend to specific groups of microentrepreneurs. But one of the most interesting examples of a client driven approach to product design was CEMEX's "Patrimonio Hoy initiative" in Mexico. CEMEX is a Mexican company that sells cement and other building materials throughout urban areas. As Prahalad describes in his book, *The Fortune at the Bottom of the Pyramid*, Patrimonio Hoy staff spent many months with slum dwellers to understand their lives, their construction patterns, and their interactions with the distributor of building materials. As a result they developed a solidarity group based lending model that allowed clients to accumulate savings toward building materials, and ultimately, borrow a little to finish their small projects. The savings and credit groups were managed by neighborhood staff, and the local distributors were worked into the model in a way that increased their sales.

Savings Mobilization: Perhaps the most fruitful area for further design and delivery innovation is deposit mobilization. There would seem to be ample opportunity to design products around specific family goals such as meeting annual school fees or planting expenditures and around specific cash flow such as harvest payments or the daily profits from a microenterprise.

The usefulness of this approach was tested in a field experiment with the Opportunity International Bank of Malawi. In this (randomized control trial) exercise, smallholder cash crop farmers were offered either an ordinary savings account or a commitment savings account where they voluntarily 'froze' their accounts until a specified date immediately prior to planting season so the funds would be available for farm inputs. Those relatively few farmers that did take up the commitment products saw an increase in land under cultivation (9.8%), use of agricultural in-

puts (26%), crop output in the subsequent harvest (22%), and household expenditures in the months immediately after harvest (17.4%). Commitment accounts also allowed farmers to ‘credibly claim’ that their funds were tied up when faced with demand from their social networks.¹⁶

Micro-insurance: Micro-insurance is in its infancy when compared with micro-credit and deposit mobilization. We simply don’t know which products beyond credit-life work very well for the poor. And, in fact, credit life mostly is a good deal for the MFIs that offer it. The key challenge with micro-insurance is to ensure that it offers good value for the poor.

One example of a creative approach to insurance is the “Caregiver” insurance product offered by the Micro Fund for Women in Jordan. Initially, the organization had focused on developing a traditional health insurance product that would ensure its clients could obtain access to the health care they needed – by charging a premium that would then cover charges at the doctors’ office or the hospital. After studying their clients’ needs, as related to health events, they came to understand that the women had access to health services, but were not taking advantage of them due to the ancillary costs of hospitalization. So they developed the Caregiver policy that covers per diem for each night in the hospital, costs of hospitalization, lost income when not working, travel costs, and other costs associated with not working while sick. By covering the gaps in the costs associated with a health event, the product was well received by clients. After a year, the product reported achieving full sustainability, even after paying out 300 claims on a client base of 13,500 women. And, women are getting treated more frequently than before.

But there is more to understanding clients than just figuring out a new market niche to fill. The work of the MicroInsurance Centre’s MicroInsurance Learning and Knowledge Project (MILK) is drilling down far more deeply than any other effort in an attempt to look at individual insurance products from the perspective of the business case for the insurer, and at whether these products represent good value for clients. The later, “Doing the Math” efforts compare premium payouts to the alternative ways that the low-income families would normally pay for the cost of risks covered by the insurance to see whether their investment in premiums are a good bet. While they are not RCTs or impact studies, they do represent a critical step in how we need to be engaging with clients in coming years of micro-financial product design!

4 Improvements in delivery channels that may benefit clients

From the perspective of potential clients, the transformation that is occurring in the access to national payments system may be the most important development in the financial services industry in many decades. We have yet to see, but the possi-

¹⁶ Burne, Gine Goldberg, Yang, “Commitments to Save: A field experiment in Rural Malawi”, May 2011.

bility may exist to drive transactions costs down to historically low levels which could permit the inclusion of exponentially greater numbers of lower income members of the general public. While initially, these transactional systems were built on networks of retail to clear banking halls of bill payments, they are increasingly channeling conditional cash transfers and other government payments, tax payments, and to send money (remittances) between private citizens. It is these two later functions that have the potential to include hundreds of millions of poor who live on less than 2 dollars a day – and maybe, providing one of the key ingredients in any national financial inclusion plan.

Payments Systems: Over the past decade, a number of countries have invested in the development of their national payments systems. Some countries have moved to create transactional platforms that associate non-banking (retail) infrastructure with the financial system in order to create access to the financial system in neighborhoods and villages where there are no bank branches. National governments are seeing the advantages of these ‘agent’ banking systems to channel government conditional cash transfers, salary and other payments, and even, private remittances. This reduces costs to governments for making these payments and increases their degree of control over money flows as cash emerges from the informal and travels into the formal financial system.

Brazil is a world leader in agent-banking. Within a few short years after their creation in the late 1990s the four large banks that manage most of the agents had covered virtually every single one of 5,564 municipalities in the country. Today they have around 150,000 agents that handle well over one billion dollars a year in small transactions. According to CGAP, bill payments compose almost 90 percent of transactions in urban areas, while deposits and withdrawals and loan repayments and others composed 60 percent of rural transactions. Profits are stronger in rural areas due to the present fee structure, even though there are fewer and smaller transactions every day. Consumer lending has increased 500%, in significant measure due to the existence of agent-banking. At least 12 million ‘simplified’ saving accounts were opened.

The Brazilian agent-banking system has faced difficulties, which are certainly a harbinger of challenges most other newer systems will face in coming years. Agents complain of security risk, 41% have been robbed with an average loss of \$8,100 for which they are responsible for the first \$540. Almost 30% report having money stolen by their own workers. And 16% have had clients engage in fraud, mostly with counterfeit bills. Cash management time is substantial and most agents go to the bank twice a day to clear their accounts. Poor connectivity reduces the profit margins in many areas from 10% (\$124) a month to 2.6% (\$27) a month. Most agents do not make enough money from fees to consider it a driver for the model, they do not really even know how much they are making.¹⁷ For most agents, their profits amount to an insignificant 5 dollars a day. Banking agents have seen a strong uptick in their other business due to higher foot-traffic through their shops, which seems to

¹⁷ CGAP, “Branchless Banking in Brazil; Building viable networks”, February 2010.

be their primary motive for continuing to participate. And yet, agent-banking plays a vital role for increasing financial inclusion in rural areas.

Mobile Money: One extremely exciting variant of agent-banking is mobile money. Mobile money allows people to send money over their cell phones through a vast network of agents, mostly airtime resellers. These resellers are spread across the country and especially in poorer neighborhoods and rural villages that are often net recipients of remittances from family working in the cities. The hope is that transaction costs for basic financial services can be driven down very low, perhaps as low as us\$0.15. Airtime resellers and other agents are mostly very local businesses who pay their employees a small fraction of what a teller would make at a bank.

The most significant experience to date with mobile money is M-Pesa in Kenya where since 2007, 15 million Kenyans have used the system to send money to someone else. In a month, more transactions flow through M-Pesa than globally, through all of Western Union. The mobile money service is a significant profit center for its Telcom parent (Safaricom), and it continues to grow. Families that use M-Pesa have dramatically reduced their transaction costs from 3 dollars a payment to less than 50 cents.¹⁸ A study has shown that clients who use M-Pesa can keep a better pattern of consumption, and in particular, a better food consumption patten when facing negative income shocks, like losing a job, cattle death, crop or business failure or health shocks.¹⁹ This is because M-Pesa's efficiency as a money transfer system turbo-charges social networks that respond at a time of crisis.

At present, M-Pesa is being used:

1. to transfer money into savings accounts and make loan payments (M-kesho product with Equity Bank and other such relationships),
2. to sell index-based micro-insurance to farmers (Kilimo Salama with Syngenta Foundation),
3. to channel the transactions of tiny SACCOs who don't have their own back office operations,
4. to offer a pre-paid VISA Card,
5. to offer a pre-paid smart card (Changamaka) that allow members to receive medical treatment at designated hospitals for at a low per-visit cost,
6. to help farmers acquire irrigation pumps (Kickstart), and to channel conditional cash transfers to the very poor to help buy food (Concern Worldwide),
7. and, to provide safe drinking water through a fee-for-service model (Grundfos LIFELINK).

¹⁸ Michael Ferguson, "Notes From the Field: The Emerging effects of M-Pesa's rural outreach at the household level," February 2010, Microfinance Opportunities.

¹⁹ Jack, William G. and Suri, Tavneet, Mobile Money: The Economics of M-Pesa (January 2011). NBER Working Paper No. w16721. Available at SSRN: <http://ssrn.com/abstract=1749882>

Without doubt, the development of this mobile money network is spurring tremendous innovation in financial and other services to the poor that are based on a steady stream of very small transactions.

Early on, journalists commented on the fact that the extension of banking agents into a couple of previously unserved areas of the Amazon River of Brazil had led to higher levels of enterprise growth and consequently, municipal tax revenue. Instead of having to go down-river several hours to transact, local families were able to receive their remittances, salary checks and other payments locally, and spend them locally too. This impact on local communities and ultimately, national economies is just beginning to be explored. A recent study of M-Pesa concluded that it had four local effects:²⁰

- **Local economic expansion:** In essence, the team found that, M-Pesa facilitated increased money circulation which had an effect of increasing local consumption. This meant more business for local store owners and others. In addition new business and employment opportunities arose out of the establishment of M-Pesa agents; existing store owners could also diversify their offering by including this service that is now in much demand
- **Security:** Other than physical security (i.e. muggers realizing that few people carry liquid cash) the study found that M-Pesa contributed to money security, that is by enabling people to safely store funds in their mobile money account
- **Capital accumulation:** Being able to save money instead of spend it enabled wage earners to accumulate financial resources on their phone safely even without having to have a bank account or resort to a less secure mechanism such as keeping cash under the mattress
- **Business environment:** “M-PESA reduces the overall transaction cost of moving capital along a network and increases the flow of capital. While the amount of money M-PESA moves is relatively small among formal financial systems in Kenya, the number of transactions and volume of flow is increasing and covers larger segments of Kenya’s population in terms of income, age and depth and breadth of access (Jack and Suri, 2009)”

Furthermore, in perhaps one of the few more negative externalities of M-Pesa, a recent AfDB brief outlines why it thinks that M-Pesa may be contributing to Kenyan inflation as the velocity of its transactions are three or four times higher than other components of money.²¹

²⁰ “Megan G. Plyler, Sherri Haas and Geetvea Nagara “Community-Level Economic Effects of M-PESA in Kenya: Initial Findings“,” IRIS Center, University of Maryland.

²¹ AfDB Brief, “Inflation Dynamics in Select East African Countries: Ethiopia, Kenya, Tanzania, Uganda;” 2011.

From the perspective of the clients, the challenge of all agent-banking systems is whether they can drive transaction costs down sufficiently to enable traditional financial products to become more attractive, or to support the development of new types of services. As yet, the experiences are new and the fee structures are not yet settled. For example, today, M-Pesa fee structures favor small savers. Deposits into the system are free and only withdrawals are charged. That would favor small savers who would drop off money each day but only withdraw occasionally – a pattern development finance groups would like to encourage. But already, M-Pesa agents are agitating for fees on all transactions – which could rapidly reverse this ‘favorable’ bias toward individuals who save small amounts frequently. Until fees structures settle, there is no way to know whether the poor will incur lower costs as a percent of the total transaction. It will be interesting to see whether mobile money can spread more rapidly than at present. Right now, in a number of countries, it’s being held back by banks.

Another challenge will be to push (non-mobile money based) agent-banking models out into poorer neighborhoods and villages in poorer countries. Thus far, agent-banking models have grown quickest in middle income countries where there is a substantial “bill-paying” middle class whose transactional volume is sufficient to float the system. In poorer countries, efforts are being made to float new systems on the back of remittances and conditional cash transfers. It’s clear that these volumes are not sufficient to float the more complete banking agents of the “Brazilian” type.

But most importantly, from a client perspective, the development of agent-banking transactional platforms does not guarantee the development of client centric, higher value, financial products that respond better to family goals, cash flows, and vulnerabilities. Just because a poor person in a village receives a remittance from a family member in the city or a conditional cash transfer from the government, they should not be considered to be ‘included’. The most basic level of financial inclusion should be based on whether an individual has an account into which he or she can deposit funds for an indeterminate purpose and indeterminate time. And then, we should concern ourselves with whether these accounts are useful on the basis of the number of transactions in them. Only then, can we understand whether the spread of agent-banking represents the most significant pro-poor disruptive ‘technology’ in the modern history of retail banking.

5 The Importance of Strong Institutions

Strong institutions are key to reaching clients with a fuller range of more sophisticated financial services that are safe, affordable and easy to use. Only institutions that have achieved sustained profitability, a strong equity base, secure access to capital from financial markets, and extensive outreach can invest the necessary financial and human capital in next generation products. The economics of these next generation financial services will require them to be offered at very large

scale at a very low price point that can only come from that scale. The more individualized credit products, low-balance deposit accounts, and a wider variety of micro-insurance will all require significantly lower transaction costs. Many of these products will grow out of new business models that pair microfinance institutions with operators of national payments systems, insurance and re-insurance companies, national retail chains, and potentially, mobile phone operators.

Fortunately, the microfinance sector has become highly concentrated in most countries where the top five MFIs reach more than 80% of all clients.²² The top 200 MFIs all have several millions or tens of millions of dollars in equity and can undertake the large investments in back office MIS, branch and agent networks, market studies, and additional staff that will be required. They operate on a national level, serve hundreds of thousands, or millions of clients, and have often already entered into major corporate partnerships to generate new opportunities for clients.

That said, there are still many countries where no MFIs have achieved the necessary scale to enter into the arrangements that underlie Version 3.0 business models that will better serve clients needs. Support organizations, microfinance investment vehicles, and donors will still need to provide technical assistance, access to international capital markets, and support to create the necessary supporting infrastructure in those countries. Governments will need to put in place appropriate regulation and supervision schemes, non-bank financial institution frameworks, payments/transactions networks, and coordinate among a variety of agencies to seamlessly promote the partnerships that will form the new business models for full financial inclusion.

Two very important steps in the right direction have been the creation of the Alliance for Financial Inclusion that brings together the top regulators and financial authorities from almost 80 countries and the Global Partnership for Financial Inclusion of the G20. Both initiatives have built a growing consensus around the importance of incorporating the bulk of the population into the formal financial system as a means to encourage economic growth, food security, and to combat financial crimes. These organizations have been amply supported by global technical organizations like CGAP, UNCDF and the UN Special Advocate for Financial Inclusion, the IFC, and others who have contributed their expertise.

6 Conclusions

The recent push to put the focus back on clients is welcome and relevant. The community that has believed in the usefulness of microcredit, and more broadly, microfinance, has built a significant number of well performing financial institutions that serve the poor. It took the better part of twenty years to demonstrate that microfinance could become a legitimate part of the banking system, that institutions that serve the poor can be profitable, can become publicly owned companies,

²² MIX Market, 2012.

and can reach scale that is relevant on a national level. These are tremendous achievements, not replicated in many other fields of development.

Nevertheless, the provision of financial services to the poor is characterized by an extremely limited variety of loan products, some, but not sufficient deposit services, and very little insurance beyond credit-life. There is great enthusiasm for the role of payments systems in reaching the poor, but it's not yet clear that these systems will be viable in low-income neighborhoods and rural villages. It's time to move to the next stage in a general strategy to provide financial services to the poor; figuring out what services are most useful to the poor that we can provide profitably. To accomplish this, we need to keep the following in mind:

The present conversation around responsible finance is useful, even necessary. It can also become a distraction from the overall goal of full financial inclusion if it becomes our principal client-facing objective. Responsible finance does not push the field forward, does not lay out a series of ideas for how more and a more diverse set of clients can be served with a full range of useful products. It focuses too much on 'do no harm' and not enough on 'do good'.

The only reason we can re-focus on clients is that we have sustainable, scalable, and strong financial institutions that have a double bottom line objective; they care about reaching down market. We must strengthen our resolve to support the growth of the field. There are a significant number of market segments that are not well served and the appropriate institutional structures still need to be put in place.

It is more critical than ever for governments to build the necessary infrastructure that can provide the single most important drop in transaction cost of the past 40 years. In some cases they will need to make its infrastructure available, will need to push its transactional volume through payments systems to ensure their viability, and may need to use some financial institutions to directly offer financial services. In all cases, governments will need to set financial inclusion goals and engage in appropriate financial regulation and supervision.

This paper has identified the opportunities that remain to better serve clients. There are clients who engage in agriculture, small business, day and casual labor, fisheries and forestry that are not well served with present suite of microloan products. There are relatively few men in the lowest income brackets who are served. There are countries and regions of the world where microfinance has only started and the institutional structures remain weak.

There are a wide variety of financial needs that could be better addressed with more attention to the financial goals, cash flows and vulnerabilities of the poor. It's clear that the greatest challenge of all is to develop savings accounts that are capable of receiving small amounts on a daily basis, and secure them against the daily pressures to spend. While we have gained a number of insights into the financial behavior of the poor but have not yet turned them into products that work better for millions of families.

The lasting legacy of micro-credit may well be that the poor are a worthy economic segment, are engaged in their own progress, and if given basic tools like finance, can pull themselves up into a better situation. Let's hope that the current

debate about clients doesn't truncate the drive to serve them with a full range of useful products offered by strong, market driven institutions that have a profit motive front and center in their mission statement. Version 3.0 of microfinance should return clients to the center of our attention; insisting that it is time to design a next generation of a more complete range of financial services that are based on a more thorough understanding of clients' financial goals and capabilities, that work for the organizations that provide them.