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PoP Briefing Note # 5

Creating Better Portfolios: Core Financial Products for the Poor

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Portfolios of the Poor: How the World's Poor Live on $2 a Day examines the basic question of how the world's poorest households survive on such modest incomes. The authors report on yearlong "financial diaries" of villagers and slum dwellers in Bangladesh, India, and South Africa-surveys that track penny by penny how households manage their money (see Research Methodologies Briefing Note). The stories of these families are often surprising and sometimes inspiring. Most poor households do not live hand to mouth, spending what they earn in a desperate bid to keep afloat. Instead, they rely upon an array of complex tools, and lead active financial lives because they are poor, not in spite of it. They create "portfolios" that leverage both informal networks and formal institutions to address their immediate and long-term needs.

Financial Traits of Poor Households

Cash flow

When it comes to managing their financial lives, poor households face a "triple-whammy": incomes are small on average, they are irregular and unpredictable, and few financial tools are available to make the most of what is earned (see The Poverty Trap 'Triple-Whammy' Briefing Note). As a result, rigid loan terms can deter the very poor from borrowing. More "cash flow-friendly" loans might involve shorter terms, smaller installments, or flexible repayment schedules that can help households match loan repayments with cash flows.

Borrowing to meet everyday needs: Subir and Mumtaz, Bangladesh

Subir, Mumtaz, and their five sons lived in a Dhaka slum. Between Subir's income as a rickshaw driver, rent from a temporary boarder, Mumtaz's income as a maid, and their sons' wages, their daily household income ranged from $1.90–$3.15, placing the family in the poorer half of the Bangladesh sample. Although Subir could have earned more if he had owned a rickshaw, he did not seek a microfinance loan to fund his business because the couple was focused on their more urgent short-term needs. Their highest priority was to make sure that they could feed their family every day. The couple placed a premium on the flexibility and convenience of their financial tools, even though these tools were not always reliable.

Flexible and convenient savings products are also useful. Open-access or "passbook" savings accounts allow clients to deposit and withdraw savings at any time and in any value. In some cases they don't even have to visit a branch office to do so-some programs deploy staff members at regular intervals to collect deposits. Clients who use passbook savings accounts typically save a little each week, and withdraw two or three times a quarter. New technologies like mobile banks have particular promise in making these kinds of frequent transactions viable for banks.

Loans to smooth consumption: Ramna, Bangladesh

As part of the Grameen II program, Ramna took out an $83 loan and topped it up several times. While these loans were not used for business enterprise, Ramna was certain of their value. Without access to usefully large lump sums from Grameen loans, maintenance tasks such as stocking up on food, keeping her sons in school, or buying her ailing husband medicine would have been much harder-and more expensive.

Diversity of Loan Needs

The diaries revealed that households seek loans for a range of needs, not only for business ventures. In fact, the poor largely repaid loans by drawing on ordinary

household cash flows, not business revenues.
Households in one diary sample, comprised of Grameen Bank customers, diverted half of their "production" loans to putting food on the table, paying down debt, and meeting other pressing consumption needs.

Tradeoffs
Oftentimes, poor households face a tradeoff between the flexibility of informal financial devices and the reliability of formal institutions. For the poor, being able to have it all-access to financial tools that are reliable, convenient, and reasonably priced-would make a big difference (see Understanding Microfinance Pricing Briefing Note). Formal lenders can address the tradeoffs that poor households currently face by offering product features such as: 1) penalty-free grace periods when cash flow problems arise, 2) "top up" loans which can be refreshed to the amount originally disbursed part way through the repayment schedule to increase liquidity, and 3) loans with a range of terms, including short-term, emergency loans.

The price of flexibility: Mohammed Laiq, India
Over the course of the research year, Mohammed Laiq borrowed five interest-bearing loans, including a relatively large one for $32 from a moneylender, to pay for house repairs. The original terms of repayment were $.75/day for 50 days, which included an interest fee of $.11/day. This fee equates to an annual interest rate of 125%. Instead of adhering to the 50 day term, however, Mohammed took 330 days to repay the loan. He explained that moneylenders don't worry about gaps in payment and often expect it, and this flexibility helped Mohammed match repayment to his cash flows. Moreover, he paid interest on only 50 days, not 330, and as a result paid an annualized interest rate of only about 19%. Mohammed's experience highlights the not uncommon practice of actual interest rate payments totalling less than "advertised" rates, once the actual days of payment are taken into consideration. This story also highlights the way that flexibility is built into informal financial systems.

Core Features of Financial Products for the Poor
Finding the Discipline to Accumulate Useful Lump Sums
Buying assets, paying for celebrations, and dealing with emergencies all require larger sums of money than poor households typically have at their disposal. To accumulate them, the poor create disciplining devices that use restrictions and social pressure to protect savings in the face of temptation. For example, savings clubs shift money into a "hands-off" account and guard against the temptation to spend spare money in trivial ways. Structurally, the clubs are often very flexible: they can accommodate almost any number of members, payment intervals, and pay-in amounts. Poor households use the clubs because the deposit requirements are small enough that they don't strain household income, but they are large enough to add up over time to a usefully large amount. Yet these clubs also have drawbacks-they can be unreliable and risky, and they can make considerable demands on members' time.

Another way poor households patch together larger sums is to take interest-bearing loans instead of using existing savings (see Borrowing to Save Briefing Note). One diarist justified her decision to take out a $15 loan (at 15% monthly interest) despite having $55 in a liquid savings account by explaining: "At this interest rate I know I'll pay back the loan money very quickly. If I withdrew my savings it would take me a long time to rebuild the balance." An alternative solution to this situation is to create commitment savings products that help poor households build (and rebuild) savings balances.

Learning from Grameen II
In 2001, after a decline in the quality of its loan portfolio, Grameen Bank adopted a new model. Grameen II was designed to be more flexible than the original model. The bank relaxed lending rules, established an open passbook savings program, added a commitment savings plan called the Grameen Pension Scheme, and created the "loan top-up" facility, under which a loan can be refreshed to its original amount (see Grameen II Briefing Note). The success of these new products shows that introducing innovative features can make a meaningful difference to providing more effective financial tools for the poor.