From standardization and cross-subsidization to service differentiation and external subsidies:

a microfinance strategy for reaching the poorest of the poor

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INTRODUCTION

Two of the major, inter-connected debates in the field of microfinance today concern: 1) the extent to which microfinance institutions (MFIs) should focus their efforts on reaching self-sustainability; and 2) the extent to which they should and can provide financial services to the *poorest* of the poor.[1] These debates are inter-connected because the poorest of the poor are hard for MFIs to reach on a sustainable basis. This is due to their small transaction amounts (even relative to those of the poor) and to the fact that their greater need for flexible microfinance services makes it more costly to serve them relative to the revenue they generate.

These debates take place in the context of an organizational field populated by MFIs whose business model requires them to use standardized processes and services to provide financial services to the poor. Standardization is necessary to keep the costs of multiple, small transactions to a minimum, because the small amounts involved generate very low revenues given that financial services are priced as a percentage of the amount involved. Thus standardization is considered a key to sustainability.[2]

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[1] These services include credit, savings, insurance, and payments or remittances. The poor are those living below the poverty line established by the government of the country in which they live, or those living on less than $2 per day (adjusted for purchasing power parity) (Microcredit Summit Campaign, 2005).The poorest are those living at less than 50% of the poverty line, or those living on less than $1 per day (PPP adjusted) (Microcredit Summit Campaign, 2005).

[2] For example, Grameen Bank for about 20 years offered one basic credit product, the weekly installment loan through a peer group with a term of one year. In 2004 it introduced Grameen Bank II, which gave borrowers the option of a "flexible loan," but still kept the "basic loan" as its main credit product. (Grameen Bank, 2003)

Standardization has two opposed effects on the poorest of the poor. On the one hand, standardization can result in their cross-subsidization because the poorest of the poor receive the same service at the same price, even though the cost of providing that service relative to the revenue it generates is higher due to the smaller size of their transactions. On the other hand, standardization can result in the exclusion of the poorest because they cannot conform to the requirements of the standard, or cannot use the financial service in its standard form (Woller 2002, 307-8).

This essay examines the choices facing an MFI wishing to serve the poorest of the poor, as well as the less poor (those who are better off than the poorest but still live below the poverty line), as a way to maximize its outreach. It argues that the best option for an MFI seeking to reach the poorest of the poor is to create a differentiated set of services to serve them, and to seek external, subsidized funding for that activity where necessary. This argument is contingent on the positive climate for the financing of efforts to reach the poorest of the poor today, as well as on the MFI being able to solve some internal problems concerning organizational capacity, the interests of internal stakeholders, and the migration of existing, very poor clients to the new services.

CROSS-SUBSIDIZATION IN FINANCIAL SERVICES PROVISION

Cross-subsidization in the provision of financial services is common. The provision of financial services is such that there is almost always some sort of cross-subsidization going on, for the simple reason that almost every client presents a slightly different cost calculus to the organization and the cost of differentiating among clients is high. The most common form of cross-subsidization is from clients transacting in large sums of money, on the one hand, to clients transacting in small sums of money, on the other hand, where the basic nature of the service is the same and the price charged is a percentage of the amount of the transaction. The cost of providing the service on each transaction is the same, but the revenue earned varies, with more income being earned from the larger sums. As a result, a financial institution will earn excess profits on the larger-than-average transactions and below-normal profits on the smaller-than-average transactions. Financial institutions do differentiate among their customers according to transaction size, for example by paying a higher interest rate on larger savings deposits, but the differentiation involves large categories of customers, within which there is enough variation to generate cross-subsidization.

Financial institutions face the same situation with borrower risk. In a perfect world each borrower would be charged a price (interest rate) on their loan based on their risk of delinquency and default. But such a differentiation among borrowers is prohibitively costly. As a result, financial institutions pool borrowers into broad risk categories that include borrowers whose likelihood of delinquency and default are significantly different from each other. Unlike in the case of loan size differentiation, it may be the case that the less risky borrowers are still better off in this "broad risk category" situation than they would be in a risk-differentiation situation. After all, the costs of risk differentiation may be sufficiently high that, when the lender passes them on to the borrower through fees and interest charges, the cost of the loan is higher than it would have been in the "broad risk category" situation.

Cross-subsidization is more likely in microfinance where the premium is on keeping transaction costs low through standardization. MFIs offer customers with a wide variety of transaction sizes and risk profiles the same service at the same price. Furthermore, because MFIs often operate as monopolies with little competition, they have not faced competitive pressures to differentiate their services to retain their best customers.

This cross-subsidization takes place within a large, but limited customer base – the poor. Through their pricing, geographical targeting, and service delivery methodologies, MFIs make their services unattractive to middle-income and wealthy individuals. As a result, any cross-subsidization within the organization's customer base flows between groups that are poor.

The implications of this for the poorest of the poor are ambiguous. Those that are able to gain access to the services of an MFI also gain access to the cross-subsidy. But standardization makes it difficult for the poorest to gain access to MFI services, because the standard service does not meet their needs. This exclusionary impact can be exacerbated through policies such as paying front-line employees on the basis of commission as a percentage of the transaction amount – the poorest have smaller transactions and employees can discourage them from using the MFI's services – or requiring membership in a peer group to gain access to a standardized loan service – the poorest may be less able to form such groups (Woller 2002, 307-8; Rutherford 2004; but also see Stuart 2006 for a contrary view of group formation among the poorest based on Indian caste data).

The result is a situation with the following characteristics: some of the poorest gain access to cross-subsidized services, while others are excluded; and, the less poor are the ones who end up subsidizing the poorest. Is this situation satisfactory? If the aim is to maximize the outreach of the MFI then it is far from satisfactory. The MFI is limiting its outreach to the poorest to those who are able to make use of the standard services. And the less poor are being charged a higher price for the standard services than they would otherwise be, because they are cross-subsidizing the poorest. So even if the aim of the MFI is to increase its outreach to the less poor, this strategy is only partially successful assuming a downward-sloping demand curve.

SERVICE DIFFERENTIATION AND EXTERNAL SUBSIDIES

One way to solve this problem is through service differentiation. The contention is that services that differentiate between the less poor and the poorest serve two purposes. First, such differentiation creates services that are suitable to the poorest, thus increasing the outreach of an MFI to them.[3] Second, it makes explicit the process of cross-subsidization in two ways: 1) the creation of the new service(s) will require expenditures of an MFI for the specific, explicit purpose of serving the poorest; 2) if the differentiation results in the migration of the poorest who are currently served by the standard services to the new services, then there will be a decrease (possibly to zero) in the number of people being subsidized through the standard services.

If the service differentiation strategy succeeds, then an MFI will be serving the less poor with one set of (standard) services and the poorest with another. As a result, an MFI may *choose* to lower the price of the standard service, thus increasing the attractiveness of the standard service to the less poor, increasing outreach in that market segment, and preparing the MFI for any future competition it may face in that market segment (McIntosh *et al.* 2005, 285). But this option can only work if an MFI can break even on the new services targeted at the poorest, and it is unclear that this is possible, especially if large-scale outreach is a goal.

Alternatively, an MFI can keep the pricing of standard services the same. This will result in an increase in profits from them, which an MFI can then *choose* to use to subsidize the poorest. This puts us back to where we were before, with the poor subsidizing the poorest, but at least now the subsidy is more explicit and the poorest have more access to financial services through the new services. The danger here is that the more explicit nature of the subsidy makes it more vulnerable to criticism from within the organization. Furthermore, if the new services result in a higher percentage of the poorest gaining access to services, then the total amount of the subsidy will grow, putting a financial strain on the MFI as a whole.

In this context, outside funding to subsidize the services to the poorest make sense. An MFI can market a set of differentiated services, targeted at the poorest, to providers of funds based on the fact that there is a specific target population that they believe is worth reaching. Furthermore, the very weakness of the differentiated service approach to serving the poorest in terms of gaining internal support – the explicit nature of the subsidy going to the poorest, is a strength in attracting external funding. The more clearly an MFI is able to articulate the size of the subsidy needed to serve the poorest, the better for fundraising purposes.

There are, however, some problems with this strategy: two related to the decision to differentiate and two concerned with the decision to seek external funding. First, given the MFIs' traditional strategy of standardization, is differentiation going to be disruptive to the operations of an organization that adopts it? Standardization keeps things simple; differentiation not only requires an MFI to move down the cost curve on a new set of services, but also to do so without disrupting the operations of the organization with respect to its standard services. An MFI deciding to adopt a service differentiation strategy as a way to reach the poorest of the poor must be willing and able to install the organizational capacity that will allow it to offer a wide variety of services to different, targeted markets.

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[3] It should be noted that I am not only thinking of credit services for the poorest. In fact, it may be the case that the first need of the poorest lies in more flexible savings or insurance services.

There is also a concern that the migration of the existing poorest clients to the differentiated service will not take place. As a result, an MFI may end up in a situation in which it has a service designed for the poorest that attracts a new set of clients, while the existing poorest clients continue to use the standard services at a cross-subsidized rate. An MFI can encourage a migration by increasing the difficulty for the poorest to gain access to the standard service. Or it can encourage migration by actively marketing the new services to the existing clients.

With respect to external funding, an MFI has to be willing and able to access external funding. Even if an MFI wishes to expand its outreach by serving the poorest of the poor, as we are assuming here, there may be limits as to how far it is willing or able to go. A member-owned organization that prides itself on its independence may be unwilling to sacrifice that independence for the sake of further outreach, and may decide that internal cross-subsidization is a better option. On the other hand, a for-profit entity with a double bottom-line strategy or a non-profit organization may see differentiation plus external subsidies as a way to increase outreach without burdening the less poor.

In terms of the ability to raise external funds, MFIs are likely to have some experience, so this is less likely to be a problem. What is likely to be a problem is the question as to whether support of external fund providers can be sustained in the long run. At the time of writing, there is considerable support in the funding community for efforts to reach the poorest of the poor. An MFI that adopts the strategy of differentiation and external subsidies will have to ensure that this support continues.

CONCLUSION

An MFI seeking to increase its outreach to the poorest of the poor, while maintaining its ability to serve the less poor, should consider a strategy of service differentiation supported by external subsidies. Service differentiation will enable an MFI to reach more effectively both the poorest of the poor and the less poor, while also preparing the MFI for any potential, future competition in the less poor market segment. But service differentiation is costly, *and* makes explicit the subsidy inherent in a standardized service delivery system. As such, it raises the question as to who should pay to subsidize the poor. If it is not external providers of funds, then it will be the less poor. The argument here is that the former are a better option.

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