

Creating Better Portfolios
Lessons from Portfolios of the Poor: How the World's Poor Live on \$2 a Day

Financial Access Initiative

July 2009

Contributions to this research made by a member of The Financial Access Initiative.

The Financial Access Initiative is a consortium of researchers at New York University, Harvard, Yale and Innovations for Poverty Action.

NYU Wagner Graduate School
295 Lafayette Street, 2nd Floor
New York, NY 10012-9604

T: 212.998.7523
F: 212.995.4162
E: contact@financialaccess.org

www.financialaccess.org

Creating Better Portfolios

Lessons from Portfolios of the Poor: How the World's Poor Live on \$2 a Day

This brief looks at ways to envision the next generation of services for the "bottom billion" by examining what is and isn't working for poor households as they patch together their financial lives.

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 the yearlong "financial diaries" of villagers and slum dwellers in Bangladesh, India, and South Africa—records that track penny by penny how households manage their money. 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 surprisingly 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.

MECHANISMS MATTER

Cash-flow

Understanding the cash-flow of households is necessary to understand the financial lives of poor. Wealthier households manage finances based on risk and return; poor households focus on cash-flow rather than returns—working to ensure that they can get the money they need exactly when they need it. The \$1 and \$2 a day measurements reflect *averages*, over a year, and mask the irregularity and unpredictability of incomes, a fundamental challenge of poverty. The poor are subject to a "triple-whammy:" incomes are small, on average, they are irregular and unpredictable, and financial tools are seldom available to make the most of what is earned.

Researchers found that the very poor were excluded from financial services when the loan terms were too rigid and those that joined microcredit schemes left after failing to complete repayments. A more "cash-flow friendly finance" could involve loans with shorter terms and smaller payments that could be extracted from normal household cash flows, such as a small loan made to a vegetable vendor on a slow business week to help ensure she can buy fresh stock for the next day. Also important is flexibility in payment schedules, such as loans to farmers where repayment can be deferred in lean times and ramped up at harvest time.

Borrowing to meet everyday needs: Subir & Mumtaz, Bangladesh

Subir and 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, household income ranged from \$1.90 a day (\$.27/person/day) and \$3.15 a day (\$.45/person/day). The family fell into 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. Long-term goals were not the primary financial concern of the family; instead the couple borrowed and saved to meet their pressing 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.

Diversity of loan needs

The diaries reveal that households seek loans for a wide range of needs, not only for business ventures. Second, the poor largely repay loans from ordinary household cash-flow. One diary sample, comprised of Grameen Bank customers, divert half of their "production" loans to putting food on the table, paying down debt, and meeting other pressing consumption needs.

Loans to smooth consumption: Ramna, Bangladesh

Ramna took out a loan of \$83 to buy food stocks in a lean period. She made weekly payments with money from her husband's income, interest-free loans from family and neighbors, and her Grameen II personal savings. In April 2003, she topped-up her loan to buy grain to keep for the coming monsoon period. In October, Ramna got another top-up worth \$67 when her father-in-law passed away. She topped up her loan twice more during the diary year to pay for school fees, stocks of grain, and medical treatment. Annual interest on her loans was 20%. While these loans were not used for business enterprise, Ramna was certain of their value. Without access to the flow of 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.

Tradeoffs

Even in the most resource-constrained diaries, price was not the overriding determinant of financial choices among the poor. Instead, flexibility remained a priority. Even with access to microfinance institutions, some individuals still turned to moneylenders because they offered more flexible terms and pricing. But even beyond price, poor households face a tradeoff between flexibility, found in informal financial devices, and reliability, more common in 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. Banking features that clients in developed financial markets take for granted would greatly benefit the poor, such as loan disbursements made on the date promised, in the amount agreed upon, and at a standard price; savings accounts that allow convenient deposits and withdrawals; and insurance contracts that pay out quickly and with little haggling when needs arise.

Formal lenders can address the tradeoffs that poor households currently face by offering products 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, one of which was from a moneylender in the amount of \$32 to pay for house repairs. This was a relatively significant loan as his average monthly income was a little more than \$40 and it was irregular. The original repayment schedule terms were \$.75 a day for 50 days, \$.11 (per day) was for interest. This equates to an annual interest rate of 125%. However, instead of adhering to the daily loan repayment schedule over 50 days, Mohammed took 330 days to repay the loan, doing so in large sporadic sums. Yet, he paid interest on only 50 days, not 330. This translates into an annual interest rate of about 19%. Mohammed stated that the moneylenders don't worry about the gaps in payment and often expect it, and this flexibility was important.

THE IMPORTANCE OF SAVINGS

Saving was common among the diary households. The financial diaries show that many households created (and then spent) large sums during the course of the year, but had difficulty accumulating over the long-term. Savings were too often depleted by emergencies, or lost due to theft if they weren't kept in a secure location.

Accumulating useful lump sums

To accumulate savings, the financial diaries reveal how poor households create self-discipline devices like rule-bound savings clubs to protect their savings in the face of temptation. The insight aligns with new research in behavioral economics that examines the social, cognitive and emotional factors that affect economic decisions. These devices serve the role played by automated transfers to savings accounts or “stop orders” for earners in developed economies. Savings clubs shift money into a “hands-off” account and guard against the temptation to spend spare money in trivial ways. 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 a household’s income, but they are large enough to accumulate to a meaningful size over time. The drawbacks are that clubs can be: unreliable—not all members pay on time, which makes it impossible to anticipate the timing and amount of payout; risky—funds stored at a neighbor’s home may be vulnerable to temptation or theft; and demanding—some memberships require regular meeting attendance, which imposes time commitment.

Instilling self-discipline

Another way poor households in the financial diaries patched together larger sums was to take interest-bearing loans instead of using savings. 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 the bank’s loan portfolio, Grameen transformed its model and established Grameen II. The organization identified the rigidity of the Grameen model as its fundamental weakness. Examples of the system’s inflexibility were: the barriers to financial recovery borrowers faced when they fell “off track,” the limited access clients with savings accounts had to their money, and the assumption that clients were exclusively interested in borrowing. Modifications to the agency’s products included relaxing lending rules, establishing an open passbook savings program, adding a commitment savings plan, and creating the “loan top-up” facility, under which loans could be refreshed to the amount that had originally been distributed. These changes were aimed at making it easier for cash-strapped poor households to manage cash day to day, and to accumulate large sums in a secure savings device.

Today the Grameen II personal passbook savings account allows individuals to deposit and withdraw savings at any time in any value. For many of the financial diaries clients, this was the first time they had access to a flexible, but reliable account of this kind. They typically saved a little each week, and withdrew between two and three times a quarter. Grameen made depositing easier by sending a worker into the village each week. The researchers observed larger cash flows in the Grameen II passbook accounts than in the 1999-2000 diary set when deposits into microfinance savings were standardized at a low rate, and withdrawals were much harder to make. Grameen II demonstrates that introducing better products can drastically change an equation, and that long-term savings in poor are possible.

Grameen also introduced a popular commitment savings plan, known as the Grameen Pension Savings (GPS). GPS offers a good rate of interest in return for regular monthly deposits over a five- or ten-year term. The structure of GPS offers clients the discipline they need to deposit consistently and maintain their savings for future use. GPS is a “pension” in name only and is not restricted to retirement needs: many younger families see the program as a means to save for medium-term expenses, such as school fees or a wedding.