Filling the Deposit Gap in Microfinance

Dale W Adams
Park City, Utah
October 12, 2002

The core of the microfinance industry is comprised of thousands of organizations that provide loans to people of modest means. These organizations typically rely on subsidies and on outside sources for funds. Some former core organizations, especially in Latin America, have matured to the point where they obtained bank charters, or bank-like supervision, that includes permission to accept deposits. On the fringe of this core, additional institutions such as financial cooperatives, postal savings systems, and some traditional banks do microfinance.[1] Most of the remaining core organizations do not mobilize voluntary deposits, although they might collect forced savings. This results in a large deposit gap in microfinance that is only partially filled by organizations that have matured out of the core, organization on the fringe, and by informal finance. As a whole, the microfinance industry has been highly successful in providing loans to millions of new borrowers, but it has been far less successful in expanding deposit services for poor people, particularly in rural areas.

I'm pleased to see that an increasing number of policy makers recognize the need to fill the deposit gap.[2] If I'm not mistaken, a major supposition behind this conference is that this gap should be filled primarily by organization in the core of the industry. For reasons I'll describe more fully later, I'm uncomfortable with this approach. I'll also argue that before trying to fill the gap we must understand why it occurred. I'll then go on to argue that most of the deposit mobilization ought to be done by organizations on the fringe of the industry: officially recognized banks, financial cooperatives (a.k.a. credit unions), and postal savings systems. Before exploring these topics I share several of my assumptions.

- First, I believe that more poor people could benefit from access to quality deposit services than can benefit from subsidized lending programs.
- Second, I also believe that large amounts of deposits can be mobilized from poor people, more than enough in most cases to cover prudent lending opportunities.
- Third, I further believe there is a conflict between deposit mobilization and altruistic lending. Both are useful activities, but they must be separated.
-

Explaining the Deposit-Gap

Clarifying the reasons for the deposit gap might assist in designing methods to fill it. Over the years I've heard at least six overlapping explanations for the paucity of deposit mobilization. The traditional excuse has been that most people lack the capacity to save because of their poverty. More recently a few observers have argued that many poor people do not save in financial form because they lack opportunities to do so. Some of these same observers also argue that poor people make few deposits because the interest paid is too low or the quality of services too unsatisfactory to provide positive incentives. I've heard a few key people further argue that small deposits are just too expensive to mobilize and manage. I've also heard some government and donor employees murmur -- under their breath -- that deposit mobilization projects are not a way to further their career. Finally, many people in the industry say the gap is due to lack of government permission to accept deposits.

[1] In addition, an even larger number of poor people regularly use informal finance, both to obtain loans and to manage their deposits. This includes many individuals who borrow from semi-formal or formal lenders and, at the same time, participate in informal finance.
[2] Recent efforts by CGAP, Microsave, and WOOCU have stimulated this awareness.

Capacity to save

Compared to a decade ago, fewer policy makers now argue that poor people lack the capacity to save. Those who continue to make this argument ignore a good deal of history. A large number of studies and experiences over the past 150 years, especially in Asia, strongly suggest that most poor people will save a surprising amount if they have opportunities and incentives to do so. For example, the financial cooperatives that were spawned in Germany in the mid-1800s, and later grafted into the farmers associations in Korea, Japan, and Taiwan, were built on voluntary deposits (Hyun; Kato; Lee and others; Ong and others). A few major banks such as the Bank of America, the French Caisse Nationale de Credit Agricole, and the Japanese Norinchukin Bank were initially erected on small deposits. More recently, postal savings systems in Japan, Taiwan, and China have mobilized huge amounts of deposits from people of modest means (Leong, Scher, The Taiwan Economic News). The experience of the Units Division of the Bank Rakyat Indonesia (BRI) the past twenty years is also a well-known example of a successful deposit mobilization effort (Robinson).

Additional insights on savings capacities in other regions have been provided by research on informal finance. Numerous studies, for example, have shown that people of modest means often deposit substantial amounts of money in self-help financial groups (Bouman). Researchers estimated that the float in these informal groups in Cameroon exceeds the volume of formal deposits in the country (Schrieder and Cuevas). Other research showed that most employees of a large agricultural bank in Egypt maintained a substantial part of their financial savings in these informal groups (Baydas and others). Additional investigation in Bolivia and the Philippines showed similar savings patterns among poor households (Adams and Canavesi; Adams and Nazarea-Sandoval).

In some countries such as Bangladesh, Egypt, El Salvador, Mexico, Pakistan, and the Philippines large amounts of remittances are sent to households of modest means. Remittances from the United States to Mexico amount to about $10 billion per year, an amount many multiples the volume of lending done by the microfinance industry in the country. These funds have undoubtedly augmented the savings capacity of receiving households and thereby expanded the potential for deposit mobilization in areas that receive these remittances.

Compared to several decades ago, fewer policy makers now maintain that poor people lack the capacity to save. As a result, limited savings capacity is likely not a primary explanation for the current deposit gap in the microfinance industry.

Opportunities to deposit

Deposit mobilization is affected by self-fulfilling prophecies. If policy makers assume certain people are too poor to save, and then implements policies that severely limit their access to deposit facilities, one should not be surprised when few deposit are mobilized. It goes without saying that individuals must have easy access to deposit services to facilitate deposit mobilization. Potential depositors are highly sensitive to the transaction costs that are imposed on them by deposit takers, especially the time and distance involved in making small deposits. Despite the rapid multiplication of organization doing microlending, many of these lenders lack permission to accept deposits and have, therefore, provided few additional voluntary savings opportunities for poor people. The decay of some postal savings systems, the contraction of some financial cooperatives, and the collapse of numerous government owned banks have reduced the opportunities for poor people in may countries to access deposit facilities, especially in rural areas.

In some cases, the rapid expansion of subsidized microfinance lending has crowded out banks that might, otherwise, have provided more deposit services to poverty-niches in financial markets.[3] Also, in some cases, various banking regulations limit the ability of banks to open branches that might fill the deposit gap. Hefty legal reserve requirements in a few countries similarly discourage banks from vigorously capturing deposits. Furthermore, in some countries bouts of inflation and economic uncertainty or wars continue to restrict deposit mobilization.[4]

The results of a handful of pilot projects in Latin America funded by the Agency for International Development (AID) that substantially expanded deposit services show that access is highly important in influencing deposit mobilization (Arbuckle and Adams; Gonzalez-Vega; Richardson; Vogel). Although other factors are likely also involved, the lack of convenient financial institutions that accept financial deposits explains part of the deposit-gap. A fundamental question is why have various organizations moved so slowly in filling this gap?

<u>Incentives to save</u>

Compared to a decade or so ago, there are far fewer restrictions in most countries on what deposit takers can pay on deposits. For many years in most low-income countries interest rate restrictions, hefty amounts of subsidized lending, and inflation resulted in most depositors receiving negative real returns on their financial deposits. While depositors will maintain part of their savings in deposit even when they receive negative real rates of interest – because of liquidity requirements – they do so with little enthusiasm and are unwilling to add substantially to their deposits.

Fortunately, most institutions that are authorized to accept deposits now have wide latitude in the incentives they can offer to depositors. As a result, the incentives issue is likely less of an explanation for the deposit gap than was true several decades ago.

<u>Deposits are too costly</u>

As the late Frits Bouman often pointed out, poor people deal in transactions that are measured in cents not dollars. This is especially true regarding their deposits. They typically have only small amounts to deposit, they often make a number of deposits and withdrawals, and the total amount in their accounts may be small. If the institution accepting deposits does not have an efficient information management system the costs of handling these transactions and accounts can discourage them from seeking this business.

Adding deposit taking to lending activities allows economies of scope, but it also augments management problems and increases workloads for employees. It likewise involves keeping more cash on hand, thus increasing security costs. Managers are also forced to make more liquidity management decisions. Clearly, adding deposit services can substantially increase costs and make financial intermediaries less sustainable unless cost reducing technologies are adopted. A hallmark of the microfinance industry has been cost reducing innovations in lending, but not in deposit taking. Why?

To adequately understand the costs-are-too-great argument, one must ask the comparative question. Deposit taking is too costly, but compared to what? If an organization can obtain concessionary funds from government or donors it is logical for lenders to look at deposits

---

[3] I vividly remember talking to commercial bankers in Bangladesh who said they avoided doing business in rural areas because of the many subsidized elements of the microfinance industry that had colonized the countryside.
[4] Nonetheless, in the early 1970s I was surprised by the amount of deposits an agricultural development bank in Vietnam mobilized in the midst of a war. In some cases, uncertainty prompts saving.

as a more costly source of funding. Even when so-called market rates of interest are charged on loans provided by donors or governments, these sources of funds may be less expensive than paying similar rates of interest on deposits plus incurring the transaction costs of mobilizing and managing small accounts.

I remember several conversations with a manager of a German consulting firm who was involved in the development of the Cajas Municipales in Peru during the 1980s. He came away from that experience convinced deposits were too expensive to mobilize. His opinion later strongly influenced the design of microfinance projects in other countries. I question, however, the appropriateness of generalizing from the Peru experience in the 1980s. This was a period in Peru of hyperinflation, extreme depression, and availability of funds from donors for microlending on highly concessionary terms. These conditions certainly limited the capacity of people to save and severely crimped the incentives that could be offered. Despite this harsh economic environment, nonetheless, an AID-sponsored pilot project was highly successful in mobilizing deposits at about the same time in Peru (Vogel). It is especially noteworthy that AID did not provide concessionary funds for lending in this project. As a result, the managers of the bank and financial cooperatives involved in the project did not view deposits as a more costly source of funds than other sources, because they had no other source, unlike the managers of the Cajas Municipales.

Clearly, perceptions about costs have contributed to the deposit gap. This same cost problem, however, faced those who earlier wished to make small loans, but techniques were then designed to lower costs. Do managers of the microfinance industry have incentives to discover and implement similar cost-reducing techniques in deposit mobilization?

<u>Furthering careers</u>

Like depositors, government and donor employees respond to incentives. The paucity of deposit promoting projects suggests that few of these employees see deposits as a fast track for career advancement. In the 1960s and 1970s I saw a number of AID employees who fomented subsidized lending projects in Latin America and later rise to positions of leadership in the Agency, even though most of their credit projects eventually imploded. In the late 1970s and early 1980s, I saw a handful of innovative Agency employees develop small deposit mobilization projects that, in my opinion, were highly successful.[5] As far as I know, however, these risk-taking employees were never rewarded for their innovations and the Agency quickly lost interest in deposits in the stampede to fund microlending programs.

I don't wish to criticize AID. It at least experimented with deposit mobilization. I've looked in vain for similar efforts within the project portfolios of the World Bank, the Inter-American Development Bank, the African Development Bank, the Asian Development Bank, the Food and Agricultural Organization, the International Fund for Agricultural Development, European donors, the Japanese development agency, and foundations that support development. The lack of interest in deposit mobilization among donors is reflected in their employees' expertise. There are hundreds of these employees who are comfortable designing credit projects. Specialists in deposit mobilization, however, are as scarce as hens' teeth.[6] The paucity of this expertise among employees of agencies in the core of the microfinance industry and among the consulting firms that feed off the industry suggests it will be difficult to mount a substantial deposit mobilization effort in the near future. This staffing problem is unlikely to change until deposit mobilization has a much higher priority in development strategies.

[5] Barry Lennon, Doug Tinsler, Roberto Casto, Clliff Barton, and Charles Blankstein were among those innovators.

[6] By specialists, I mean people who have had hands-on experience in fostering successful deposit mobilization projects such as Richard Patten, Robert Vogel, David Richardson, Lee Arbuckle, John Gadway, and Jeffrey Poyo.

In retrospect, deposit mobilization does not fit with donor priorities: moving relatively large amounts of money quickly into countries through development projects. In most respects, deposit mobilization is the antithesis of this. From my point of view, this systemic problem explains most of the deposit gap.

<u>Institutions lack authorization</u>

Most countries prohibit organizations from mobilizing voluntary deposits unless they have official permission from banking authorities to do so. Still, one has to wonder why more organizations in the core of the microfinance industry didn't start much early to push for permission to accept deposits. Was it because participants were too pessimistic about capacities to save, could provide too few incentives, or thought it was too costly? Overtime, I suspect that all of these factors help explain some of the slow movement toward seeking permission to accept deposits. Still, I believe that something more fundamental is involved. Perhaps that something could be called Shaw's Law.[7]

Shaw's Law

Shaw's Law states that the availability of inexpensive outside funding discourages deposit mobilization. Its corollary is that deposits will only be mobilized when there is little or no outside funding available to potential deposit takers. Verifications for this law can be gleaned from a review of successful deposit mobilization efforts as well as from the experience with subsidized and targeted lending efforts. Could anyone imagine, for example, that the farmers associations in Korea, Japan, and Taiwan would have had much interest in mobilizing voluntary deposits if the Japanese government had offered these associations access to subsidized funds? Similarly, would the BRI have encouraged their units division to mobilize deposits if the Central Bank of Indonesia had continued to allow BRI ample access to concessionary discount lines? In the same vain, would the financial cooperatives in the Dominican Republic, Guatemala, Honduras, and Peru that were prompted to mobilize more deposits by AID-funded technical assistance projects have turned their backs on deposits if AID or other donors had offered them subsidized funds?[8]

Recommendations for Donors

AID's experience with small farmer credit programs, the World Bank's funding of development banks, and the Inter-American Bank's efforts to channel funds into financial cooperatives through a regional organization all discouraged deposit mobilization efforts. I wonder if all of the donor and government money given to the microlending industry hasn't had the same result?

What can donors and governments do to avoid Shaw's Law? My suggestions follow:

1. Donors should avoid providing funds for lending to organizations that might promote deposit mobilization.
2. They should confine their subsidized lending to altruistic lenders.

---

[7] Named after Edward Shaw whose 1973 book first drew attention to the importance of deposit mobilization in national development.

[8] In the early 1990s I saw a dramatic example of this in Egypt where AID spent a good deal of money trying to reform a traditional agricultural bank, including stimulating more deposit mobilization. These efforts were later undercut by a large World Bank loan that provided funds to the bank more cheaply than the bank could obtain them from depositors. The agricultural bank quickly lost interest in the difficult task of mobilizing voluntary deposits.

3. They should strengthen prudential regulation and supervision.
4. More donors ought to provide small technical assistance grants to reform and strengthen financial cooperatives and postal savings systems.
5. The larger donors should promote changes in bank branching restrictions, encourage lower legal reserve requirements, and eliminate other regulations that discourage banks from seeking more deposits, especially in rural areas.
6. All donors should discourage access to second tier banks by microlenders who have deposit-taking authority.
7. All donors should stimulate cost-reducing innovations in deposit taking.
8. Donors should also reward employees for designing creative and effective deposit mobilization projects.
9.

Conclusions

Substantially reducing the flow of funds into the microfinance industry is likely politically impossible. Advocates for the industry have sold too many politicians on the merits of debt in resolving poverty. Furthermore, there are too many organizations, employees, and consultants who benefit from this system to expect it to shrink or disappear. In fairness, one might argue there is a role for specialized lenders who receive outside funds and subsidies, what I call altruistic lending. The question is how to quarantine these funds and build firewalls between altruistic lending and deposit taking. In my value system, it is appropriate to assist poor people with lending that is subsidized and often managed by those with social objectives. I'm quite uneasy, however, in entrusting poor peoples' deposits to these types of systems. I'd feel more comfortable if these two important activities were segregated. If this were done, I suspect there would be far more innovation and outreach in deposit taking.

None of this, however, resolves the incentive problem within donor and government agencies. Unless much higher priority is assigned to deposit mobilization in poverty alleviation programs this incentive problem will throttle efforts to move to deposit-based financial intermediation in the microfinance industry.[9]

[9] Where microfinance conferences are held is a metaphor for the priority given to deposits. Most of these conferences, including this one, are located in the centers of governments or near donors, instead of being located in the hinterland near depositors.

References

Adams, Dale W and Marie L. Canavesi de Sahonero, "Rotating Savings and Credit Associations in Bolivia," Savings and Development 13(1989): 219-236.

Adams, Dale W and Virginia Nazarea-Sandoval, "Informal Finance in A Semi-Rural Areas of The Philippines," Savings and Development 16(1992): 159-168.

Arbuckle, Lee and Dale W Adams, "Reforming Credit Unions in Honduras," in Safe Money: Building Effective Credit Unions in Latin America, edited by Glenn D. Westley and Brian Branch, (Washington, D. C.: Inter-American Development Bank, 2000): 115-128.

Baydas, Mayada M. and others, "Informal Finance in Egypt: Banks within Banks," World Development 23(1995): pp. 651-661.

Bouman, F.J.A., "Rosca and Ascra: Beyond the Financial Landscape," in Reconstruction of Financial Landscapes: The Fine Art of Mapping Development, edited by F.J.A. Bouman and Otto Hospes (Boulder, Colorado: Westview Press, 1994).

Gonzalez-Vega, Claudio (ed.), Republica Dominicana: Mercados Financieros Rurales y Mobilizacion de Depositos (Santo Domingo: Amigo del Hogar, 1992).

Hyun, K.N. and others, "Rural Household Savings Behavior in South Korea, 1962-76," American Journal of Agricultural Economics 61(1979): 449-454.

Kato, Yuzuru, " Mechanisms for The Outflow of Funds from Agriculture into Industry in Japan," Rural Economic Problems, December 1966, pp. 1-20.

Lee, Tae Young and others, "Savings Deposits and Credit Activities in South Korean Agricultural Cooperatives 1961-1975," Asian Survey 17(1977): 1182-1194.

Leong, Elaine, "China's Postal Savings Service Challenges State Banks," Finance Asia September 5, 2000.

Ong, Marcia M.L. and others, "Voluntary Rural Savings Capacities in Taiwan," American Journal of Agricultural Economics 58(1976): 578-582.

Robinson, Marguerite, The Microfinance Revolution Volume 2: Lessons from Indonesia (Washington, D. C.: World Bank, 2002).

Richardson, David "Model Credit Unions into the Twenty-first Century," in Safe Money: Building Effective Credit Unions in Latin America, edited by Glenn D. Westley and Brian Branch, (Washington, D. C.: Inter-American Development Bank, 2000): 91-113.

Scher, Mark J., "Postal Savings and The Provision of Financial Services: Policy Issues and Asian Experiences in The Use of The Postal Infrastructure for Savings Mobilization," DESA Discussion Paper No. 22, (New York: United Nations, December 2001).

Schrieder, Gertrud R. and Carlos E. Cuevas, "Informal Financial Groups in Cameroon," in Informal Finance in Low-Income Countries, edited by Dale W Adams and Delbert A. Fitchett (Boulder, Colorado: Westview Press, 1992): pp.43-56.

Shaw, Edward S., Financial Deepening in Economic Development (New York: Oxford University Press, 1973).

The Taiwan Economic News, April 25, 2001.

Vogel, R. C., “Savings Mobilization: The Forgotten Half of Rural Finance,” in Undermining Rural Development with Cheap Credit, edited by D. W Adams and others, (Boulder, Colorado: Westview Press, 1984): 248-265.