Can Microfinance Meet the Poor's Financial Needs in Times of Natural Disaster?

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MICROENTERPRISE BEST PRACTICES

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by

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CAN MICROFINANCE MEET THE POOR'S FINANCIAL NEEDS IN TIMES OF NATURAL DISASTER?[1]

Microfinance institutions (MFIs) are close to the poor—they strive to serve those who are excluded from the formal banking sector, and bring them into the market for financial services. USAID's Microenterprise Best Practices (MBP) Project has focused on the ability of MFIs to serve poor communities affected by crisis, and to reduce poor communities' vulnerability to crisis. Can microfinance be effective in the context of sudden natural disasters or other emergencies? For both microfinance practitioners on the one hand, and disaster mitigation professionals on the other, this is a burning question to address.

HOW DO THE POOR COPE WITH NATURAL DISASTERS?

Natural disasters are a recurrent condition in many parts of the world—and an infrequent but devastating occurrence in others. Regardless of frequency, however, poor people have a number of choices in meeting their financial needs when disaster strikes. These choices have been extensively documented in the literature. For simplicity, we list six financial options facing poor households in a crisis:

1. Reducing household consumption—often by reducing food intake
2. Making distress sales of physical assets, including livestock
3. Sending family members to search for work in less-affected areas
4. Drawing upon savings—held either in the form of cash or non-cash assets
5. Borrowing—from family, informal sources, or microfinance institutions
6. Using remittances

Households may use these options in combination or in sequence depending on the type and size of disaster, the type and magnitude of assets held by the household, and the market conditions that prevail immediately after a disaster strikes. For example, the household may start by using cash on hand, but if food is unavailable or prohibitively expensive, the household may be required to quickly resort to other options. Moreover, some options may be "reversible," where the household can replenish stocks or savings after the disaster has passed. These options are likely to be preferred over difficult-to-reverse options such as migration or sale of long-term household assets.

In general, the first three of these options—reducing consumption, selling assets, or migrating in search of work—are unappealing responses to a disaster. They result in reduced physical health, a lower household asset base, and a less coherent family unit than before the disaster strikes. Poor households take these steps when other options are exhausted.

[1] This article draws on a three-year research effort about microfinance in the context of rapid-onset natural disasters.

The remaining three options reflect the household's pre-disaster household and community safety net: does the household have accessible accumulated savings, good standing in the community, prior borrowing relationships, and good family relations? Depending on the depth of their safety nets and the size of the disaster, poor households make choices between these six options to weather the emergency.

How much do poor households plan for the "unknown"? Clearly, poor households know they are vulnerable. Research shows that the majority of poor households in all parts of the world are hit by a range of crises—ranging from personal crises within the family, to aggregate or "covariate" shocks hitting all members of the community. Households have developed techniques to protect themselves financially against personal and highly likely emergencies, such as illness, death, or theft. These responses have included insurance, contingency savings (either individually or in groups), and accumulation of assets that can be liquidated in times of need.

More difficult, however, is protecting against a large-scale but uncertain emergency like a natural disaster. The poorer the household, the more difficult will be the decision between regular meals or a child's education on one hand, and investing in a stronger house in case of a hurricane on the other. In such cases, most households would choose the former—investing in the immediate, the certain, and the path showing obvious benefits to the household. Because of this reality, poor households have rarely pursued strategies to prepare for emergencies, and are limited to choices between coping mechanisms when disaster strikes.

THE ROLE OF OUTSIDERS IN EXPANDING OPTIONS FOR DISASTER PREPAREDNESS

"Outsiders"—individuals or institutions who are not locked into a survivalist circle—may be able to significantly expand the range of financial options available to poor households in preparing for potential natural disasters. With outside support, poor households or communities may be able to undertake any of the following:

1. Invest in disaster-proof activities as a mitigation strategy
2. Borrow to build disaster-proof residences, schools, or water supplies
3. Save specifically for large-scale emergencies
4. Establish credit lines for use in emergencies

Several of these financial service efforts led by outsiders have been documented. They show a range of purposes and institutional homes. For example, the Grameen Bank in Bangladesh provides housing loans for individuals willing to build disaster-resistant houses (see Center for Urban Development, 2000, forthcoming). Others are based on community mobilization strategies, and may include such diverse objectives as raised water supplies, community-managed cereal banks, or raised communal land as a safe-haven (see Nagarajan, 1998, or Brown and Nagarajan (1), 2000, forthcoming).

To date these efforts have not been widely replicated. Moreover, it remains unclear whether such efforts can play a role in protecting poor communities affected by highly <u>infrequent</u>

disasters.[2] What is important for our discussion here, however, is that there is evidence that outsiders can play an important catalytic role in mobilizing poor households or communities to better prepare financially for the unexpected.

THE ROLE OF MICROFINANCE INSTITUTIONS FOR DISASTER RESPONSE AND MITIGATION

First, who participates in microfinance programs? Microfinance institutions (MFIs) provide financial services—typically credit and savings—to poor communities that are otherwise cut off from formal financial services. MFIs distinguish themselves from standard banking institutions by their physical proximity to clients, regular face-to-face contact with clients, and often, by the peer-lending system through which clients cross-guarantee each other's loans. These characteristics of microfinance make MFIs a uniquely high-potential vehicle for reaching and organizing poor communities in case of a natural disaster:

- MFIs serve difficult-to-reach clients, with whom they maintain regular contact, a relationship which is essential for interacting with vulnerable populations both before and after disaster strikes;

- High-quality MFIs develop a trust-based relationship with clients, which increases the MFI's ability to discuss difficult topics or to interact during crises;

- Because MFIs often work with organized groups of clients, information and services can be delivered on a leveraged basis, either for disaster preparedness or for disaster response.

Despite these advantages, there are characteristics of microfinance that may impede its effectiveness in meeting the poor's needs in a natural disaster context. A "three-point primer" is in order to highlight relevant aspects of microfinance.

Despite best intentions to the contrary, microfinance remains primarily a credit-based industry. This is due to the institutional difficulties of transforming weak credit-only NGOs into well-functioning, regulated financial institutions capable of managing savings, insurance, or remittance services. Many credit-only MFIs mobilize "compulsory" savings—required as collateral or a pre-requisite to a borrowing relationship. The typical program holds these funds until a borrower leaves the program, at which time the lump-sum (often with interest) is returned. But because they cannot be withdrawn at the individual client's discretion, compulsory savings are not accessible in a natural disaster context without special dispensation from the MFI. This is slowly changing, as microcredit institutions are recognizing that the more flexible the savings product, the more satisfied the client, and the longer the client's relationship with the MFI.

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[2] Legitimate questions arise, for example, as to how frequently and severely natural disasters should strike before poor people are encouraged to invest their scarce resources in preparedness activities.

Second, it is important to note that microcredit and microfinance institutions have slowly but steadily moved from a “development” focus to a “financial” focus. In part, this transition reflects the efforts of NGOs to transition to strong regulated financial institutions capable of collecting savings. It also reflects increasing donor unwillingness to provide funding to MFIs that are not able to maintain their loan capital through timely loan recovery at market rates of interest. In the long-term, this transformation to a banking mentality may strengthen the ability of microfinance institutions to serve poor communities during crises. As long as they are credit-only institutions, however, this process means that MFIs may be less willing to serve higher-risk clients, and are less willing to provide subsidized services lest it undermine their “business-like” image with clients.

Finally, microcredit and microfinance institutions are notoriously undercapitalized. Reserves are kept to a bare minimum to allow the maximum possible lending outreach. Even savings reserves and insurance premiums may be eyed with the desire to use the capital for income-earning purposes. Thus, when disasters strike, MFIs typically find themselves without sufficient cash reserves on hand to weather the emergency. As client loan repayments stop, the MFIs struggle to pay their staff, much less to make emergency loans.

Even with its current challenges, what role can microfinance play in a natural disaster emergency? The role of microfinance can be separated into disaster response on the one hand, and disaster preparedness on the other.

Disaster Response

In terms of disaster response, a few of the larger, better-capitalized, and regulated MFIs have been able to match their post-disaster services to the preferred coping mechanisms requested by their clients. Specifically, these MFIs have provided their clients with post-disaster savings and loan services (see Brown and Nagarajan (1), 2000, forthcoming). Studies show that MFI clients who have access to these products are less likely to resort to distress sales of assets after disaster strikes. Unfortunately, very few MFIs have the institutional structure or capital base required to provide these services, for the reasons discussed above.

For smaller MFIs that cannot offer savings or amass the necessary reserves to provide post-disaster funding, new efforts are underway to create “disaster loan funds”—either for individual MFIs or through umbrella or “apex” institutions. These funds—based on earmarked donor contributions—serve as reserves for large-scale emergencies only. For the MFI, they act as an alternative to commercial lines of credit or emergency requests to donors, so that they can get cash (in the form of loans) into the hands of affected clients immediately following a natural disaster. For more information on these nascent funds, see Brown and Nagarajan (2), 2000, forthcoming). It is important to note that—generally—these funds serve only existing clients of the MFIs, not the broader community.

Disaster Preparedness

While disaster response is often the most difficult for smaller MFIs, even the smallest MFI can play a constructive role in disaster preparedness. It is helpful to separately consider those preparedness measures that an MFI can undertake internally, and those that it can undertake in partnership with other organizations.

Internal Disaster Preparedness

Staff preparedness is perhaps the most important task. MFIs are unique in the regular contact their staff has with even the most remote clients. In the event of an emergency, MFI loan officers are often the first to reach affected communities. These field staff should be trained—before disaster strikes—as to their responsibilities and the extent of their decision-making authority. Typical requirements of field staff include: informing households on where to access emergency services such as medical supplies, clean water, and shelter; informing MFI headquarters on the extent of the disaster in the community; and determining the need for and terms of loan rescheduling. Field staff who have the necessary information to fulfill these tasks - as well as a disaster-resistant methods of transportation and communication—will be much more effective that those who have not.[3]

Client preparedness is another area where any MFI can play a constructive role. Because MFIs serve the poor, their clients often live in highly vulnerable physical locations. Encouraging clients—through education or loan incentives—to move to safer locations or develop better shelters is one option, but may be beyond the abilities of many MFIs. As an alternative, MFIs can help vulnerable client groups to mentally prepare for disasters and have plans on how to respond.

External Disaster Preparedness

The MFIs can also develop relationships with non-MFI institutions. Except in areas hit by cyclical disasters, MFIs are rarely aware of, much less in contact with, disaster warning systems. Rather than suggest that each MFI create these partnerships, however, donor organizations or microfinance network organizations may be more cost-efficient channels to track and disseminate disaster warning information. This channel of communication may also serve to link MFIs with relief organizations that can mobilize quickly after disasters strike. Either through networks or on their own, MFIs can also prepare by developing lines of credit—either with commercial banks or donors—for emergency draw-down. All of these partnerships offer important opportunities for MFIs to become better prepared to serve their clients—as well as survive the crisis themselves—without losing their “financial services” perspective.

To date, very few MFIs have taken the path of disaster preparedness activities or products. On the financial side, loans to encourage diversification into disaster-proof activities or safer

[3] Equipping MFI field offices with cell phones and boats have made MFI staff much more effective in disaster response in some flood-prone areas. These tools allow field staff to both reach (and save) at-risk households, as well as communicate with headquarters.

housing, for example, are still rare. Efforts to link loan clients to institutions that can provide voluntary savings or remittances are also rare. Lines-of-credit and remittance services are only now appearing in the microfinance world. And lack of "mental awareness and preparedness" of MFI management and field staff is still a major hindrance to prioritizing disaster mitigation. Thus, despite the fact that these preparation efforts are achievable with the current talent and resources of the microfinance industry, a great deal of training of the microfinance industry is required to raise the consciousness and the will to act on this front.

A VIEW FROM BANGLADESH

Despite the lack of attention to disaster conditions in the microfinance industry as a whole, the experience of MFIs in Bangladesh is heartening and warrants a closer look. Bangladesh differs from many microfinance contexts in that it is characterized by a significant number of broad-based, well-managed, flexible MFIs. When combined with an environmental context of frequent rapid-onset natural disasters, we find a history of thoughtful innovation on microfinance products and mechanisms to protect clients from natural disasters.[4]

On the product side, Bangladeshi MFIs have led the industry in insurance, credit, and savings services. On insurance, Bangladeshi MFIs have taken the lead in developing products to insure lives and outstanding credit balances for clients. Innovations in insurance have sufficient experience in a disaster context to show "second generation" approaches to insurance, which corrected some early missteps in insurance product design (see Brown and Churchill, 1999).

Bangladeshi MFIs have also taken the lead in loans for disaster-proof housing, as mentioned above, as well as in small emergency loans and larger asset replacement loans. In addition, Bangladeshi MFIs have accumulated experience on when, to whom, and with what terms and conditions, these loan products should be offered after a disaster strikes. The Bangladesh experiences do show one important limitation of microcredit as a coping mechanism: loans are limited to previous members of the MFI whose accounts were in good standing before disaster struck.[5]

Finally, Bangladeshi MFIs have taken the lead in offering flexible deposit services, even in unregulated institutions.[6] This has allowed a much greater coverage of local communities by MFIs—where many times the number of individuals apply for deposit services as credit

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4 Microfinance efforts in Bangladesh are also complemented by an extensive disaster preparedness and response system which provides an institutional framework in times of emergency. This context has both drawn MFIs further along the preparedness path, and allowed the MFIs to depend upon complementary services provided by other institutions.

5 MFIs hit by disasters in other parts of the world are now considering experiments to allow new clients to enter programs immediately after a disaster strikes. These new clients may need to produce undamaged or repairable physical collateral or cash savings to qualify, since the "character and peer-group" forms of collateral are difficult to assess in an emergency environment.

6 Despite the benefits of making deposit services widely available, there is a danger in the Bangladeshi experiment in unregulated savings: clients with deposits in unregulated institutions may fall prey to weak or fraudulent institutions.

services in any given community. For a range of reasons, flexible savings is perhaps the most important financial product for households to have when disaster strikes. Bangladeshi MFIs are now exploring how to manage client deposits to ensure that MFIs can access sufficient cash to release savings to clients when disasters strike. (For more information on Bangladeshi disaster products, see Brown and Nagarajan (1), 2000, forthcoming).

The Bangladesh experience also illustrates a range of internal and external mechanisms the MFIs have used to both prepare for and respond to natural disasters. To list them briefly:

- Development of Disaster Loan Funds—both for individual MFIs and for groups of MFIs;
- Relationships with disaster warning and disaster response institutions;[7]
- Involvement of commercial banks in disaster response;
- Involvement of citizens in disaster response;
- Development of staff incentives to keep staff in the field and hard at work after disaster strikes;
- Use of high-tech communication methods to keep field staff and headquarters in touch; and
- Coordination with early warning systems, and monitoring of branches located in vulnerable areas.

All of these products and methods required pre-planning on the part of the MFIs. Because Bangladesh has a twenty-year old microfinance industry, as well as a history of frequent and significant natural disasters, pre-planning and well-conceived response mechanisms are more highly developed here than nearly anywhere else in the world.

LESSONS AND CHALLENGES FOR MICROFINANCE

As we look broadly at microfinance as an industry, and at specific experiences in the natural disaster context, it is possible to draw several broad lessons:

1. Microfinance cannot be a financial safety net to an entire affected community, but can play an increasingly constructive role in disaster preparedness and response as it expands its range of products and services.
2. Establishment of long-term relationships between individuals and MFIs allow poor households access to existing MFI products that can help reduce some of the hardships caused by natural disasters. This is especially true for institutions participating in Disaster Loan Funds.
3. Preparedness of the MFI's staff and systems is the key to providing timely response to clients.

[7] The Helen Keller Institute in Bangladesh publishes a vulnerability index for every county based upon the frequency of disasters, availability of infrastructure, etc. This information—in the form of quantitative rankings and maps—can be valuable to MFIs in preparing themselves and their clients for disasters.

4. Timing of MFI services matters to clients: emergency loans must be available quickly after a disaster strikes, while reconstruction support is useful once the household has fully passed the emergency stage.
5. With foresight, regular MFI products can be modified to be useful in post-disaster settings, and regular MFI systems can be disaster-protected.

Along with these broad lessons, there are also clear bottlenecks that limit the role MFIs currently play in natural disaster response and mitigation:

1. Most MFIs do not have the liquidity position (or access to a Disaster Loan Fund) to respond quickly or fully in a disaster context.
2. Most MFIs—from management, to field staff, to reserves, to information and communication systems—are not currently prepared to either weather or respond to a natural disaster situation.
3. Most MFIs have not considered client needs from an emergency perspective; rather products and services are primarily geared to day-to-day business or household concerns.
4. Demand for special services may be small, yet may require significant institutional investment. Therefore, individual MFIs are unlikely to invest in developing or maintaining these services.
5. Regulatory restrictions and limits to institutional capacity will keep most MFIs from mobilizing voluntary savings for the foreseeable future.

The good news is that—with careful planning—most of these bottlenecks can be removed or reduced. Therefore, the first step is to engage the microfinance community—at multiple levels—in a dialogue about natural disasters and other types of environmental instability. The microfinance community is still young—and therefore very much in a learning and collaborative mode. Disaster professionals need to encourage MFIs not only to be prepared to respond to disasters, but to actively engage with clients and communities in mitigation planning. Donors can provide financial incentives to take this step. Moreover, MFIs can join this effort without stepping outside of their role as financial service providers. MFIs must, however, broaden their view of types of financial services they can provide in order to play a constructive role in this context.

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