

The Next Stage of Financial Inclusion
By Dean Karlan

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Nonprofit organizations led the way in developing microcredit offerings for the poor. Then for-profit companies took over large swaths of that newly created market. Yet research on the needs and habits of the poor shows that nonprofits continue to serve a vital function when it comes to bringing financial services to those who need them most.

The Next Stage of Financial Inclusion

By DEAN KARLAN



Finance can be a glue that holds all the pieces of our life together. It enables money to be in the right place at the right time for the right situation. To borrow and save is to move money from the future to the present, or from the present to the future. To insure is to move money from a “good” situation to a “bad” one. Ideally, we would never have to think about finance. It would be seamless, operating in the background. It would allow us to invest and consume exactly as we deem optimal, given all the other constraints that we have in life.

For finance to work this way, four conditions need to be in place: enforceability of contracts, an absence of transaction costs, perfect competition, and fully rational consumer behavior. No country fully meets these ideal conditions, of course. But in developing countries, the situation is especially challenging: Contracts are often not enforceable; long physical distances drive up transaction costs; a lack of competition gives a small number of firms an inordinate degree of market power; and behavioral biases (which

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are present in wealthy countries, too) lead people to make systematic and costly mistakes.

For a long period, such inefficiencies prevented financial markets from emerging in these countries, and the result was stark: The poor had little access to credit and little ability to build savings through formal institutions. The obstacles were simply too high for traditional banks to want to serve them, and no one else was filling the gap. Then, starting in the 1970s, Muhammad Yunus changed the landscape of finance for the poor. He developed a new business model—known as microcredit—that lowered transaction costs for the lender and removed some of the information asymmetries that made it difficult to lend. This innovation required some tinkering, some exploration, and a great deal of risk. In its early stages, the microcredit movement was not financially sustainable; it required a subsidy. For that reason, donors and nongovernmental organizations (NGOs) played a central role in building the movement.

Today, the business of providing microcredit has reached a stage of relative maturity. Significantly, for-profit companies and investors are now shifting into this space, and in some cases nonprofit organizations have even converted to for-profit entities. In Mexico, for example, Compartamos Banco started as a nonprofit organization and then converted to a for-profit operation; it was the first micro-lender to become a publicly traded company. SKS Microfinance, based in India, followed a similar path.

As lenders have made that shift, at least one NGO—Unitus—has disengaged from the microcredit field in order to focus on needs that the for-profit sector isn't serving. Joseph Grenny, a cofounder of the organization, explains that decision: "Unitus found that for-profit microcredit providers in a robust competitive marketplace tended to provide better loan products to the poor at better interest rates than NGOs. And yet in some regions of the world that robust competitive marketplace could not develop because inefficient NGOs who dominated the sector operated with grant capital.... In the financial inclusion sector grant funds at some point become an obstacle to progress rather than an accelerator of change."¹ Grenny may or may not be correct in suggesting that nonprofits pose an "obstacle to progress." What matters, though, is the perception that led a large NGO like Unitus to direct its operations away from microcredit and into other activities.

The time has come, in short, to take stock of the broad movement to expand access to financial services among the poor. What's next for that movement—the movement for financial inclusion? Where should donors and NGOs who care about financial inclusion now turn their attention?

It's not as though advances in the microcredit industry have solved the problems that result from a lack of financial inclusion. Recently, there has been a flurry of randomized trials designed to measure the impact of microcredit projects, and these studies have shown strikingly consistent results: Microcredit is having a positive yet relatively modest impact on people's lives. Across a set of studies that cover eight countries (Bosnia-Herzegovina,² Ethiopia,³ India,⁴ Mexico,⁵ Mongolia,⁶ Morocco,⁷ Philippines,⁸ and South Africa⁹), researchers found only one instance (South Africa) in which microcredit borrowers experienced a large increase in income. (In that case, significantly, the lender departed from the standard model of targeting entrepreneurs and instead targeted consumers.) In

DEAN KARLAN is professor of economics at Yale University and president and founder of Innovations for Poverty Action.

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addition, the programs covered by these studies produced few if any downstream impacts in areas such as health, education, and female empowerment. These studies show that although microcredit rarely leads to an increase in aggregate income or long-term consumption, it can help borrowers cope with risks and shocks by improving their ability to smooth consumption and retain assets. There is also some evidence (although it is not overwhelming) that microcredit initiatives can lead to greater investment in enterprise. Those positive outcomes are important, but they are hardly transformative in scope or scale.

In light of these findings, and in light of the move by for-profit companies to provide microcredit services in more and more markets, is there a role for nonprofits in the field of financial inclusion? To be more specific: Is there a place for subsidies in that field? Donors and NGOs, after all, should not subsidize an activity when investor money is readily available to serve that purpose. They should, however, provide subsidies when there is an opportunity to close a gap created by market failure.

Broadly speaking, there are three important roles that nonprofits can play in the financial inclusion arena—roles that do require subsidy: reaching populations that for-profit institutions have little or no incentive to target; building trust between those institutions and the populations they serve; and promoting innovation. With the first of those roles, subsidies may be necessary over a long term. With the second and third roles, subsidies will ideally be necessary only until the relevant financial markets become fully developed.

SERVING THE UNPROFITABLE

When a service provides a vital social benefit, there may be a justification for subsidizing that service. For many years, that was indeed the justification for traditional microcredit operations. But as business processes improved, and as costs and risks decreased, the need for subsidies became less crucial in many segments of the microcredit market. Even so, there is a strong case for using subsidies to provide financial services to underserved groups that for-profit institutions do not yet target. In particular, certain populations are simply *too rural*, *too poor*, or *too young* for those institutions.

Too Rural | Rural areas suffer from being not only poorer than urban areas, but also more costly for financial institutions to reach. The high fixed costs of serving clients in those areas often makes for-profit microcredit operations unsustainable. Furthermore, even in markets where formal microcredit is present, many are wary of borrowing from a microlender. The reasons for their reluctance include concern about price, fear of reprisal in the case of default, and discomfort with the formality of institutional lenders.

In response to these challenges, NGOs such as CARE,

Catholic Relief Services, Freedom from Hunger, Oxfam, and Plan International have begun to promote a mechanism of financial inclusion—sometimes called “savings-led microfinance”—that focuses on creating community savings groups. NGO field officers present the savings group model to locals at a public meeting and invite attendees to form groups. Although there are many types of savings groups, each type follows a similar structure: About 10 to 30 people come together to make a weekly contribution to a shared pot of savings. Rotating savings and credit associations designate one member of the group to receive the weekly group contribution as a loan, which the member then repays in weekly installments. Accumulating savings and credit associations, meanwhile, collect money into a common fund, and members who need credit can then draw from it.

The theory behind savings groups is multifaceted. They act as a communal commitment device, in which people make a pledge to save and then rely on their peers to help make sure that they do so. That device may help them overcome personal temptation and money management challenges, or it may help them keep a commitment to save in the face of pressure from spouses or family members. The tight social bonds created within these savings groups also help to ensure loan repayment; in effect, group members pledge their social collateral to obtain a loan.¹⁰

Participants pay interest on their loans, but because they also function essentially as co-owners of a bank, they get back part of the interest that they and other group members pay into a common pot. All paid interest, therefore, remains within their community as

earned income. The savings group approach has other advantages. It requires no initial outside capital, and it allows for a smooth transition of banking operations to a for-profit financial institution once a savings group becomes large enough to be profitable. (In several African countries, for instance, savings groups have undergone exactly this type of transition in partnership with Barclays Bank. In Tanzania, similarly, Plan Tanzania launched savings groups that now have links to formal accounts at the National Microfinance Bank.) For that reason, and because the setup costs for a savings group are fairly small, this model is relatively easy to scale up.

There are important limitations to the savings group model. Benefits have to accrue without any infusion of capital, and it may take considerable time for people to accumulate enough savings to make a noticeable difference in household income or consumption. Those who participate in savings groups, moreover, are not necessarily the poorest members of their community. In one study, conducted in Mali, researchers found that more-connected women in a village were more likely than others to participate in a savings group.¹¹

Innovations for Poverty Action (IPA) has conducted randomized trials of savings group interventions in four countries (Ghana, Malawi, Mali, and Uganda). Overall, these studies have shown modest but positive impacts.¹² (See “Savings Grace” below.)

Too Poor | For many years, the microcredit movement has aimed to help the poor build sustainable livelihoods through microenterprise, cash-crop farming, and the like. Yet some people are essentially too poor to access microcredit. In some cases, microcredit institutions require a borrower to have an existing source of income before they

will extend a loan. Members of a lending group might not perceive a would-be borrower as credit-worthy. Sometimes people are simply unwilling to accept the risk or the price of the loan. A microloan, moreover, will most likely not benefit someone who is too unhealthy to work, or someone who does not take in enough calories to maintain a livelihood. In these cases, a subsidized program may be necessary.

Consider the Ultra Poor Graduation Model, a global initiative launched by the Consultative Group to Assist the Poor and the Ford Foundation. Graduation Model programs provide beneficiaries with a holistic set of services that includes livelihood skills training, productive asset transfers, consumption support, access to savings opportunities, frequent monitoring in the form of weekly visits, and, in some cases, health information or health care. The goal of the Graduation Model is to

Savings Grace

In Mali, a consortium that includes Plan International, Oxfam, and Freedom from Hunger (FFH) has implemented savings group programs in certain rural areas of the country. Over a three-year period, Innovations for Poverty Action (IPA) conducted a randomized evaluation of one such program—a program that covered 500 villages located in parts of central Mali that are too remote to support formal financial institutions.

The program uses the model of an accumulating savings and credit association: Members take out loans from a shared fund into which each of them contributes. They rely on technical support from an NGO, but they are fully responsible for managing the fund. They make decisions on who will receive a loan, and they set the terms and conditions of each loan. The group can offer flexible payment options to borrowers—for example, by allowing a member who is sick to forgo payment for a week. At the end of the yearly savings cycle, members receive lump-sum payouts from the fund.

For the randomized trial, which IPA conducted in conjunction with FFH and Oxfam, IPA measured outcomes that involved variables such as access to finance, economic activity, food security, consumption smoothing, social capital, and intra-household bargaining power. The NGOs promoted the savings groups in 209 of the 500 villages and did not promote them in the remaining villages. IPA researchers conducted several household surveys to collect information on 6,000 households in all.

The study yielded mixed results. Even three years after the start of the intervention, there was little evidence of increased investment in business or agriculture and no evidence of increased investments in education, in health or health expenditures, in women's bargaining power, or in levels of community involvement. In certain measures that reflect levels of financial inclusion, however, the results were more promising: In treatment villages, households increased their total savings and livestock holdings, and they enjoyed higher levels of food security. In particular, they experienced smoother patterns of food consumption over the course of a year.

The bottom line is simple: By setting up savings groups, NGOs can make modest but important improvements in the lives of the poor, and they can do so at low cost.

enable beneficiaries to form an asset base and to become engaged in sustainable income-generating activities within a two-year period.

IPA and the MIT Jameel Poverty Action Lab have led randomized trials in seven countries (Ethiopia, Ghana, Honduras, India, Pakistan, Peru, and Yemen) where Graduation Model programs are under way. Preliminary results show that these programs cause an increase in household income and in consumption—food consumption, in particular. Overall, these results show consistent and large positive impacts, even after allowing for the high cost of program implementation.

Graduation Model programs, to be sure, offer far more than “financial inclusion.” But I cite them as a potential model for NGOs in the financial inclusion field because they require subsidies—something that NGOs are, of course, built to provide—and because they achieve what many NGOs in that field have been trying to achieve with microcredit: They help the ultra-poor escape poverty through the development of income-generating activities.

Too Young | For regulatory reasons, and sometimes for business reasons, young people are another group that the for-profit sector often fails to reach. Those under the age of 18 are typically unable to open bank accounts, and even when they have a legal right to do so, the business case for banks to provide that service is less than clear. In some markets, financial institutions target young people in an attempt to build brand loyalty, but that is not a common practice in the developing world. To fill this gap, many NGOs now run saving and financial education programs aimed at this population. Evaluations of these programs have shown promising results.

Super Savers, for example, is a program implemented by the Private Education Development Network in Uganda. The program, which provides primary school students with a safe way to save money, was the subject of a randomized trial conducted by IPA. In the study, researchers assessed the impact of various payout arrangements. In one variation, students who saved money within the program received cash payouts, but they did so in circumstances that effectively “nudged” them to buy school supplies with their cash. (The supplies were available for sale at the same time and in the same place where they could make withdrawals from their accounts.) In a second variation, students received their payout in the more restrictive form of a voucher that required them to make an education-related purchase. Students in a third group served as a control. In addition, a random half of each treatment group received a “parental outreach” sub-treatment in which the students’ parents learned about the program. The results were as follows:

- Students in the cash payout group saved more within the program than those in the voucher group.
- Students in the cash payout group who also received the parental outreach sub-treatment bought more school supplies than both those in the voucher payout group and those in the control group.
- Students in the cash payout group had higher test scores than both those in the voucher payout group and those in the control group.

These short-term findings suggest that saving at school can help young people build good habits and that those habits can affect educational outcomes. They also suggest that a less restrictive arrangement can be more effective than one that is highly restrictive.

Longer-term results will shed light on whether programs of this kind instill financial habits that last into adulthood. In any event, this intervention offers a clear example of an effort to deal with market failure: It is unlikely to pay off until the children who participate in it become adults, and they (or their parents) may be unwilling to pay a sufficiently high price for this service. Banks, of course, cannot charge the future adults who will benefit from the service. When the benefits of a program lie far in the future and when future beneficiaries are not in a position to cover the current costs of the program, the case for subsidizing those costs is fairly strong.

BUILDING TRUST

Several trust-based market failures exist that often prevent consumers and firms from coming together to complete a useful transaction: The two parties may have a perfectly good exchange to make, but one of them does not believe that it can rely on the other.

We can see evidence of this problem in non-financial situations. In Uganda, IPA collaborated with a for-profit firm and a nonprofit organization to conduct a randomized test that functioned essentially as a horse race: Using a single team of marketing agents, IPA coordinated a door-to-door sales effort that involved selling medicines, and researchers randomized whether on a given day those agents represented the nonprofit or the for-profit firm.¹³ By designing the test this way, IPA was able to hold constant the training of the agents, and to ask simply whether customers were more likely to buy a product from a nonprofit than from a for-profit company, or vice versa. IPA also randomized whether the product being sold was well known (Panadol, a pain reliever) or not (Zincaid, a product that helps improve water quality). The results were striking: For the well-known product, there was no difference in the purchase rate. The marketers, when wearing shirts emblazoned with the logo of the for-profit firm, sold that product to 78 percent of households; when they wore a shirt with the nonprofit logo, they sold the product to 79 percent of households. For the unfamiliar product, the difference in purchase rate was large and significant—31 percent (when agents represented the for-profit firm) versus 49 percent (when they represented the nonprofit).

In the financial inclusion arena, trust problems become manifest in several ways. Households will not save if they do not trust a bank to engage in prudent practices, or if they worry that their savings might be unavailable for withdrawal. People will not borrow if they think that a lender is not forthright about the full cost of a loan, or if they fear that the lender will use extreme measures—such as public shame or physical violence—to collect a debt. Farmers will not insure their crop if they do not trust an insurance company to pay out when they submit a claim.

A randomized evaluation of a rainfall insurance program in the Northern region of Ghana demonstrated the importance of trust in marketing a financial product.¹⁴ In the first year of the program, researchers offered farmers either free or subsidized rainfall insurance. Then in the second year, researchers observed whether the first-year experience affected farmers’ decision on whether to buy insurance. (Each farmer was offered insurance at one of several randomized prices.) A clear pattern emerged: Farmers who received an insurance payout (that is, after experiencing bad rainfall) were more

likely than farmers in a control group to buy insurance the following year. But farmers who did not receive a payout (that is, because they experienced a normal level of rainfall) were less likely than farmers in the control group to buy insurance the following year. What's more, in cases where more people in a farmer's social network received a payout, the farmer was more likely to buy insurance the following year. The implication is fairly stark: To these farmers, the lack of a payout actually had a worse effect on their willingness to trust than having no experience with the product at all.

Nonprofits have the potential to play a critical role in solving this problem of trust. People may find them to be more credible, and more likely to be acting in clients' interests, than a for-profit microfinance institution (MFI). They are in a position to provide honest information on which MFIs are most trustworthy and on which products are most suitable to consumers. They might, therefore, play the role of "verifier and endorser" on behalf of particular MFIs. Going a step further, an NGO might establish guidelines for lenders, monitor their activities, and certify whether they engage in responsible practices: Are there hidden fees? What methods does a lender use to collect bad debts? Does the lender present financing costs in a transparent and usable fashion? (See "Smart Move" at right.)

The endorsement or certification of MFIs that provide high-quality products may be the simplest and most cost-effective way to overcome the trust gap. But NGOs can also build trust more actively by co-marketing new products alongside for-profit firms. Collaborative marketing of products has the benefit not only of increasing overall trust in an MFI, but also of aligning consumers with products that feature the best terms for their purposes.

Consider again the example of rainfall insurance. In India, researchers tested several methods to increase the purchase rate of that product.¹⁵ Before the start of monsoon season, a trained insurance educator visited households to present information on the features of a certain insurance product, and households were given the option to buy it. In one test, researchers sought to find out whether endorsement by a trusted person would improve the purchase rate. BASIX, a microfinance institution, sent out agents to accompany and endorse a certain number of insurance educators during household visits. The agents were locals who had worked closely with people in their village on a series of financial products. The

test yielded some telling results: Demand for insurance was 36 percent higher in households served by an endorsed insurance educator than in those served by a non-endorsed educator. Another finding showed that demand for insurance was significantly higher in villages where visits by endorsed educators had taken place.

PROMOTING INNOVATION

The nonprofit organizations that led the microcredit movement ought to be proud of what they have achieved. The fact that for-profit companies have mimicked them, and in some cases pushed them aside, is a testament to their success. They innovated, and then for-profits imitated. So one crucial role that nonprofits can play is this: Keep innovating. Focus on developing services that improve the financial opportunities available to clients—in particular, services that may eventually cease to require a subsidy.

Why not rely on for-profit companies to spur innovation in the financial inclusion arena? After all, when for-profit firms expect to reap windfall profits, they have shown themselves to be very willing to spend large quantities of money on high-risk innovations. (Take pharmaceutical research, for example.) For various reasons, however, that logic may not apply to the field of financial inclusion.

Smart Move

In recent years, people in the nonprofit world have started to create formal, sector-wide efforts to fill the trust gap that continues to hinder the drive toward greater financial inclusion. In 2008, the Center for Financial Inclusion (a unit of the nonprofit Accion International) convened industry leaders from around the world to launch the Smart Campaign, an initiative to establish a set of "client protection principles" and to embed those principles into the microfinance industry. The seven principles cover the following topics: appropriate product design and delivery, prevention of over-indebtedness, transparency, responsible pricing, fair and respectful treatment of clients, privacy of client data, and mechanisms for complaint resolution.

In its early years, the campaign worked to raise awareness of client protection among microfinance institutions (MFIs), investors, donors, and other stakeholders and to encourage those groups to improve their practices. The campaign also created a set of indicators against which institutions could assess their performance, and it developed training tools to address specific weaknesses.

Over time, however, Smart Campaign leaders realized that self-reporting and self-policing alone would not instill confidence in clients that MFIs were actually following the client protection principles. In 2010, therefore, the campaign began work on a Client Protection Certification program. Through a series of pilots, the campaign tested and finalized a certification method and a list of client protection standards. The full program launched in January 2013, and the campaign has licensed four specialized microfinance rating agencies (M-CRIL, Microfinanza Rating, MicroRate, and Planet Rating) to conduct certification missions. So far, nine MFIs have become Client Protection Certified, and dozens more are undergoing evaluation to achieve that status.

Information on certification status has the potential to inform a wide range of industry practices, including investors' decisions about which MFIs to support and regulators' efforts to address client protection issues. Many industry stakeholders—including investors like Deutsche Bank and Oikocredit, and international networks like the Microfinance CEO Working Group—have publicly committed themselves to encouraging affiliated MFIs to become Client Protection Certified. The long-run vision of the Smart Campaign is to create a "trust mark" that microcredit clients can use in selecting their financial services provider.

Naturally, self-regulation involves many potential problems. MFIs, like any organization, have an incentive to misreport information on everything from their product design to their enforcement practices. Certification efforts like the Smart Campaign might change the behavior of lenders, or they might simply create another hurdle that MFIs must jump over in their quest for investment funds.

When all of the upside of an innovation is likely to accrue to clients, and not to a firm, the firm has little incentive to invest heavily in research and development. That is especially true in cases where it is difficult to reverse a change. If banks, for example, find that it is not profitable to offer credit with a delayed repayment schedule,¹⁶ or at lower interest rates,¹⁷ it may be difficult for them to revert to an earlier, more profitable practice.

Another reason that for-profit firms are unlikely to invest in this area is that the financial returns from a process innovation may be small or nonexistent. Patenting business process ideas is difficult, and for-profit companies must assume that other players in the financial services field will soon take up any profitable innovation—and will neutralize their profitability by doing so.

NGOs may be better suited to exploring such improvements. Their goal, after all, is not to reap financial profits, but to increase the welfare of a population. Nor do they have to worry that competitors might erode the returns on their investment. On the contrary, if other parties put them out of business by offering a similar product or service, they have a ready response: Mission accomplished! Rather than viewing an investment in innovation through the lens of “costs” and “expected returns,” NGOs need worry only about the opportunity cost of not using that money in some other way.

Here, I put forward two examples of potential innovation in financial inclusion: the use of equity in place of debt, and the use of flexible repayment schedules.

The practice of offering equity, rather than debt contracts, is one area of innovation that is ripe for exploration. In conservative Islamic regions of the world, the use of microcredit is often limited because many Muslims do not believe that the standard microfinance models are compliant with Sharia law. In response, people have begun to experiment with so-called “Islamic financial models,” which usually replace the tools of debt and interest with methods of leasing or selling assets. These models take various forms: Murabaha, which allows an asset to be sold in cash installments with an agreed-upon markup; Ijarah, in which users pay a monthly fee to lease an asset; and Musharaka, a partnership in which participants provide financing, time, or other resources to support a project and then share profits and losses. Evaluating these and other alternative ways for people to access capital is an excellent task for NGOs. In fact, some of these models might be applicable beyond the Islamic world. Limiting debt and focusing on equity, after all, could be an attractive option for other kinds of customers.¹⁸ Equity, for instance, provides a way for small business owners to invest in growth without having to repay a loan. But how can financial institutions make such models profitable enough to work on a large scale? By exploring such questions, NGOs can help to develop new financial services.

Experimenting with repayment schedules is another promising avenue of innovation. In corporate project finance, cash flows get matched: A firm that borrows money to build a factory typically does not start paying back principal until the factory has begun to generate revenue. This matching of inflows to outflows is not a standard practice in microcredit. Instead, MFIs typically require regular payments. Yet many MFI clients have highly variable incomes. So adding flexibility to repayment programs could decrease default

rates, increase an MFI’s potential client base, and increase the size of potential loans. Informal providers, such as moneylenders, already have the ability to implement this kind of flexibility. Their monitoring is so comprehensive that they can tell whether a borrower who misses a payment is likely to make it up later. MFIs could build a similar capability into microcredit products by (for example) providing clients with vouchers to present in lieu of payment.¹⁹

In a similar vein, introducing a more generous grace period early in the loan repayment cycle could help borrowers. Currently, most MFIs require repayment of a loan to start almost immediately. Because it often takes a while for business investments to generate a profit, strict repayment schedules may discourage profitable but risky investments. Could changing the structure of repayments generate more investment and higher long-term income?

To answer that question, a team of researchers ran a field experiment with a population of poor, urban borrowers in India.²⁰ Working with an NGO, the researchers increased the normal two-week grace period to two months for one group of clients and compared the results for that group with the results for clients who had to comply with the usual two-week repayment period. For clients in the treatment group (that is, those who had the longer grace period), the likelihood of starting a business was 4.5 percent, compared with 2 percent for clients in the control group. Three years later, weekly business profits for clients in the treatment group were 41 percent higher, and monthly household income was 19.5 percent greater, than they were for clients in the control group. Yet those improvements came at a cost. Default rates after one year were much higher for the treatment group (6.2 percent) than for the control group (1.7 percent).

Noting that clients were willing to pay more for the longer grace period, the researchers modeled lender profits in a world where clients could choose either option. Lenders, according to this analysis, could break even with the longer grace period if they charged an interest rate that was more than twice as high as the normal rate—but only if there was no change in the quality of clients. So the viability of this repayment model among for-profit institutions is unclear. There is a notable trade-off between increased revenue and increased risk. But further experimentation by NGOs could improve that equation by showing how to decrease default rates and how to make the strategy more cost-effective.

Efforts of that kind are already under way. Kiva, a nonprofit organization that allows people in the United States to lend money to microcredit institutions around the world, recently began a program called Kiva Labs. Through that program, donors can enable innovation in microlending by providing subsidies that encourage lenders to absorb additional risk. As a result, lenders are motivated to tinker—to find ways to alter their loan contracts so as to improve access to credit among the poor.

Naturally, not all innovation will work. For that reason, donors and NGOs need to commit themselves to rigorous testing of their efforts and to sharing what they learn from their failures as well as their successes.

THE CHANGING ROLE OF NONPROFITS

The nonprofit community cleared a path for private-sector institutions to provide financial services to the poor on a for-profit basis.

This achievement has created a conundrum: What is the next step for donors and nonprofits that view the advancement of financial inclusion as part of their mission? They could shift their focus entirely, by investing their resources in a field such as health or education. (They should, after all, direct those resources to activities that require a subsidy.) But that would be an unfortunate move. It would leave in place several market failures that persist with respect to providing financial services to the poor.

Here, I have outlined three roles that nonprofits can adopt to help mitigate those market failures. First, despite the expansive reach of the microcredit movement, there are many potential beneficiaries whom the industry has not yet reached. The too rural, the too poor, the too young—these groups make up important market segments from a social welfare perspective. Nonprofits may be able to resolve the cost issues that come with serving them. Then, as was the case with microcredit, for-profit firms are likely to enter these newly established markets.

Second, a lack of trust raises a large barrier to developing certain financial services markets. Nonprofits, insofar as people are inclined to trust them, can help people gain confidence in the products and services that financial firms provide.

Third, many of the products currently offered by the microcredit industry are rigid and formulaic, and for-profit firms are often unwilling to take on the risks associated with exploring new product options. That is particularly true when a novel offering is likely to benefit clients more than it does any given firm. Thirty years ago, the same limitation applied to the microcredit field, and nonprofits took the lead in figuring out how to make lending to the poor a sustainable business. They can and should continue the charge for innovation in this field.

Before nonprofits can play these roles successfully, they need to understand their larger role as advocates of financial inclusion. An understanding of that role starts with a recognition that nonprofits face a fundamental and intrinsic incentive problem. Compare their incentive structure with that of a for-profit firm. The latter type of organization has a straightforward mission: Earn profits. (Some businesses claim to have a “double bottom line,” but that designation does not lessen their need to make a profit.) If a firm is profitable, it will stay in business. But if the firm pursues a bad idea, or if it implements a good idea badly, it will lose money. Eventually, an unprofitable firm will cease to exist. With a nonprofit, by contrast, the ability to achieve a given mission is distinct from the ability to raise money. A nonprofit may be brilliant at designing and implementing programs but horrible at fundraising; in that case, it will go out of business. Or it may be brilliant at fundraising but horrible at designing and implementing programs; in that case, it will stay in business.

There are different ways to deal with this problem. Donors should demand accountability from their nonprofit grantees, and nonprofit managers should insist on program accountability as well. Ultimately, though, nonprofits must focus on playing a role that reflects their core strengths: In part by deploying subsidies, they can investigate whether a given model or approach actually works.

In the three areas of opportunity that I have discussed, the long-term aim of the movement for financial inclusion should be to transfer successful practices to the for-profit sector. The reason

is simple: Because of its incentive structure, the for-profit sector is well equipped to implement and sustain such practices on a large scale. But we are not yet at a point where for-profit firms can take responsibility for the entire field of financial inclusion. Many gaps remain within the financial services market. Nonprofits can work to figure out how best to fill those gaps, and ideally they will leave behind a clear trail of evidence from which others can learn. If they succeed in making financial exclusion a relic of the past—if one day they notice that for-profit firms have again entered their space and competed them out of business—then they will have achieved an essential part of their mission. ■

NOTES

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