THE ROLE OF THE FINANCIAL SECTOR IN POVERTY REDUCTION

BY

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Introduction

Poverty reduction has been receiving increasing global focus and the challenges are becoming more daunting. It is, however, encouraging to note that research findings and empirical evidence have shown that significant poverty reductions are possible and have, indeed, occurred in many developing countries. In particular, it has been established that growth and poverty reduction go hand-in-hand. For example, studies have revealed that the absolute number of people living in poverty has dropped in all the developing countries that have experienced sustained rapid economic growth over the past few decades. The relevant question is, what type of policies can influence growth and poverty reductions?

There is no doubt that the establishment of a stable macroeconomic environment is an important precondition towards poverty reduction. Moreover, policies should be designed to raise the level of investment in infrastructure and people in order to enhance income generating capacities of the rural areas, which account for nearly 63 percent of the world's poor, with the proportion as high as 90 percent in China and Bangladesh and between 65 and 90 percent in Sub-Saharan Africa, including Nigeria. Latin American countries are perhaps the exceptions where poverty is concentrated in urban centres.

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The objective of this paper is to examine the role and challenges facing the financial sector in providing the necessary financing on appropriate terms, volume and value, and in a timelymanner. The paper is divided into six sections; following this introductory part, the conceptual framework on the role of the financial sector in poverty reduction is outlined. In section three the experience of the role of the financial sector in fighting poverty is reviewed with specific emphasis on the role of banks in micro- credit delivery in section four. Section five examines future challenges of the sector while I make my concluding remarks in section six.

2. Conceptual Framework On The Role of The Financial Sector in Poverty Reduction

The literature on the role of the financial sector in poverty reduction is scanty, although there have been several case studies on how financial institutions in selected countries have designed programmes or introduced products to specifically target the poor in the society to enhance access to credit for productive activity and improvement in their economic well-being. Over the past two decades new approaches known collectively as MICRO FINANCE have emerged that apply sound economic principles in the provision of financial services to low income customers. Examples abound in countries like Bangladesh and Indonesia, which provide financial products that match the needs of low-income clients, using innovative collective monitoring to strengthen repayment performance and charging interest rates that cover operational costs.

It is important to underline the fact that easy access to credit is more beneficial to this category of borrowers than interest rate subsidy. Targeted public sector rural credit programmes, especially if they are subsidized, benefit the non-poor far more than the poor. The poor want credit that is available on acceptable terms and when they need it. However, there is a general consensus in the literature that access to credit by the poor is necessary but not sufficient to guarantee the success of micro-credit schemes. Participation of the poor in the whole process of identifying and managing community-based projects that respond to the priority needs of the poor is considered essential. This is critical to ensuring local commitments and sustainability. In fact, participation of the poor in the whole process is an integral part of the UNDP micro-credit strategy, which recognizes the social, cultural and financial considerations that are necessary for any successful scheme. Recent experiments with community-based credit programmes in which the poor actively participate in the making of lending decisions and, which are subject to peer accountability, have been successful in reaching the target group at reasonable cost.

Micro-credit support under the UNDP approach is anchored on a set of six key guiding principles, strategies and approaches. <u>First, is the adoption of people and community-centred participatory development approach</u> in which the community and group involvement and ownership is the basis for building a sustainable credit administration. This is done through:

* Working preferably with groups that have been in existence for a period of time with an established structure of governance and a savings culture through regular contributions of members that are designed to support self-help initiatives of the group or its members;
* Encouraging group-led initiatives with clear and simple business plans and group lending as against lending to individuals;
* Ensuring high repayment performance and cost recovery by the use of peer pressure and group solidarity;
* Mandatory contribution of up to 10-15% of the initial loan capital by the group, etc.

The second strategy is to <u>match the objectives of the scheme with the needs</u>, culture, values and aspirations of the group and community members while the third strategy focuses on <u>building real partnership among relevant government agencies, banks, NGOs, community based organizations [CBOs], UNDP and group beneficiaries in credit administration.</u> The fourth strategy of the UNDP scheme recognizes <u>the need for</u>

government/donor collaboration with banks as well as capacity building support to NGOs and CBOs that operate micro-finance institutions providing financial services to low income borrowers. The fifth strategy relates to the accessibility of the financial services that will be offered under the scheme while the final strategy is designed to achieve financial and operating self-sufficiency. This This final strategy is aimed at:-

* Establishing appropriate interest rate in line with what is obtainable elsewhere in the country.
* Ensuring high repayment rates of between 95-100%; and
* Encouraging savings mobilization and banking culture.

These strategies, if well articulated, usually guide the management of the scheme to recognize that strong leadership vision and sound professional management as well as commitment to poverty reduction, form the key to sustainable financial services.

Apart from the UNDP approach, the World Bank Group has also designed its own strategy to facilitate the availability of financial services to the poor. The World Bank through its financial sector network helps countries to strengthen their financial systems to grow their economies, restructure and modernize institutions, and respond to savings and financing needs of all people including the poor, by providing financing, policy research and advice, as well as technical support on several areas of the financial sector, including rural and micro-finance/small and medium enterprises [SMEs].

In the specific case of the rural and micro finance/SMEs, it has been observed that high level of poverty combined with slow economic growth in the formal sector have forced a large part of the developing world's population into self employment and informal activities. Thus, many of the World Bank Group's client governments place a high priority on developing their indigenous private sector to participate in and lead future growth. A related and equally pressing issue is raising the ability of the self-employed and rural poor to sustain the economic activities essential to their survival. A diversified financial sector capable of meeting the full range of demand for financial services, including informal and small businesses, is thus, needed to facilitate this objective. The related current challenge in small and medium scale enterprises [SMEs] development is to build on the success of micro finance, establishing good practices for SME financing and for the provision of non-financial services to SMEs.

A variety of financial institutions, worldwide, have found ways to make lending to the poor sustainable and to build on the fact that even the poor self-employed repay their loans seek savings opportunities. The challenge is to build capacity in the financial sector drawing on lessons from international best practices in micro credit/small enterprises and rural finance.

The objective of the World Bank group's strategy is to increase access to financial services of low-income households by addressing three principal areas:-

* Fundamental framework: the policy, legal and regulatory frameworks that allow innovative financial institutions to develop and operate effectively;
* Institution building: exposure to and training in best practices that banks and micro finance organizations need to expand their outreach and develop sustainable operations, along with performance based support for capacity building; and
- Innovative approaches: leasing, lending and other products that the World Bank Group can use to increase access to financial services.

1. The Nigerian Experience In Micro-Credit Financing

Successive governments in Nigeria have emphasized the need to address poverty in the country. For this purpose, a number of policies and programmes have been designed to meet the needs of the poor. Most of these programmes have micro-credit components covering some specific sectors as well as multi-sectoral interventions. These interventions have been rationalized on the grounds that because of the high risks and costs associated with these sectors and groups, the private sector, particularly the financial sector operators would not get involved in activities in these sectors or those associated with the poor in the society. Some of these programmes include: the Agricultural Development Programme (ADP), rural banking schemes and the establishment of specialized institutions and programmes, such as the Nigeria Agricultural and Cooperative Bank, Peoples Bank, Community Banks, the National Economic Reconstruction Fund (NERFUND), National Directorate of Employment (NDE), the Directorate of Food, Roads and Rural Infrastructure (DFFRI), Better Life for Rural Women as well as the Family Economic Advancement Programmes [FEAP]. It is important to note that non-governmental and community-based organizations have also operated various forms of credit schemes in the rural and low-income urban areas throughout the country.

These initiatives have, however, recorded limited success in reducing poverty. The problem with most of the government's micro-credit schemes is that, they were in many instances incompatible with the existing traditional savings and loans schemes operated by the local communities and are usually politicized. This may explain why most of the government-sponsored schemes did not achieve their primary objectives, including the reduction of poverty. It should, however, be acknowledged that many community-based organizations succeeded in meeting their set targets as well as achieving more favourable repayment rates on their scheme.

With particular reference to the financial sector, prior to the adoption of the Structural Adjustment Programme (SAP) in 1986, the Central Bank of Nigeria's monetary policy guideline made it mandatory for all commercial banks to open rural branches under the Rural Banking Scheme, to facilitate savings mobilization and extension of bank credit to the public. Moreover, commercial banks were mandated to extend a specified proportion of their total loans and advances to agriculture as well as small and medium scale enterprises.

These directives were expected to positively impact directly on the lives of rural dwellers and the poor in society by providing food and employment. In compliance with the directives on the Rural Banking Scheme, in appreciable number of rural bank branches were opened, which helped in promoting rural savings and expanding bank credit to the rural communities, albeit to a lesser extent.

Development Finance Institutions (DFIs)

Similarly, a number of development banks were established and their programmes targeted at the poor segment of the society. Most notable among the programmes designed to facilitate economic growth and development, and indirectly reduce poverty in Nigeria was the Nigerian Agricultural and Cooperative Bank (NACB), which was established to lend to agriculture, including to small-scale farmers, using cooperative societies as a channel of loan disbursement and repayment. The CBN contributed 40 percent of equities to NACB and stipulated that shortfall in commercial and merchant bank lending be transferred to the Bank for on-lending to the agricultural sector.

Under the Agricultural Credit Guarantee Scheme Fund (ACGSF), which represents another aspect of the micro-credit scheme, the CBN has made a notable impact in touching the lives of the poor segment of the society, who have directly benefited from the scheme. Between 1978 and 2000, guaranteed loans worth N2,768,716.90 million were granted for the development of the agricultural sector of the economy, which directly benefited the poor in the society (see table 1). Theestablishment of the Nigeria Bank for Commerce and Industries (NBCI) was inspired by the need to provide institutional financing to small borrowers engaged in commercial and industrial production but were not eligible to borrow from the Nigerian Industrial Development Bank (NIDB), which was established to cater for the need of bigger borrowers. The various development finance institutions made reasonable impact on the growth of the economy, although in some cases performances were below expectation. The probable reason why the efforts made in the financial sector to boost the economy and reduce the plight of the poor in the society during the period yielded marginal success was that the schemes lacked focus and were not properly targeted on the poor.

Peoples Banks of Nigeria.

Following the introduction of the SAP and the liberalization of the financial sector, a significant number of banks, became distressed while many of the healthy ones closed down their rural branches. Most of the rural dwellers lost the opportunity of saving as well as other privileges which these rural branches offered. To compound the problem almost all the development finance institutions whose programmes had, hitherto, helped to improve the lots of the poor started to experience distress. The Federal Government consequently established the People's Bank of Nigeria to target the poor at both the rural and urban areas: both rural and urban branches were opened to mobilize savings and advance credit to the poor. Between 1990 and 2000, Federal Government's subvention to the People's Bank of Nigeria amounted to N1,869.3 million while total credit advanced to the poor amounted to N3,490.5 million (see table 2).

Community Banks

During the same period, community banks were licensed to operate both in the rural and urban areas to complement the activities and programmes of people's Bank of Nigeria. Unlike the people's Bank, the community banks were community-based and entirely funded by the communities themselves, groups of people or cooperative societies. The community banks mobilized rural savings and granted credit to the communities where they are based. This helped to improve the lots of the poor by providing them loans and employment. For a period of 11 years (1991-2000), community banks gave out loans and advances amounting to #14,621 million, out of which agriculture and forestry got #4,083.90 million or 27.9 per cent, while manufacture and food processing got #1,656.60 million or 11.3 per cent (see table 3).

4. Micro-Credit Delivery By Commercial and Merchant Banks in Nigeria

Commercial and Merchant banks have been contributing to micro credit delivery in Nigeria by providing loans and advances to small and medium scale enterprises. However, they have not been able to address the needs of the rural poor, specifically because the traditional banking service provided by these banks and other formal financial institutions were not tailored to meet the needs of micro-enterprises as profitable entities. This may explain why in recent times, the share of their total credit to SMEs has declined drastically. The reason for this apathy to cater for the poor may result from the fact that the poor often cannot provide conventional collateral and the preference by banks to make large loans to avoid high cost of administering a large number of small loans. This has in turn created a gap in mobilizing savings from and advancing credit to low income earners. The financial institutions needed to fill this gap are either unavailable or inexperienced to cover the needs of the poor as similar institutions have done in India, Indonesia, Mexico, etc. The few that are available are constrained by socio-political factors, policy inconsistency and weak regulatory framework. The consequence is that they have been prevented from growing and developing financially sustainable operations. Poor infrastructure has also hindered productive activities in the rural areas.

All things considered, there is no doubt that the financial sector has played an important role in the provision of micro-credit and, thus, the reduction of poverty in Nigeria by providing subsidized credit to both the agricultural and small scale industrial sectors. These have helped to generate employment and output growth rate as well as improve per capita income in the rural communities. However, the contributions fall below the minimum required to reduce poverty on a sustainable basis. If the strategies adopted by the UNDP and World Bank, enumerated in section 2, are used as the standard measurement of micro finance in Nigeria, we may conclude that unsustainable financial services have been the major problem in Nigeria's micro-credit administration.

5. Future Challenges for the Financial Sector in Poverty Reduction

There is no doubt that micro finance plays an important role in the reduction of poverty in many developing countries that have experienced fast economic growth in Southeast Asia. The creativity and contributions if a large number of the poor who may not be formally employed are captured through the community based micro-finance strategies in those countries. Micro-finance activities, where well organized, are highly dynamic with strong profit margins and significant growth potential. There is, however, a number of problems associated with small unit enterprises sponsored under this micro-financing scheme. Such problems include: - lack of access to credit by the poor in the society, limited managerial and technical skills, which hinders the prospect of the scheme, and lack of information about marketing their products. The constraints listed above are some of the inherent problems in micro financing, which the financial sector would need to address.

Given the potential of micro-finance to alleviate poverty and stimulate economic growth in a poor developing country, it is necessary to develop a viable and responsive financial services strategy for the poor in Nigeria. One active way that has been used to attract commercial banks to low-income clients in some countries is through the use of financial intermediaries operating closer to the target clients. If there is strong emphasis on savings mobilization, micro-finance would effectively bring help to the low income people to increase and stabilize their income and assets. In this regard, the role of the financial sector in savings mobilization cannot be over-emphasized.

The absence of financial institutions in most rural communities in Nigeria has made the CBN's drive to enhance the cultivation of savings culture or habit among our rural populace ineffective. The rural communities and in particular, the low income group in the society have their own traditional machinery for mobilizing savings, and sometimes it would be beneficial to build on such tradition in operating these schemes. If the formal financial sector can tap into these traditional entities and be prepared to pay the appropriate interest rates, it would have succeeded in fulfilling its role as financial

Intermediaries and, thus, facilitate access to banking and other financial devices by the poor.

The recent initiative by banks to set aside 10 percent of their profits before tax for equity participation in small and medium scale industries is noteworthy, but would not likely fully address the financing problems of the rural sector. The main issue that needs to be vigorously addressed is how to mobilize savings for micro finance. The poor in the society have demonstrated tremendous capacity to use their limited access to financial services to improve themselves and what they need is an empowerment to do so. This can be done by developing a sound, innovative, autonomous and responsive financial intermediaries that are located very close to the target areas. Such financial intermediaries should be able to:

- Mobilize savings from rural communities and low income earners.
- Liaise with external bodies [e.g. government agencies,, UN/international agencies, commercial banks, etc.] to obtain funds;
- Provide other formal products and lending services targeted at the client;
- Provide social banking and other technical services to the poor such as project and business plan preparation, capacity building and providing market information;
- Coordinate loan recovery efforts and manage funds received from community groups using banks ; and
- Generate and manage a set of information system for record keeping, monitoring and evaluation.

There is need, therefore, to establish intermediary financial institutions to build sound and responsive banking services to the poor by improving their access to capital loan funds and technical assistance. To this end, micro-finance networks should be encouraged at the national level to provide the appropriate infrastructure for exchange of experience, performance standards and institutional development support. There is also the need for a mechanism to encourage linkages between the intermediary finance and institutions, commercial banks, development banks, etc. We need to evolve a comprehensive guideline for the monitoring and evaluation of micro-credit activities, which will integrate various approaches in such a manner as to reflect the cultural, social and economic needs of the people, taking cognizance of the past experiences.

In addition to the above proposals, the monetary authorities can contribute significantly to reducing poverty in Nigeria through improvements in the macroeconomic environment and ensuring the soundness and stability of the financial system. With regard to the macro economic policy environment, the CBN has an important role by ensuring that price stability remains its primary policy objective. This is important because in a macroeconomic environment characterized by high inflation and exchange rate instability, it is the poor that are the most vulnerable group in the society that suffer most and bear the brunt of the instability. This is because they do not hold or have access to assets that they could use as hedges. Thus, monetary policy that guarantees medium to long-term price stability would protect the poor, facilitate economic growth and, hence, indirectly contribute to reducing poverty in the country.

A sound, stable and efficient financial sector is necessary for the attainment of the main macroeconomic objectives, including sustainable output and employment growth. An efficient financial sector improves the demand for money and, therefore, the process of physical capital accumulation, which promotes economic growth, a prerequisite for poverty reduction. Furthermore, interest rates that are positive in real terms would contribute to enhancing financial savings, viable investments and efficiency in resource allocation. In the special case of the low income and poor groups, a low interest rate regime could be beneficial to them, but only in an environment of low and stable inflation, which reinforces the need for price stability as the main objective of monetary policy. Thus, the financial sector has a major role to play in poverty reduction by bringing down interest rates to affordable levels for the poor.

6. Conclusion:

The paper addressed the economic dimension of poverty reduction, particularly the role of the financial sector in the reduction of poverty in Nigeria. It noted that both the Government and the financial sector have made efforts in micro-credit financing, which is a major constraint to the fight against poverty in Nigeria because, the poor do not have access to credit facilities. However, these efforts have yielded very little tangible results due to the strategies adopted in these micro-credit financing schemes. Although, the paper considers access to credit very necessary for a successful micro-credit scheme, it, however, stresses the need for the participation of those involved in the whole process of identifying and managing community- based projects, which respond to their needs. In other words, there is the need to pursue vigorously a sustainable human-centered development strategy capable of achieving a structural transformation of the economy. And efforts should be made to accent to job creation strategies and adopt an integrated approach to poverty reduction. It, therefore, advocates the adoption of UNDP strategies, which involve the adoption of people and community-centered participatory development approach, access to the financial services that will be offered under the scheme, building real partnership among relevant government agencies, banks, NGOs, community-based organizations, etc, and achieving financial and operating self sufficiency. The paper also stressed the need to develop viable and responsive financial services for the poor in Nigeria. It suggests attracting commercial banks to low income clients through the use of financial intermediaries operating closer to the target clients and noted that if there is a strong emphasis on savings mobilization, micro-finance is very effective in bringing help to the low income people to increase and stabilize their income and assets. Finally, the paper underscored the importance of the macroeconomic environment in any programme to alleviate poverty in Nigeria. In this regard, it underlined the role of CBN in pursuing price stability as the main objective of monetary policy as well as ensuring the soundness, stability and efficient functioning of the financial system and the benefits of a low interest rates regime to the most vulnerable groups in the society.

MICRO-FINANCE AS A STRATEGY OF POVERTY REDUCTION

- **Section 1.0**
- The present administration decided for best-reasons to give attention to poverty reduction:
- Poverty assessment study (1980-1996) Commissioned by World Bank indicated that about 2/3 of population were below the poverty line in 1996.
- Since then poverty had risen to an estimated poverty level of 70.6% in 1999 from 65.6% in 1996.
- The movement in the per capita household expenditure (pce) had been declining indicating poverty level, but rose by 10.8% in 1999 due to improved workers remuneration and the new taxable income bands to enhance purchasing power of the citizenry.
- The paper is structured into 5 sections with section 1 being the introduction, section 2 conceptual framework and country experiences. Section 3, efforts put in place in Nigeria and the multilateral institutions, section 4 offers the micro-finance models and principles supporting the model for Nigeria. Section 5 concludes the paper

SECTION 2.0

- **Conceptual Framework**
- Conceptually understanding how to alleviate poverty is central to development economies.
- Programs that provide credit and build human capital try to eliminate the causes of poverty.

- Timothy Besley (1997) two disparate approaches to poverty program design:
- (i) **Technocratic** (Economist), and (ii) **Institutional.**
- **Technocratic approach** associated with economist and targeting poor (directing resources to people with the greatest need).
- **Institutional approach** (non-economist) social/welfare which have failed due to incompetence / corruption. / diversion.
- The gulf between the two is the role of NGOs.
- **<u>The Transfers Concept</u>**
- The most commonly accepted model of transfers is the cost-minimizing approach of transfers to the poor.
- The model view society as composed of those who make transfers (the rich) and those who receive them (the poor).
- Transfers can perform two distinct roles – first as collateral and second as a way of improving the operation of credit markets.

- **<u>Country experiences</u>**
- There are various breakthroughs in the last decade that have made micro-finance program an imperative to alleviating poverty.
- First and most important is the longstanding and fundamental assumptions about the bank ability of the poor. This has been overturned based on well-documented experiences in banking with the poor in a selection of developing countries.
- Second, a shift in thinking within the effort of credit delivery and savings to the poor to include low-income customers in the national financial systems (including non-bank financial institutions). What are the implications?

- Third is the development of new lending technologies that are effective (using full cost interest rates and high loan repayment rates).
- Micro- finance institutions have become financially sustainable (full financial sustainability is reached when administrative, loan loss, inflation and financial costs are covered entirely by revenues).
- New focus on mobilizing savings among the poor (for sustainable operations).
- **<u>Some Micro-Finance Models</u>**
- There are basically formed and informal models of purveying micro-credit to the poor.

- **<u>Informal Model</u>**
- Informal Model is built around group concept. The model had been largely successful, groups with commitment, Voluntary and Cohesive. (I) The Grammen Bank experience in Bangladesh. (ii) NGOs, (iii) Esusu
- **<u>Formal Model</u>**
- The formal micro-finance model is built around formal financial institutions. The model largely unsuccessful. The reasons were:
- Limited knowledge of the poor:
- No closer relationship between the formal and informal institutions.
- Credit need of the poor small and per client costs are high and expensive to reach groups of client.
- **Linkage Model**
- The framework for linking informal to the formal formed the basis for the
- breakthrough and paradigm shift.

- Nigerian Agricultural Cooperative and Rural Development Bank (NACRDB)
- Ghana framework registered collectors association in the bank (What are the obstacles and successes?).
- The linkage should be enhanced by designing policy to overcome the observed obstacles such as distrust, inadequate knowledge about informal agents and prejudice – creating risky environment for formal banks linking up with informal micro-credit activities.

- **Donors Model**
- UNDPs
- The Ekpuk (family) model

Section 3

- **Efforts At Micro-Credit Delivery to the poor**
- Several programs since early 1970 and strongly from 1986 ADPs, NDE, Better Life for Rural Dwellers, Family Support, DFRRI, Rural Banking ACGSF.
- **Problems** - most not relevant, urban structured from the standpoint of the realities of (who is the poor?) – understanding the poor
- Lending procedure tortuous process

- **Bilateral/Multilateral Institutions Efforts**
- Assisting countries to understand the poverty situation in developing economies .
- Provide Poverty Assessment Study as Strategy for debt concession HIPC initiative .
- **Core Principles** (country-driven, result-oriented comprehensive, partnership oriented).
- Key processing for Effective poverty Reduction Program
- Develop a comprehensive understanding of poverty and its determinants.

- Choose the mix of public actions that have the highest impact on poverty reduction.
- Select and track outcome indicators using appropriate framework.

Section 4

- **Micro-Finance Model for Nigeria Poverty Alleviation Strategy**
- From the Concept of Transfers (using fiscal operation) realistically the government should pursue a progressive micro-finance model.
- Assist the totality of the needs of those groups that will participate.
- Serve as seed capital
- Finance start ups
- Linked institutional framework
- Operations concentrated in rural areas and focus on micro-enterprises.
- Ensure working capital loans
- Do not include restrictions .
- Allow for guarantee that matches their capacities such as personal guarantees and peer pressure.
- Prioritize the process using the information on poverty assessment.

- **Principles For Effective Micro-Finance Institutions**
- Simplify services
- Offer small initial loans
- Offer short term loans
- Localize services, focus on scale
- Shorten turn around time
- Motivate repayment
- Recognize that the poor do save
- Charge full-cost interest rates.

Section 5

- **Conclusions**
- Looking ahead to the future of micro-finance programs in Nigeria several conclusions could be drawn.
- Significant room for improvement within the current programs using the established principles and best practices.
- The unique condition the country is in now to finance transfers through budgetary allocation – the treasury.
- Micro-finance could be run by other financial institutions in spite of the merger NACRDB.
- Training is key to effective/efficient program.
- Political stability flows from having more stakeholders participate in the resource endowment of the country for growth and sustainable development.