

innovations

TECHNOLOGY | GOVERNANCE | GLOBALIZATION

Special Edition for the World Economic Forum Annual Meeting 2009

Social Innovation in a Post-Crisis World

Lead Essays

Social Innovation in a Post-Crisis World Klaus Schwab & Hilde Schwab

Social Ventures as Learning Laboratories J. Gregory Dees

Macro Impact on Microfinance Roshaneh Zafar

A Bank as Courageous Investor Ellen Seidman & Ron Grzywinski

The Upside of the Downturn Peter Blom

Cases Authored by Innovators

Power Play Rory Stear and Kristine Pearson

Ending Dependency Cosmas Okoli

Empowering the Rural Poor to Develop Themselves Bunker Roy

Garden in the Desert Ibrahim and Helmy Abouleish

From Fear to Hope Karen Tse

Perspective on Policy

The Resilience Imperative Philip Auerswald and Debra van Opstal

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About *Innovations*

Innovations is about entrepreneurial solutions to global challenges.

The journal features cases authored by exceptional innovators; commentary and research from leading academics; and essays from globally recognized executives and political leaders. The journal is jointly hosted at George Mason University's School of Public Policy, Harvard's Kennedy School of Government, and MIT's Legatum Center for Development and Entrepreneurship.

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Macro Impact on Microfinance

Throughout 2008, Pakistan's economy shadowed the meltdown of the global financial system; however, certain elements of the economic set-up here have especially affected households at the bottom of the pyramid. Over the past year, the Pakistani economy has faced many challenges including a growing fiscal deficit, a plummeting exchange rate, and increased inflationary pressure caused by rising energy and commodity prices. The Sensitive Price Index (SPI), which measures a basket of goods related to food items, has been growing at an average rate of 31% this year, while energy prices have risen more than six-fold. According to the latest inflation monitor report from the State Bank of Pakistan (October 2008), the SPI will continue to increase, in contrast to the global decline in commodity, oil, and food prices. In Pakistan, prices of most food items, including wheat, pulses, rice, vegetable oil, and vegetables, continue to rise substantially. Wheat prices alone have contributed 15.9% to the SPI and will likely continue to exert this pressure in the coming months, given the devaluation of the rupee and Pakistan's growing reliance on food imports. Furthermore, the report tells us, inflation is having a regressive impact on low-income households.

The relentless increase in food prices has quickly eroded the purchasing power of low-income households, which tend to spend a large proportion of their income to meet their basic consumption needs. For example, Kashf Foundation research has shown that on average, low-income households are spending 66% of their household income on food. In other words, they are highly food dependent, and in the long run the rise in food prices can seriously damage their nutritional intake and in turn their health, thus perpetuating endemic poverty.

The current economic scenario creates a multidimensional dilemma for microfinance institutions (MFIs). MFIs traditionally provide financial services to the "unbanked," households that are not included in the documented and formal economy. Microfinance includes a broad range of demand-oriented services, including but not limited to credit, savings, insurance, and remittances. The sec-

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tor has evolved from a basic focus on micro-credit only to a focus on inclusive financial services, to enable low-income households to make better and more informed financial decisions.

The key question to ask is this: How are the growing economic crisis and the inflation in food prices, affecting microfinance operations, and how will that process continue? They are having at least four distinct impacts.

- The first is on the ability of low-income households to make payments on their existing loans, which could in turn damage the portfolio quality of outstanding loans.
- The second impact could be on the demand for loans: given the impact of inflation and the decline in the exchange rate, people will need larger loans to set up small businesses. Meanwhile, more and more households may drop below the poverty line, thus enhancing the overall demand for financial services.
- The third impact is related to the ability of MFIs to raise funds for lending in a very tight and illiquid financial environment; this could in turn limit the ability of MFIs to provide their clients with long-term and continuous access to financial services, thus negating the impact microfinance can have on poverty in the short run.
- The fourth impact occurs as rising food prices affect the ability of households to invest in the future of their families, as they have less ability to invest in nutritional intake, health care, schooling, etc. Traditionally, microfinance has improved the lives of clients' families, bringing them better nutrition, health care, and the chance for children to attend more years of school.

To understand the first impact, consider the case of Bank Rakyat Indonesia (BRI), a publicly-owned commercial bank with a large micro-loan segment, during the Far East financial crisis of 1997-98. During the height of the financial crisis in Indonesia, when many private and public financial institutions were being liquidated, the BRI's micro-loan portfolio remained viable, and it was able to ride out the storm. In fact only BRI's corporate lending segment was restructured, given its many non-performing corporate loans; it was then merged with other banks. It is well known that BRI's 3 million borrowers continued to repay their loans throughout the crisis; today BRI is rated among the highest-earning banks in Asia, with an ROE of 28%. The BRI example shows that, to some extent, microfinance clients are decoupled from the formal economy, given the nature of their businesses and their overall economic status.

In Pakistan, the portfolio quality for MFIs continues to be sound overall, with 3.1% of the portfolio at risk for the sector, compared to 2.1% for Asia as a whole. However, other aspects need to be considered to help MFIs manage the current crisis and to ensure that the portfolio quality remains strong. In times like this, it is important to remain prudent and to focus on ensuring long-term and transparent relationships with clients. Kashf has evolved a clear and strong code of consumer protection that focuses on three principles—truth in lending, non-abusive or non-

Coping Mechanism	Percentage of Clients
Eat less	78%
Cut back on other expenditures	56%
Take out a loan	42%
Work longer hours	19%
Start another business	16%
Pull children out of school to go to work	10%

Table 1. How Clients Cope with Food Inflation.

Source: Kashf Food Security Survey, August 2008.

coercive recovery practices, and customer care—in order to promote robust client-staff relationships. Moreover, being prudent means curtailing innovations in product lines and not offering new financial products right now. In fact, we had planned to scale up two new products in 2008: a home improvement loan and a mandatory health insurance scheme. Though both of these products were well received in a stable financial environment, we have rolled them back until the country’s economic situation improves.

To understand the second impact, Kashf Foundation recently conducted a study on the impact that food price inflation has had on our clients; the results are in Table 1 above. We found that microfinance clients are not only demanding larger loans to help sustain their businesses, but are also requesting more loans so they can establish more businesses per household as a mitigating step. The food price spike has forced many Kashf clients (99% of them women) to take on new jobs, in addition to running their own businesses, in order to contribute more to their family income. Sixteen percent of the clients we surveyed have even established a new business to increase cash flow. This trend will certainly increase the demand for loans.

Keeping these trends in view, Kashf has slightly increased its initial loan size, from \$125 to \$190, to account for the impact of inflation on the purchasing power of the rupee. Furthermore, we are looking at ways to bring down transactional costs for clients and are currently engaged in an extensive process of re-engineer-

ing to improve our product features and procedures and to make them more client friendly, while at the same time providing adequate risk-management tools.

The third impact, as mentioned earlier, results from the current lack of liquidity in the capital markets and the inability of MFIs to raise money from commercial sources. In the beginning of 2008, liquidity quickly dried up in the financial sector as the State Bank of Pakistan enacted a tight monetary policy. Unlike 2007, when the Foundation was able to raise \$32 million in the commercial market to meet its growing capital needs, in 2008 access to finance was highly constrained. In March 2008, therefore, Kashf decided to revise its target of reaching out to 550,000 clients by December 2008, aiming instead at 350,000. In addition to reducing our growth target, we established a higher cash reserve ratio to ensure that our institution would remain liquid and able to meet our refinancing needs at the end of the year.

Inflation was also affecting the cost of our operations: funds cost more and salaries rose, along with transportation and utility costs. Despite the pressure on its own-lending rate, the Foundation did not increase its interest rate to its clients; this did not seem politically prudent, given the highly inflationary environment. As a result, our financial viability has fallen, and our overall financial sustainability has suffered. In the long run, we will need to adjust the rates we charge our clients, but for the moment we have decided to continue with our previous pricing and plan to seek grant funding to enable us to manage the current financial deficit in 2009.

Previous impact assessments of Kashf Foundation have revealed that with sustained access to financial services, over 30% of microfinance clients are able to move above the poverty line within three years. In fact, repeated access to small loans has helped to build up the confidence of thousands of women and their families and has restored dignity and pride at the grassroots level.

Consider Salima, who has had to contend with a range of difficulties and traumas. Her husband was a drug addict, which made him extremely violent and abusive towards his family. Seven years ago Salima heard about Kashf Foundation and took out a loan of \$75, which she used to purchase cloth and stuffing materials to make children's toys. She was able to earn \$75 to \$100 per month from her first venture. She took out further loans to expand her business and was able to increase her returns rapidly. Today this has enabled her to send all her children to school, and her two elder sons have finished high school.

The success of Kashf Foundation's ground-breaking work in Pakistan can be seen in the story of Salima and its impact on the lives of its clients' children.

However, as our survey found, 79% of clients now eat significantly less than before the current inflationary trend began, and 29% reported that they had gone hungry for one to four days. A full 97% said their families were getting less nutrition, especially because they were eating fewer fruits and vegetables. As we all know, malnourishment and undernourishment lead to poorer health, lower productivity, and other problems. In the long run, this trend could have an impact on

Macro Impact on Microfinance

the overall financial performance of low-income households and could thus drive down the quality of the portfolio.

It is worth reflecting on the BRI case again to understand how microfinance can help sustain clients in this current economic crisis. During the financial crisis in Indonesia, a key reason for BRI's success was the 23 million low-income depositors who continued to save with the bank to manage uncertain future cash flows. With this purpose in mind, Kashf Foundation has recently sponsored the Kashf Microfinance Bank Limited, which will provide low-income households with the opportunity to open deposit accounts. Kashf Microfinance Bank's other sponsors include International Finance Corporation (IFC), Shore Cap International and the World Women Banking Equity Fund in the U.S., and Triodos Bank in the Netherlands. It is well known that societies that save are more likely to build strong economies. By providing low-income depositors with the opportunity to save and to borrow, both Kashf Foundation and Kashf Microfinance intend to promote "Prosperity with Dignity" all across Pakistan. Jointly, the two organizations will be able to provide financial services to over 1.5 million poor households by 2012.

Such is our goal, despite the world financial crisis.

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