The Rise of Microfinance: An Interpretation of the Issues and Concerns that Remain

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Historical Overview of Microfinance

- **Microcredit – issuance of small loans to the poor for entrepreneurial purposes**
- 16th Century: Pawn Shops – collateral based loans
- 18th Century: Irish Loan Fund System – non-collateral based loans
- 19th century
  - Financial Cooperatives – Germany
  - Indonesian People's Credit Banks
- 1950s – 1980s Development and Subsequent Failure of State Owned Development Banks
- 1970's associated with the formal birth of microcredit
  - Grameen Bank in Bangladesh – established by Professor Yunus
  - Accion International
  - FINCA
  - SEWA – Self-Employed Women's Association Bank – India
  - Bank Rakyat Indonesia (BRI)
  - Aga Khan Agency

Evolution of Microcredit to Microfinance

- 1990s: Evolution of Microcredit to Microfinance
- Microcredit began with the narrow focus of providing small business loans
- Focus expanded to include not only the issuance of small business loans, but:
  - accepting savings deposits
  - facilitating money transfers
  - issuing insurance
  - providing small consumer loans for such things as housing, education, household capital goods and other consumption activities.

Questions and Concerns to be Addressed

- is the microfinance revolution sustainable as a strategy for survival
- does microfinance generate economic growth and development comparable to other policy options
- can the microfinance movement that has thus far been fueled by subsidies eventually operate free of subsidization and, if so, what are the trade-offs that are likely to be incurred as a result
- should microfinance be merged with the formal financial sector and, if so, what is the path for convergence
- is provision of microcredit in and of itself sufficient to help move people out of poverty or should a broader and more holistic approach be implemented, one that encompasses business training and education, health care and health education, education for the children of loan recipients, in addition to the provision of small loans
- should poverty alleviation be the main goal of microfinance and the focus of impact studies

Questions and Concerns to be Addressed

- is microfinance the most efficient use of donor resources or would those resources yield a greater rate of return in the provision of other social goods and services such as education and health care or the construction of wells to access clean water, i.e.,
- are the poor best served by microfinace or by other means
- how are microfinance initiatives to be assessed and how are the economic and social impacts to be estimated
- will microfinance be able to serve the poorest poor in light of the relatively new focus of microfinance institutions on self-sufficiency and economic profit? There exists concern that resources are being or will be diverted away from other basic services – health care, education, potable water projects because of the current popularity of microfinance programs.
- Advocate/Practioner Issue with respect to raising funding

Goals of Microfinance: Economic and Social Justifications

1. Prepare clients for participation in the formal banking system
2. Poverty alleviation and economic investment – encouraging savings and investment

MFIs first and foremost have tended to target women - Why Women?

1. Evidence indicates that financing women has a greater impact on the household than financing men. This supports the recognition that women frequently undertake projects for the benefit of the entire family.
2. Women relative to men consistently exhibit higher payback rates.
3. Women have been historically largely excluded from access to financial capital through the formal banking system because of:

   a. Individual Barriers b. Economic Barriers c. Social/Cultural Barriers d. Political/Legal Barriers

Goals of Microfinance: Economic and Social Justifications

4. Microfinance, by definition, seeks to finance small, mostly self-employment entrepreneurial activities that are largely undertaken in the informal sector. Examination of informal sector participation reveals that women constitute the largest share of the nonagricultural labor force particularly in Africa

5. Because women’s access to credit is extremely limited, they are more likely to accept the less favorable terms offered by microfinance institutions: higher interest rates, small loans, frequent and immediate payback schedules, required training sessions, weekly meetings, and joint liability

Goals of Microfinance: Economic and Social Justifications

6. **Microfinance schemes have been celebrated for their ability to address social objectives.**

a. Way to improve the situation of women in developing countries who often face unequal access no only with respect to financial credit, but with respect to access to adequate health care, nutrition,and education.

b. Women are overrepresented among the poorest of the poor, tend to have lower literacy rates; higher mortality rates; are often paid less and work more; are responsible for both household and market production; are responsible for the educational and health needs of their children.

c. Empowerment of women and enable them to achieve self-agency

d. Increase a women's ability to impact household decisions by increasing her bargaining power.

e. access to networks and markets increase information acquisition and increase the female participant's well-being. This may spillover into a women's participation in other community roles – social and political.

Goals of Microfinance: Economic and Social Justifications

- Bottom-up approach as opposed to top down:

  a. reduce corruption compared to top down policies related to international aid and debt relief

  b. work through the market and utilize market signals avoiding the common disincentives that are created by more standard types of transfer programs

- **Capital Market Inefficiencies** – investment projects judged worthwhile – where the expected rate of return exceeds the opportunity cost of production – go unfunded

  a. Money lenders

  b. Lack of collateral and inability to access financial capital

  c. Discrimination

  d. Agency Problems

  e. Distribution

  f. Limited Liability, Moral Hazard and Adverse Selection

Models of Microfinance

- The Group Lending Model pioneered by the Grameen Bank
  Self-selection
  - Joint liability
  - No collateral
  - Relies on social contracts and social capital for group formation and enforcement of repayment
  - Average loan size is about $134 for a term of 1 year
  - Interest rate is below that needed to cover the costs – relies on subsidization

Models of Microfinance

- BancoSol Bolivia and Bank Rakyat Indonesia (BRI)
  - BancoSol – group lending; BRI – individual
  - Both are financially self-sustaining
  - Neither lend to the poorest poor
  - Average loan size is $900 for BancoSol and $1,000 for BRI
  - Nominal interest rates range from 32% - 51%
  - BancoSol – does not require collateral; BRI does
- Bank Kredit Desa (BKD)
  - Self-sufficient
  - Group lending model
  - Average loan size of $74 and repayment term of 10-12 weeks
  - Nominal interest rate of 55%
  - Does not require collateral, but has adopted a village level management structure

Models of Microfinance

- Village Banking
  - Serve a relatively poor, female client base
  - Group size of 30 – 50 members
  - Are set up as village financial institutions in partnership with local groups
  - The group receives an initial loan that it then lends out to its members. Initial loans may be as small as $50 and repayment over a four month term. Interest income is collected to cover administration costs and add to the base of loanable funds.
  - Repaymet of the initial loan is held in an external account
  - Subsequent loans to members are based upon the amount of savings deposits the borrower has accumulated. These savings deposits can be loaned out to group members and are held in an internal account which also includes net interest income.
  - The idea was that over time the funds in the external account could be withdrawn and the institution will become self-sufficient. Increased credit demands and slow rates of savings have slowed the road to self-sufficiency. Similar to group lending models, village banking also relies on peer pressure and local information.
  - Village banks are typically established in remote areas – rural Mali and Burkino Faso) with the focus on outreach as opposed to self-sufficiency and profitability.
  - Village banking serves a smaller percentage of clients than the group lending model.

Models of Microfinance

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◆ Monitoring and mentoring groups

- Do not require joint liability
- Provide mutual assistance and guidance by "the vetting of each member's loan fund activities" and through assistance if things do not go well for one a member of the group.
- Defaulters may be expelled from the group, but group members who pay are not in this model held responsible for those who did not.
- Reliance on social capital and social contracts foremost in this model

Remaining Issues and Concerns

- High repayment rates do not always translate into profits
- Future direction: Move from being a non-profit organization reliant on subsidies and donors to a for-profit, self-sustaining entity with an emphasis on cost efficiency and financial sustainability – this focus may favor large organizations that can exploit scale economies and reduce transaction costs. The concern is that a shift in prioritization to efficiency and profits will be inconsistent with the goals of poverty alleviation, self-agency and empowerment. Concern that the focus on profits will jeopardize long term organizational and client sustainability – long term sustainability requires both attention to developing the skills, earning capacity and empowerment which entail substantial cost in the short run
- MFIs that are breaking even (covering their opportunity costs) typically are not serving the poorest clients. Again, the question of whether self-sufficiency is consistent with the original stated goals of microfinance
- Financial viability is not necessarily enough to justify social impact although many studies focus on that factor

Remaining Issues and Concerns

- NGOs may choose social options that are unsustainable in finance (Dichter 1999). They may set low rates of interest on loans to the poor, may set an agenda that includes training in areas such as nutrition, literacy and female empowerment – pursuing a more holistic approach to poverty alleviation.

- The question remains: do credit and nonfinancial services have a synergistic relationship, i.e. debt collection is a long way from social work.

Remaining Issues and Concerns

Assessment:

- Studies to compare whether the social impacts of subsidies to microfinance institutions cannot be met more effectively and efficiently through other policy options
- There has been no systematic, cross-cultural comparative study of the ways in which microfinance programs contribute to women's empowerment. Initial study by Mayoux (1997) indicates the benefits to women are not automatic and cannot be assumed as such. Evaluations indicating increased access and high repayment levels and increased access infer that women have been positively impacted, but this may or may not be the case in terms of income-earning capacity, poverty and access to basic consumption goods such as education and health care.

Possible negative effects

- Women will work longer and harder with little if any long term increase in income
- Loans may be taken out by women and utilized by the men who set up enterprises for which women have little control but still suffer the burden of repaymetn
- Increased independence of women my lead men to withdraw their support entirely
- Concern that women may employ children in business rather than send them to school

Remaining Issues and Concerns

- Impact Assessment Studies do not provide clear evidence that microfinance moves people out of poverty (Zaman 1999) It is generally accepted that it improves household welfare through access to productive assets and helps empower the poor (Chu 1999; Hickson 1999)

Remaining Issues and Concerns

- Savings
  - Savings is a controversial part of microlending. It is recognized that savings is important and many programs include/require mandatory savings. Many group lending models require individuals to save a small amount before they become eligible for a loan
  - Internal savings may then be lent out usually at higher interest rate than the donor funded external account and after te group has experience – movement is always toward building sustainable institutions at rates of interest which cover donor costs – village banking model
  - Many MFIs do not have or require savings because savings facilities are costly. Offering deposit services is relatively expensive – high overhead costs arising from accounting and physical infrastructure required to safeguard and process deposits

Remaining Issues and Concerns

- Regulation
  - Most NGOs operate outside of banking regulations. There is an argument that regulation of these entities is needed to ensure the safety of the deposits – primarily for consumer protection measures.
  - Should not enforce interest rate caps – inhibit the efficiency of the market
  - Regulation is needed to ensure “transparency”.