# What's wrong and right with microfinance – missing an angle on responsible finance?

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## Abstract

Microfinance as the best way of tackling poverty is under attack. It has been accused of failing to help the poor, of treating its clients badly, of charging high interest rates and of encouraging poor people to take on excessive debt burdens. The authors examine these issues, and find that microfinance institutions (MFIs) can have significant positive impacts, including democratisation of banking services, provision of secure savings facilities for poor people, and social benefits, particularly for women. The paper looks at the way forward for microfinance, suggesting some changes that need to be implemented by MFIs, banking authorities and governments.

**Keywords:** microfinance, microfinance institutions, low-income households, poverty reduction, Grameen Bank, India, Bangladesh

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## Introduction

Microfinance, once hailed as the best way to tackle poverty, is under attack!! The paradox is that the discussions on the downturn start in South Asia, where microfinance began and has flourished since the 1970s. In Bangladesh, often seen as the heartland of microfinance, the Grameen Bank is being criticised and its Nobel Laureate winning Founder-Director Mohammad Yunus has been removed from its Board in 2011. (Many people believe that Yunus deserved better treatment and the current events are an offshoot of his now abandoned intentions to engage with politics in 2007.) In 2010, in Andhra Pradesh – where one-third of India's $5.3 billion microfinance industry operates – a specific law to regulate the bullying debt recovery practices of some microfinance institutions (MFIs) has been enacted. Supposedly these practices led to a series of suicides. There has been an unexpected reversal in the narrative of microfinance, which has long been presented (particularly in the USA) as a 'development success'. Is this a temporary setback or is this the end of the road for microfinance?

## What's wrong?

Let's start with what's wrong about microfinance. First, there are several different models of service delivery within the microfinance industry and these have varied impacts on poor people. However, the claims of some microfinance institutions (MFIs) – and particularly their leaders – that microfinance reaches the 'poorest of the poor' and that all loans are taken for investment in microenterprises, are nonsense. The evidence from existing studies on the impact of microfinance on the poor provides inconclusive results, ranging from a substantial positive impact in Bangladesh (Khandekar, 2005) to an insignificant impact in Thailand (Coleman, 2006). Impacts are very varied and much of the research findings depend on the analytical methods used (Hulme 2000). In a recent study on India, loans for productive purposes were found to be more important for poverty reduction in rural than in urban areas (Imai, Arun and Annim, 2010). However, in urban areas, simple access to MFIs has greater average poverty-reducing effects than access to loans from MFIs for productive purposes. In brief, MFIs generally reach a combination of poor and non-poor people. Rarely do they reach the poorest (that is something for specialised programmes, such as BRAC's programme on 'Challenging the Frontiers of Poverty Reduction: Targeting the Ultra Poor' programme and *Kudumbshree* in Kerala (see Hulme and Moore, 2007; and Arun, Arun and Devi, 2011). Loans are commonly used for many different purposes – microenterprise, education and health expenses, repaying debt, on-lending, wedding celebrations and even dowry. Microfinance is fungible and that is probably good news – as clients know what their needs are better than middle-class bankers.

Second on the list of what's wrong with microfinance, is the charge that MFI field staff have treated clients badly – encouraging them to take on bigger and bigger loans and then disgracing indebted clients in public and threatening them psychologically and physically. In India, the politicians and newspapers claim this has led to scores of 'microfinance suicides'. Whether the link between being indebted to an MFI and committing suicide is as direct as the media infer is unclear. What is clear is that the performance indicators used by many MFIs put pressure on field staff to achieve financial targets and ignore their social performance – the ways in which they relate to clients. In a recent report on microfinance in India, Srinivasan (2011) has exposed the role of unofficial microfinance intermediaries in the sector, termed as ‘ring leaders’, who provide an easy entry for new MFIs setting up operations in an area. Most of these MFIs have concentrated around the same towns and rural hinterlands and often they serve the same set of households, encouraging multiple loans. One might see these cases merely as anecdotes of unhealthy competition in the sector, or, alternatively as something deeper and more structural. In part, this massive expansion of microfinance in India was the result of the global trend in the sector to attract more private capital (by 2015, expected to rise to US$20 billion). With such high levels of commercialisation, it is only to be expected that some staff are encouraged to push their financial performance (i.e. pushing out more and bigger loans) to the limit and, sometimes, beyond the limit. This is particularly likely to happen when bank staff are male, middle-class university graduates and clients are uneducated women, as is usually the case in South Asia. MFIs need to get their houses in order by overhauling their management systems and staff incentive structures and making it clear that bullying clients is always unacceptable. It is a basic reminder that as a rule of thumb it is bad loans and bad institutions that are responsible for delinquency, rather than ‘bad clients’. (It must also be noted that many of the recent entrants to microfinance in Andhra Pradesh were following an antiquated model of microfinance that is rigid and inflexible. They used the ‘Grameen Bank I’ model – that got the Grameen Bank into financial problems in the late 1990s.)

Third comes the charge that MFI interest rates on loans are too high for poor people to pay (SKS charged 24-25 percent per annum and Grameen Bank about 22 percent per annum until recently). While the rates in South Asia may sound quite high, they are significantly lower than microcredit loans in Southeast Asia, Africa and Latin America, where rates of 50 to 120 percent APR are common. Whether the interest rates are ‘too high’ depends on the choice of comparisons. Compared to the subsidised rates of government rural credit programmes – often nine percent to 12 percent APR – MFI rates are high. But government programmes are not viable banking models – they depend on continuous subsidies – and there is much evidence that these loans have gone to rural elites and the better-off, rather than the small farmers who are claimed to be beneficiaries. In Sri Lanka and India, agricultural loans have often gone to ‘farmers in long trousers’ – you don’t wear long trousers if you grow rice! If one compares the MFI interest rates with private moneylender rates, then often their rates are lower and sometimes much lower. According to MFIs, the cost includes the cost of the MFI borrowing from the banks, employing staff to travel to villages to make and collect payments, debt write-offs and leaves them with only a small margin. Our judgement, based on experience in Bangladesh, is that MFIs such as the Grameen Bank, BRAC and ASA charge fair rates of interest, given the relatively high administrative costs of microloans and microsavings. The intense competition between MFIs in Bangladesh means that interest rates are very much ‘market’ set.

The fourth problem, common to all lending operations, is that when the volume of microfinance lending expands rapidly, there may be an oversupply of credit encouraging clients to exceed the debt burden they can manage. This has been the situation in Andhra Pradesh, where the four big MFIs (and many smaller MFIs) were increasing client numbers at five to 10 percent per month in some districts in 2009. Large numbers of newly recruited and rapidly trained staff sought to achieve the financial targets they were set and the credit bubble burst. We suspect that Bangladesh may have been developing a smaller-scale credit bubble in the late 1990s. But this bubble never burst, as key players in the microfinance market (BRAC, ASA and others) appear to have spotted the problem and decided to consolidate, rather than expand, their loans portfolios. In addition, MFIs in Bangladesh have a tool that Indian MFIs are not allowed. Bangladeshi MFIs hold 'compulsory savings' from clients and, if a client gets into difficulties with repayments, these savings provide a buffer (for the MFI and client) to manage a potential default. (The Reserve Bank of India's [RBI's] policy of not allowing MFIs to hold savings raises the risk of client defaults and MFI collapse. In addition, the sudden availability of multiple loans for rural people in Southern India may have encouraged what Stuart Rutherford calls the 'diabetes effect'.[1] People who could never get loans (sugar) grab as many as they can without thinking and become highly indebted).

## What's right?

Turning the question around, we should also ask 'what's right about microfinance'? Most obviously MFIs increase the choices that millions of near-poor and poor people have to basic financial services – loans, savings and (increasingly) insurance. This can help them manage their finances more effectively, as long as they do not borrow excessively. Effective MFIs provide valuable services to clients and add to the vibrancy of local economic life by facilitating production, exchange and consumption. This is not transformational, as Professor Yunus has claimed – economic transformations require technological, redistributional, and social breakthroughs – but it is an improvement for many poor and low-income people. Moreover, the microfinance movement has contributed to 'democratising global financial markets through new contacts, organisations and technology' (Conning and Morduch, 2011). For instance, in Kenya, people already use a text message-based service, known as M-PESA, to transfer money electronically to other mobile users, an application which has reduced their transaction costs significantly. The entry of commercial banks into the microfinance sector is another example of growing recognition and viability of the concept. This is evident in the enhanced foreign investment in microfinance, including both debt and equity during the 2007-11 period, which has quadrupled to reach US$13 billion (Reille, Forster, and Rozas, 2011). External finance is to be welcomed, as long as it is sustainable and is not fuelling a credit bubble.

Second, although proponents of MFIs emphasise microloans, many MFI clients praise improved access to microsaving services. Going into debt often worries low-income households, and so many prefer to turn regular microsavings into 'lumps' of money that can be spent on major purchases or events (Rutherford, 2000). In a recent field experiment study in rural Kenya, the results suggest that households would save more if they had access to a broader array of saving devices, from simple safe boxes to commitment contracts (Dupas and Robinson, 2011). Institutions such as *Safe*Save in Bangladesh and SANASA in Sri Lanka have spearheaded innovative approaches to microsavings. But there is often a major obstacle to MFIs offering savings products – national banking authorities. In their enthusiasm to protect poor people from fraudulent savings programmes, central banks formulate regulations that stop MFIs from offering savings products. This protects people from fraudulent operators, but often means that they need to store savings at home or in 'petticoat banks' on their person. The risk of losing such cash is a disincentive to saving for many poor people.

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[1] Personal communication with David Hulme.

Finally come the social benefits of some MFI activities. South Asia's MFIs have focused on female clients, and many organise women into loan groups or village organisations. There are detailed academic debates about the benefits and problems of microfinance groups – for example, if a woman gets a loan and passes it on to her husband for his business, is she empowered or simply manipulated? Our judgement, based on 20 years of monitoring microfinance in Bangladesh, is that on balance, the impacts have been positive. There is strong evidence that MFI group members have higher levels of contraceptive use (Schuler and Hashemi, 1994) than non-members (because they have improved information and choice) and much anecdotal evidence that joining an MFI leads to women being more physically mobile and being permitted to visit more public spaces by their husbands.

## A way forward

So, is there a way forward? Yes, but it requires changes on the part of MFIs and of banking authorities and governments. MFIs and their leaders (and the trusts, foundations and aid donors that initiate and support them) need to be more honest and more humble about their products and their impacts. MFIs need to be much more transparent about their charges, terms and conditions – putting them on the walls of all branches in an easy-to-understand form or printing them in borrowers' passbooks (to his shame, Professor Yunus did not do this for the first 20 years of Grameen Bank). MFIs can introduce low-cost systems to reduce the likelihood of client abuse and improve social performance. Sinha (2006) has conceptualised and developed a systematic format for social rating and social performance reporting in the annual reports of MFIs. Belatedly, microfinance institutions across the world are showing more commitment to transparency and accountability, with a growing number publicly reporting systematically on the social benefits of their activities through initiatives such as the social performance reporting awards by the Microfinance Information Exchange.[2]

Second, MFIs need to moderate their claims about reaching the poorest and reducing poverty – unless they have rigorous and independent evaluations that provide credible evidence. Providing fair cost microfinancial services to people who have limited financial access is a good enough achievement – it does not have to be the poorest of the poor, as other services, such as cash transfers, are much more effective at helping them (Hanlon, Barrientos and Hulme, 2010).

Third, MFIs need to examine the ways in which they assess field staff performance and reform them, so that field staff understand that the quality of their relationships with clients is as important as achieving financial targets (if the MFI proclaims a social mission). If they are really clever, they can recruit different types of staff. *Safe*Save in Bangladesh employs female slum-dwellers to be 'collectors' in the settlements where they live. They have detailed knowledge of their clients (which helps the banking side) and, as neighbours, they treat their clients with respect. As one collector, Sharifa, told David Hulme: 'I live here and I am not going to do things that upset people'.

Changes also need to be made by the agencies that regulate MFIs. They need to be cautious about setting interest rate ceilings on microloans as, if these are set too low, this will kill off MFIs

[2] See http://www.cgap.org/p/site/c/template.rc/1.26.12224/ (accessed 22 July 2011) for more details on this.

and reduce the financial service choices available to near-poor and poor people (Hulme and Arun, 2009). In addition, there is a need to amend banking regulations in many countries, so that well-managed MFIs can offer more savings services to their clients. As study after study shows, people on low incomes value access to secure savings service as much, and often more, than access to loans (Hulme and Mosley, 1996; Collins, Morduch, Rutherford and Ruthven, 2009). Furthermore, recent empirical evidence from Sri Lanka shows that households' probability of participating in microfinancial services increases with rising self-perception towards risk (Arun and Bendig, 2010). It is plausible that combinations of different financial products play a key role and provide a diversified portfolio of coping mechanism for individuals. However, the nature and role of regulatory practices often blocks the creation of new financial products.

Unfortunately, in many countries, governments have been lackadaisical in regulating microfinance institutions, and MFIs have subsequently developed inappropriate practices in the sector (Arun, 2005). For instance, in India, a draft on the regulation of microfinance was presented to Parliament in 2007. However, it was not treated as a priority (nor approved) and so the debacle in Andhra Pradesh necessitated the RBI to hurriedly initiate a committee to review the crucial governance issues in the sector. The Malegam Committee report submitted in 2011 tries to find a balance between the extremes on regulation (laissez-faire versus centralised control) and decided that all bank loans to microfinance institutions, including non-banking financial companies working as microfinance institutions, would be treated as priority sector lending. The report has also suggested a cap on interest rates and supported the need for a nationwide regulatory regime in the sector. Following this, the government has placed a new draft, the Microfinance Institutions (Development and Regulation) Bill 2011, on its website for wide discussion. One significant feature of the draft version is the role of RBI as the primary authority in overseeing the sector in terms of its supervisory powers over the institutions carrying on microfinance activity, in an effort to discourage state-level legislation, such as the Act in Andhra Pradesh. Although there is an industry-wide concern on the possible dual regulation from the RBI and the state government, there is huge public support towards the state-level legislations, due to the unethical practices in the sector. Sadly, the bill does not capture the range of issues addressed in the Malegam Committee report and does not fully answer the specifics for a responsive regulatory framework to support the sustainable delivery of diversified microfinancial services, and least to protect the clients from unethical practices.

Perhaps it is too much to hope that South Asia's politicians will change their behaviour towards MFIs. In India, much of the overheated criticism of MFIs is an attempt by politicians to find a scapegoat. Successive Indian governments have failed to tackle the country's agrarian crisis and criticising MFIs is a way of obscuring this failure. In Bangladesh, Professor Yunus's dismissal was perhaps more about the concerns of the political parties and the Prime Minister, that Yunus could create a new political party. In Bangladesh, many of the country's major MFIs (BRAC, ASA, Buro Tangail) have recently been gradually reducing their loans portfolio, merging branches, reducing average client debt-loads, introducing saving products and keeping quiet. In this way, they reduced the likelihood of creating a credit bubble (followed by client defaults and delinquency) in recent years. Maybe that is the way forward across South Asia – a lower profile microfinance industry, keeping its costs as low as possible, expanding incrementally and focusing as much on savings services as on loans. Microfinance is one small part of a national strategy for poverty reduction – we need to get it into perspective and keep it working effectively.

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