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Microfinance – A Way Forward

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Abstract

This paper[1] identifies key processes shaping the microfinance sector in the coming decades. The paper examines the geography of microfinance, highlighting differing evolution patterns and challenges across the world. It looks at the widespread adoption of a financial systems approach in the microfinance sector. This is set to continue because of two main processes: a shift in focus from poverty-lending towards financial service provision; and the involvement of formal banks in microfinance. The paper looks at the increasing focus on graduation programmes to support ultra-poor people, linking microfinance to social protection and other services. It outlines the great potential of new, low-cost ICT products to enable the development of new microfinance services. Finally, the need to regulate microfinance is discussed.

Keywords: Microinsurance, Microfinance, Commercialisation

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[1] This paper is a shortened version of chapters 1 and 14 of Hulme, D. and Arun, T. (Eds.) (2008). *Microfinance: A Reader* (London, UK: Routledge).

Introduction

Since the 1980s, microfinance has become a significant component of development, poverty reduction and economic regeneration strategies around the world. By the early 21st century, microfinance institutions (MFIs) have become a vast global industry, involving large numbers of governments, banks, aid agencies, NGOs, cooperatives and consultancy firms and directly employing hundreds of thousands of branch-level staff. Much of the initial excitement about microfinance centred on Bangladesh's much lauded Grameen Bank, which propounded a 'bottom-up' approach that made the social mobilisation of marginalised communities, and particularly women, a main focus. There are now many different 'models' for microfinance, and the main activity is focused on providing microfinancial services, rather than the grander goal of social transformation. Microfinance today is about drawing the benefits of contemporary capitalism down to those with low incomes, rather than promoting alternatives to capitalism. It is part of the post-Washington Consensus (Stiglitz, 1998) and not an alternative to the orthodoxy.

Access to financial services can be seen as a public good that is essential to enable people to participate in the benefits of a modern, market-based economy – analogous to access to safe water, basic health services, and primary education (Peachey and Roe, 2004). Microfinance initiatives have emerged as an alternative to the well documented failures of government rural credit schemes to reach small farmers (Hulme and Mosley, 1996) and the formal banking sector to provide services to low-income households. They pay close attention to the incentives that drive efficient performance (Morduch, 1999) in the context of small transactions and large numbers of clients. Many MFIs use group-based lending approaches and thus reduce the administrative costs (or transfer them to clients) of gathering information, contract design and enforcement of credit transactions, including loan recovery. Over time the microfinance sector has become less the domain of NGOs and non-profits and more the domain of commercial organisations.

Currently, there are 3,316 microcredit institutions reported, reaching 133,030,913 clients by the end of 2006 (Daley-Harris, 2007). According to Daley-Harris, nearly 70% of the clients were among the poorest when they took their first loan, but some observers query this claim. In terms of the financial size of the organisations, in Bangladesh, the Grameen Bank and BRAC have a cumulative disbursement of over US$4.7 billion and US$2.2 billion, respectively (Hulme and Moore, 2008). However, the phenomenal growth of the sector has brought out the issues of poor management and inadequate corporate governance among the microfinance institutions (Lascelles, 2008).

This paper attempts to identify key processes that are shaping and will shape the microfinance sector in the coming decades. At the time of writing – against the backdrop of a global liquidity crisis, the bubble of sub-prime mortgage lending in the USA, the near collapse of major banks in the USA (Bear Stearns) and Europe (Northern Rock) and a massive expansion of the use of public finance to maintain trust in the commercial banking industry – it seems appropriate to argue that the relative maturity of the microfinance sector needs full recognition. The perception that microfinance operations are somehow riskier than the operations of the more established banking sector – mortgages, savings products for middle-class people, consumer credit – loans for formal business – has clearly been proved wrong. Microfinance institutions are weathering the global financial crisis better than many of the trusted institutions of mainstream finance, as was the case in 1997 and 1998 with the Asian financial crisis (Patten *et al.,* 2001). Indeed, one could argue that mainstream banks and financial institutions would be more secure if a greater share of their portfolios were in the microfinance sector.

The geography of microfinance

Despite the phenomenal growth of microfinance over the last 25 years, most parts of the developing world remain characterised by demand for microsavings, microloans and microinsurance services vastly outstripping demand. Only in a limited number of areas – parts of Bangladesh, Indonesia, Uganda, Kenya and Bolivia – is there a competitive microfinance market where low-income people have access to a range of services and providers. Across South Asia, Southeast Asia, Latin America and Eastern Europe microfinance provision seems set to rise, through specialised MFIs and through formal banks setting up microfinance programmes. However, the likely patterns of evolution in sub-Saharan Africa and China are less clear. The different regions have distinct characteristics which are reflected in the nature of microfinance programmes and the institutions in those regions.

In Africa, relatively few MFIs have managed to reach a scale of more than 25,000 clients and provision focuses on the cities, towns and major rural trading centres. This low level of coverage is partly explained by Africa's geography. The microfinance revolution has not yet created viable models for operating in areas with dispersed populations of extremely poor people, where there is limited physical infrastructure and little institutional capacity. The application of low-cost, ICT-based services significantly increases the likelihood of product development for such populations, and the recent upturn in African economic growth rates improves MFI prospects. However, the geographical problems of microfinance provision in much of Africa are exacerbated by the more general difficulties of institutional development in Africa, state fragility and the region's reliance on donor finance and donor ideas. As a result, the pace of microfinance development in much of Africa may remain slow. We think that microfinance in Africa should focus on service provision for lower-middle and low-income households in areas where populations are dense and infrastructure is available. If effective, large-scale MFIs, led by dynamic African social entrepreneurs, can become established in more advantaged areas, and could then experiment with outreach to less advantaged regions in the future. For Africa's poor and extremely poor, poverty reduction policy needs to prioritise social protection (Barrientos and Hulme, 2008), primary education and basic health services, rather than microfinance.

Although China has one of the fastest-growing economies in the world, the majority of the population remain in rural areas and there is great scope for microfinance institutions. As most local authorities (counties) in China have limited experience in microfinance, the current policy focus is to share the achievements of successful, existing programmes, in order to encourage local authorities to increase their support to MFIs. However, HSBC has opened its first rural bank in Hubei in 2007 and many more international banks and private-equity firms are expected to start soon.

One of the emerging concerns in the growth of microfinance is the uneven degree of provision of microfinance within countries (Rhyne and Otero, 2006). For example, in India most MFIs operate in the relatively developed south of the country, and provision in the poorer north and east of the country is low to non-existent. In Indonesia there is a vibrant microfinance market in Java and the Western islands but provision in the disadvantaged Eastern provinces is much lower. This regional inequality may be matched by a 'quality gap' (*ibid*), and clients in low microfinance density areas may receive lower quality services at a higher price. Similarly, there are significant differences between urban and rural supply of financial services in Latin America and Africa.

Commercialisation and graduation

The historical debate about whether MFIs should pursue a 'poverty lending' or a 'financial systems' approach (Robinson,2001) is largely resolved. In most parts of the world the microfinance sector is adopting a financial systems approach, either by operating on commercial lines or by systematically reducing reliance on interest rate subsidies and/or aid agency financial support. This is well-illustrated by the experience in Bangladesh, where the Grameen Bank has shifted from its classic 'Grameen I' group-lending to the poor model, to 'Grameen II', which is much closer to the financial systems model (Hulme, 2008). For observers in Bangladesh this is not a surprise, given the rapid growth and success of the Association for Social Advancement (ASA), with its full-blooded, market-based approach to microfinance.

The main opponents to such a shift have not been the thought leaders of poverty lending (Professor Yunus and the lobbyists of the Microcredit Summit), but populist politicians, seeking votes, and left-wing journalists, who are repulsed by the idea of MFIs making profits from low-income people. The move towards the financial system approach and growth of the competitive environment has put the client back at the centre of microfinance operations.

This shift in the composition of the microfinance sector will continue because of two main processes. The first, illustrated by the Grameen Bank, is of existing MFIs reducing the 'poverty lending' focus of their activities and shifting to the financial service needs of low-income households, operating savings alongside loans. To save embarrassment, such MFIs can use token programmes – such as Grameen's 'Beggars Programme' – to show that their heart remains with the poor, even when their head (and financial portfolio) has moved to the market. Depending on the regulatory context, such policy changes may be matched by institutional changes as NGOs and cooperative MFIs re-register as commercial banks or for-profit, non-banking financial institutions. For instance in Pakistan, in 2002, The First Microfinance Bank was established, with support from the Aga Khan Rural Support Programme (AKRSP) and the Aga Khan Fund for Economic Development. The idea was to phase out the microfinance programme at AKRSP and to introduce a full range of financial services to the poor over the period.

The second process is of established, formal banks and financial institutions moving into microfinance. This is happening with ICICI, Barclays, ABN-AMRO, Citigroup, Standard Chartered and others. Citigroup has publicly acknowledged the potential profits it believes it can generate from engaging in the microfinance sector. ICICI bank in India expanded its microfinance portfolio from 10,000 clients in 2001 to almost 1.5 million customers with a portfolio of US$265 million by 2005. ICICI lends to selected microfinance institutions at a rate of 9.5–11 % per annum – slightly more than it charges its corporate clients – and the microfinance institutions on-lend this money to borrower groups (self-help groups, or SHGs as they are called in India) at 16–30% per annum (*Economist*, 2005). ABN-AMRO is investing heavily in promoting microfinance in the north and northeastern states of India, where MFIs are almost non-existent. It is doing this to reduce financial exclusion and make profits. Barclays has an established relationship with *zuzu* collectors in Ghana – holding the deposits that these informal door-to-door collectors gather and permitting *zuzu* collectors to reduce the charges that they levy on clients. Formal banking institutions are also engaging in financial innovations, such as venture capital funds (as with the Dutch-Ivos-Triodos Fund in India) and floating commercial and ethical bonds for MFIs (as US banks are doing for BRAC's US$75 million bonds to expand its microfinance programmes in Africa). Similarly, the development of asset-backed securitisation is emerging as a viable method for large microfinance institutions to manage their liquidity and credit risks.

While this shift of focus in the microfinance sector towards financial systems approaches is set to continue, it must be noted that the interest of MFIs and microfinance analysts in directly helping the poor has not disappeared. Increasingly, those concerned about 'poverty reduction' have promoted 'graduation' programmes that seek to provide substantial support (often financial, through substantial sums of foreign aid) to ultra-poor people (Matin and Hulme, 2003). These graduation schemes attempt to develop the capabilities of poor people – in terms of confidence, skills, assets and access to support services – so that after a period of 12 to 24 months of intensive support, such disadvantaged people can gain access to microfinancial services and operate more effectively in local markets. Such schemes have moved beyond their experimental phase and are being mounted on a significant scale in several countries (Littlefield *et. al*., 2003; Hashemi and Rosenberg, 2006). Indeed, the Consultative Group to Assist the Poor (CGAP), a donor association that seeks to promote best practice in microfinance, has taken great interest in the concept and practice of graduation (Littlefield *et. al*., 2003; Hashemi and Rosenberg, 2006). If such schemes are effective, then they can direct aid agency money towards very poor people, but be linked to microfinance by their recognition that raising the capacity of poor and ultra-poor people to access microfinancial services is a key component of poverty-reduction strategies.

All this is positive, but there still remain grave concerns about some aspects of the shift to a financial systems approach. These are illustrated by the Compartamos affair in Mexico. When this microfinance NGO became a private sector financial institution, its directors became multi-millionaires overnight. For many observers this was distasteful, as people who had negotiated public grants to establish an MFI, and who charged high rates of interest on loans to low-income people (under the banner of poverty-reduction), converted the resources generated by grants and high charges into private fortunes. Even the thought leaders of the financial systems approach to microfinance, such as Dale Adams at Ohio State University, were aghast at the way in which the commercialisation of microfinance could redistribute assets in such a highly unequal way.

Technological change

The original 'microfinance revolution' took advantage of the technological advances in ICTs of the 1980s and 1990s. However, often this was as a relatively late adopter, with many MFIs having to convert manual records to electronic systems in the mid- and late 1990s. The dramatic reductions in the cost of new ICT products – mobile phones, palm pilots and even laptops – and the rise in connectivity through mobile phones and the internet mean that in the next decade there is enormous potential for MFIs to develop new services: services that in the past would have been economically infeasible because of high transaction costs.

These technological changes have made it easier to address two main obstacles in providing financial services to poor people – managing information and service delivery costs (*Economist,* 2005). The challenge for microfinance institutions is to rethink their business models and to innovate with the ways they deliver and receive services, so that products are more convenient and cheaper for customers, services can be accessed by people in remote areas, and security is enhanced. Until now, the predominant use of technology among microfinance institutions has been to internally manage information. However, technology has an immense potential in other areas, such as payment services and credit underwriting. For instance, as mobile phone usage expands, opportunities to provide financial services in remote rural areas become feasible. The concept of mobile banking, ‘M-banking’, has great promise. The South African experience shows that low-income mobile phone banking users value the service for its affordability, ease of use, and security – and it is up to one-third cheaper than the lowest price full-service account offered by South Africa’s largest banks (Ivatury and Pickens, 2006).

SafeSave in Bangladesh provides low-income, slum-dwellers with flexible financial services. On six days a week its clients can deposit or withdraw savings, and take out or repay loans, when their collector calls at their house or business. Such flexibility creates relatively complex microfinance portfolios, but the use of palm pilots by collectors provides a real-time record of transactions and permits the bank’s books to be balanced, at a very low administrative cost, shortly after the close of business each day. The stage is now set for many other innovations of this type.

Regulation

In many developing countries, governments are still struggling with how to regulate microfinance (see Arun, 2005). Many (particularly central bankers) are inclined to attempt to regulate MFIs in the same way as they do formal sector banks. Whilst in theory this will provide savers with security, in practice it discourages the evolution of MFIs and often means that established MFIs cannot develop savings products. This keeps depositors ‘safe’ from unscrupulous or poorly-managed MFIs, but means that they have to use other savings mechanisms (hiding cash in slum dwellings, buying livestock or asking a trader to hold cash). These other mechanisms are often riskier than the services that MFIs can provide.

The sub-prime crisis in US has raised new concerns about the regulation and supervision of microfinance institutions – in many countries microfinance is the sub-prime market. Although the enhanced financial options can offer valuable services to poor people, there is a need to regulate the entry of bad practices and products, which could harm the financial system itself. As in the US credit market, sub-prime lenders may disproportionately target minority and lower-income people with higher-priced products offered on inferior terms. The entry of aggressive consumer lenders and their competition may encourage underwriting practices and poor-loan screening which devalues the portfolio quality. These kinds of situations and the increasing concerns of terrorism financing pose new regulatory challenges for the state.

Conclusion

The concept and practice of microfinance have changed dramatically over the last decade. Conceptually, the financial systems approach has gained ground over poverty lending and most serious analysts now view microcredit as only one of several components of microfinance. The argument advanced by Robinson (2001), that microfinance should seek to meet the demand of low-income people for financial services, rather than poor and extremely poor people, widely informs present-day practice. Microfinance is seen as a set of services that raises the prospects for low-income households, and some poor people, to achieve their goals – in business, consumption, education, health and other areas – and not as a magic bullet that automatically lifts poor people out of poverty through microenterprise. Microfinance specialists concerned with poverty reduction and/or extreme poverty are increasingly focusing on ‘graduation’ programmes (Hulme and Arun, 2008; Matin and Hulme, 2003) that link microfinance to social protection and other services.

The microfinance sector seems set to continue to expand and diffuse through specialist MFIs and formal banks. However, the speed and nature of these processes is unclear in sub-Saharan Africa and China. While many factors will shape the future of microfinance, one factor merits highlighting in this conclusion. It is the social energy of the tens of thousands of people who are committed to analysing microfinance and debating how additional financial services can be made accessible to the hundreds of millions of people who have very limited access to services. Few other development issues have managed to generate such passion and commitment as microfinance. Some of these analysts have it easy – they are in universities or research agencies, like us, and are paid to do such work. The majority are, however, closer to the coalface and are actively involved in planning, managing or delivering microfinancial services. It is the collective imagination and social energy of this dispersed community that has created the microfinance revolution of the late 20th century and will take it forward in the coming years.

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