What’s Wrong and Right with Microfinance

DAVID HULME, THANKOM ARUN

Recent events in south Asia have led to an unexpected reversal in the narrative of microfinance, long presented as a development success. Despite charges of poor treatment of clients, exaggeration of the impact on the poorest as well as the risks of credit bubbles, the sector can play a non-negligible role in reaching financial services to low-income households. In regulating the sector, there is need for caution in setting interest rate ceilings on micro-loans and for greater openness to micro-savings products.

Microfinance, once hailed as the best way to tackle poverty, is under attack. The paradox is that discussion of the downturn must 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 Prize-winning founder director Muhammad Yunus has been removed from the board in 2011. (Many people believe that Yunus deserved better treatment and that current events are an offshoot of his now abandoned intentions of engaging with politics in 2007.) In 2010, 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 United States) as a development success. Is this a temporary setback or is this the end of the road for microfinance?

What’s Wrong

Let us start with what is 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 MFIs, and particularly their leaders, that microfinance reaches the “poorest of the poor” and that all loans are taken for investment in microenterprises are patently wrong. Existing studies on the impact of microfinance on the poor provide inconclusive results, ranging from a substantial positive one in Bangladesh (Khandker 2005) to an insignificant one in Thailand (Coleman 2006). Impacts are very varied and 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 larger 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. Reaching the poorest is the task for specialised programmes such as BRAC’s Targeting the Ultra Poor programme and Kudumbashree in Kerala (Hulme and Moore 2007; Arun, Arun and Devi 2011). Loans are commonly used for many different purposes – micro-enterprise, education and health expenses, repaying debt, on-lending, wedding celebrations and even dowry. Microfinance is fungible and that is probably good news: clients know what their needs are better than middle-class bankers.

Second on the list of what is 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, 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 in the ways in which they relate to clients. In a recent report on microfinance in India, Srinivasan (2011) has exposed the role of “ring leaders”, unofficial microfinance intermediaries, 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 sets of households, encouraging multiple loans. One might see these cases of unhealthy competition in the sector merely as anecdotes or alternatively as something deeper and more structural. In part, this massive expansion of microfinance in India was the result of a global trend towards attracting more private capital. By 2015,
this private capital is expected to rise to $20 billion (Deutsche Bank Research 2007).

With such high levels of commercialisation, it is only to be expected that some staff are encouraged to push their financial performance, i.e., more and bigger loans, to the limit and, sometimes, beyond it. This is particularly likely to happen when the 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 bulling 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 model that got the Grameen Bank into financial problems in the late 1990s.)

Third is the charge that MFI interest rates on loans are too high for poor people to pay (SKS charged 24-25% per annum and Grameen Bank about 22% per annum until recently). While the rates in south Asia may sound quite high, they are significantly lower than microcredit loans in south-east Asia Africa and Latin America where annual percentage rates (APR) of 50% to 120% are common. Whether the interest rates are “too high” depends on the choice of comparison. Compared to the subsidised rates of government rural credit programmes, often 9% to 12% 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 do not wear long trousers if you grow rice!

If one compares the MFI interest rates with private moneylender rates, then often MFI rates are lower and sometimes much lower. According to MFIs, their costs include borrowing from banks as well as employing staff to travel to villages to make and collect payments. Further, there are debt write-offs, all of which leave MFIs with only small margins. Our judgment, 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 micro-loans and micro-savings. 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 5% to 10% 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. 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 potential defaults. The Reserve Bank of India’s (RBI) policy of not allowing MFIs to hold savings raises the risk of client default and MFI collapse. In addition, the sudden availability of multiple loans for rural people in southern India may have encouraged what Stuart Rutherford, in a personal communication with one of the authors, called the “diabetes effect”. 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 is 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 Yunus has claimed since economic transformations require technological, redistributive, 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: 1).

For instance, in Kenya, people already use a text message-based service known as M-PESA to transfer money electronically to other mobile users and this application has reduced their transaction costs significantly. The entry of commercial banks into the microfinance sector is another example of the growing recognition and viability of the concept. This is evident in the enhanced foreign investment, both debt and equity, in microfinance, which has quadrupled to reach $15 billion during the 2007-11 period (Reille, Forster and Rozas 2011). External finance is to be welcomed as long as it is sustainable and is not fueling a credit bubble.

Second, although proponents of MFIs emphasise micro-loans, many MFI clients praise improved access to micro-saving services. Going into debt often worries low-income households, and so many prefer to turn regular micro-savings into lumps of money that can be spent on major purchases or events (Rutherford 2000).
Results from a recent field experiment study in rural Kenya suggests 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 SafeSave in Bangladesh and SANASA in Sri Lanka have spearheaded innovative approaches to micro-savings. But, there is often a major obstacle to MFIs offering savings products: the national banking authorities. In their enthusiasm for protecting 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.

Finally come the social benefits of some MFIs 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 judgment, 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. Much anecdotal evidence also suggests that joining MFIs leads to women becoming more physically mobile and being permitted to visit more public spaces by their husbands.

So, is there a way forward? Yes, but it requires change 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, and put them on the walls of all branches in an easy to understand form or print them in borrowers’ passbooks. (To his shame, 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 for the annual reports of MFIs. Belatedly, MFIs 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.3

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

Third, MFIs need to examine the ways in which they assess field staff performance. They need to reform these ways, so that field staff understand that the quality of their relationships with clients is as important as achieving financial targets, especially if the MFI proclaims a social mission. If they are really clever, they can recruit different types of staff. SafeSave 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; 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”.4

**Regulatory Directions**

Changes also need to be made by the agencies that regulate MFIs. They need to be cautious about setting interest rate ceilings on microloans. If these are set too low, they will kill off MFIs 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 services as much, and often more, than access to loans (Hulme and Mosley 1996; Collins et al 2009). Furthermore, recent empirical evidence from Sri Lanka shows that households’ probability of participating in microfinance 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 in providing a diversified portfolio of coping mechanisms to 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 MFIs. These institutions have as a result developed inappropriate practices. For instance, in India, a draft bill for the regulation of microfinance was presented to Parliament in 2007. However, it was neither treated as a priority, nor approved. The debacle in Andhra Pradesh forced the RBI to hurriedly initiate a committee to review crucial governance issues in the sector. The Malegam Committee report, submitted in 2011,5 tried to find a balance between the extremes of regulation – laissez-faire versus centralised control. It decided that all bank loans to MFIs, including non-banking financial companies working as MFIs, 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.6 One significant feature of the draft version is the role of the RBI as the primary authority overseeing the sector, with supervisory powers over institutions engaging in microfinance activity. This is in an effort to discourage state-level legislation such as the one in Andhra Pradesh. Although there is industry-wide concern on possible dual regulation from the RBI and state governments, there is huge public support for 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. Nor does it fully answer the specifics for a responsive regulatory framework to support sustainable delivery of diversified microfinance services, least of all to protect clients from unethical practices.

Perhaps it is too much to hope that south Asia’s politicians will change their approach 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; criticising MFIs is a way of obscuring this failure. In Bangladesh, 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. Many of the country’s major MFIs (BRAC, ASA, Buro Tangail) in Bangladesh have recently been gradually reducing their loan portfolio, merging branches, reducing average client debt load, introducing saving products and keeping quiet. In this way, they have 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 that keeps its costs as low as possible, expands incrementally and focuses 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.

NOTES

1 The Grameen Bank model II, launched in 2001, was equipped with more suitable and comprehensive financial services for the poor. As of 2009, it had nearly 8 million depositors and 6.4 million active borrowers, with branches covering 90% of all villages in Bangladesh (Grameen Bank 2010). This phenomenal growth was due to the diverse product range, and more significantly, the element of flexibility built into the Grameen II system. In contrast, the basic goal of Grameen I was to prove that the poor are creditworthy; Grameen II was built on the principle that the poor will always pay back (see Huque 2009 for further detail).

2 Based on primary research with BRAC, SafeSave and SANASA, among others.

3 For more detail see: http://www.cgap.org/p/site/e/templat...r.Release.pdf

4 Interview with SafeSave Field Officer, Hindupara, Kapashia, Bangladesh, 21 February 2011. The name is disguised.


REFERENCES


