Microfinance and the Poor

Breaking down walls between microfinance and formal finance

Bolivian women wait in line at an automatic teller machine.

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CONTRARY TO a common impression, poor people need and use a variety of financial services, including deposits, loans, and other services. They use financial services for the same reasons as anyone else: to seize business opportunities, improve their homes, deal with other large expenses, and cope with emergencies. For centuries, the poor have used a wide range of providers to meet their financial needs. While most poor people lack access to banks and other formal financial institutions, informal systems like moneylenders, savings and credit clubs, and mutual insurance societies are pervasive in nearly every developing country. The poor can also tap into their other assets, such as animals, building materials, and cash under the mattress, when the need arises. Or, for example, a poor farmer may pledge a future season's crops to buy fertilizer on credit from commercial vendors.

However, the financial services usually available to the poor are limited in terms of cost, risk, and convenience. Cash under the mattress can be stolen and can lose value as a result of inflation. A cow cannot be divided and sold in parcels to meet small cash needs. Certain types of credit, especially from moneylenders, are extremely expensive. Rotating savings and credit clubs are risky and usually don't allow much flexibility in amount or in the timing of deposits and loans. Deposit accounts require minimum amounts and may have inflexible withdrawal rules. Loans from formal institutions usually have collateral requirements that exclude most of the poor.

Microfinance institutions (MFIs) have emerged over the past three decades to address this market failure and provide financial services to low-income clients. Most of the early pioneer organizations in the modern microfinance movement operated as nonprofit, socially motivated nongovernmental organizations. They developed new credit techniques: instead of requiring collateral, they reduced risk through group guarantees, appraisal of household cash flow, and small initial loans to test clients. Experience since then has shown that the poor repay uncollateralized loans reliably and are willing to pay the full cost of providing them: access is more important to them than cost.

The poor need and use a broad range of financial services, including deposit accounts, insurance, and the ability to transfer money to relatives living elsewhere. Experience has shown that the poor can be served profitably, on a long-term basis, and in some cases on a large scale. Indeed, well-run MFIs can outperform mainstream commercial banks in portfolio quality. The top-performing MFIs in some countries are more profitable than the top-performing local commercial bank.

In turbulent times, microfinance has been shown to be a more stable business than commercial banking. During Indonesia's 1997 crisis, for example, commercial bank portfolios deteriorated, but loan repayment among Bank Rakyat Indonesia's 26 million microclients barely declined. And, during the recent Bolivian banking crisis, MFIs' portfolios suffered but remained substantially healthier than commercial bank portfolios.

Today, microfinance is reaching only a small fraction of the estimated demand for financial services by poor households. While a few hundred institutions have proved the poor can be served sustainably and on a large scale, most of the institutions are weak, heavily donor-dependent, and unlikely to ever reach scale or independence. Only financially sound, professional organizations have a chance to compete effectively, access commercial loans, become licensed to collect deposits, and grow to reach significant scale and impact. To achieve its full potential, microfinance must become a fully integrated part of a developing country's mainstream financial system rather than being confined to a niche of the development community.

Encouraging signs of integration are beginning to emerge. In some countries, the walls between microfinance and the formal financial sector are coming down. The commercial success of some MFIs has begun to attract new, mainstream actors. Partnerships are forming, and public and private sector infrastructure and knowledge are being shared and leveraged. New technologies are also driving costs and risks down to provide services to poorer clients more cost effectively. The quality and comparability of financial reporting, ratings, and audits are improving, and domestic and international commercial investors are investing in the sector.

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What's at stake

Reliable measurement of the impact of financial services on household welfare is expensive and methodologically difficult. However, an increasing number of serious studies are suggesting that microfinance can produce improvements in a range of welfare measures, including income stability and growth, school attendance, nutrition, and health. Microfinance has been widely credited with empowering women by increasing their contribution to household income and assets and, thus, their control over decisions affecting their lives. Of course, microfinance has generated considerable enthusiasm—not just in the development community but also politically—with the predictable result that some of its merits have been oversold.

Microfinance alone is not a magic solution that will propel all of the poor—particularly the very poorest people—out of poverty. But there is no doubt that poor clients themselves value microfinance very highly, as evidenced by their strong demand for such services, their willingness to pay the full cost of those services, and high loan repayment rates that are motivated mainly by a desire to have access to future loans. Moreover, because microfinance can be delivered sustainably, its benefits can be made available for the long term—well beyond the duration of donor or government subsidies.

MFIs form one part of a much broader spectrum of socially oriented financial institutions (SOFIs) that includes state-owned development, postal, agricultural, and savings banks, as well as smaller entities like savings and loan cooperatives. These institutions are considered socially oriented because, for the most part, they were created not to be profit-maximizers but, rather, to reach clients who were not being well served by the commercial banking system. SOFIs represent a vast infrastructure and clientele: a recent, far from exhaustive survey identified well over 600 million accounts in these institutions. Although no concrete data are available on the proportion of SOFI clients who are poor, average account sizes suggest that this proportion is substantial.

Despite their extensive outreach and infrastructure, SOFIs also have significant limitations. Some of them—especially the state-owned ones—provide inferior services, are highly inefficient, and generate large, continuing losses. In many countries, financial authorities do not consider SOFIs part of the mainstream financial system and do not supervise them as seriously as commercial banks. Except in a few countries, SOFIs account for a small percentage of financial system assets and may not pose systemic risk. But in many countries, a large proportion—sometimes the majority—of households using financial services access them through SOFIs. The SOFI share of total financial system accounts is, for example, 50 percent in Bolivia and 65 percent in Côte d'Ivoire.

When large SOFIs can be turned around and run on a commercial basis, the results can be dramatic. In Mongolia, for example, the state agricultural bank restructured, moved into microfinance, and has been privatized. The bank, which serves half of all rural households in Mongolia through 375 points of sale, is now profitable. Bank Rakyat Indonesia is another restructured SOFI that now provides high-quality services to massive numbers of poor people and generates very healthy profits.

Increasingly commercial orientation

Most leading MFIs operate today on a commercial basis using the techniques and disciplines of commercial finance. They are investing in more sophisticated management and information systems, applying international accounting standards, contracting annual audits from mainstream auditing firms, and seeking ratings from commercial rating agencies. Last year, rating agencies, including industry leaders Standard & Poor's and Moody's Investors Service, carried out over 100 credit ratings of MFIs.

There is growing awareness that building financial systems for the poor means building sound domestic financial intermediaries that can mobilize and recycle domestic savings. Foreign donor and social investor capital diminishes as individual institutions and entire markets mature. For this reason, increasing numbers of MFIs are getting licensed as banks or specialized finance companies, allowing them to finance themselves by accessing capital markets and mobilizing deposits from large institutional investors as well as poor clients. Several MFIs, mainly in Latin America, have tapped local debt markets, largely by issuing private placements taken up by local financial institutions.

Dozens of countries are considering legislation to create new types of financial licenses, usually with lower minimum capital requirements, designed for specialized microfinance intermediaries. Although generally positive, this trend does pose risks. Supervisory authorities who are already stretched thin trying to monitor commercial banks can find it difficult to take on responsibility for a new group of small institutions. Moreover, a move toward specialized MFIs sometimes overlooks opportunities to involve mainstream commercial banks in microfinance.

In countries as different as Haiti, Georgia, and Mexico, partnerships between commercial banks and MFIs are an alternative to MFIs seeking their own financial licenses. These partnerships enable MFIs to cut costs and extend their reach, while banks can benefit from the opportunity to tap new markets, diversify assets, and increase revenues. Partnerships vary in their degree of engagement and risk sharing, ranging from sharing or renting front offices to banks making actual portfolio and direct equity investments in MFIs (see figure).

Forging new links

Commercial banks and microfinance institutions (MFIs) are forming partnerships.

Higher level of engagement

Bank creates loan service company	**Sogebank (Haiti)** created Sogesol, a microloan service company, in 2000.
Bank invests equity in an MFI	**Jammal Trust Bank and Credit Libanais (Lebanon)** have equity stakes in Ameen, a microfinance program.
Bank buys MFI portfolio and/or contracts MFI operations	**ICICI Bank (India)** contracts microfinance operations with self-help groups and MFIs.
Wholesale lending	**Raffeisen Bank (Bosnia)** lends to multiple MFIs in Bosnia.
Sharing/renting facilities	**Microfinance Bank (Georgia)** rents space in its offices to Constanta, a local nongovernmental organization.

Lower level of engagement

Source: Consultative Group to Assist the Poor.

In Africa, Asia, and Latin America, some local financial institutions are pursuing lower-end retail banking directly, as financial globalization heightens the competition posed by international banks for larger corporate customers. Banque du Caire in Egypt, for example, entered the market two years ago and now delivers microfinance alongside traditional products through its 230 branches. It is still too early to tell whether large numbers of commercial banks will move into microfinance. Well-run MFIs have proved to be profitable, but serving this market requires changes in systems, staffing, and culture that are not easy for traditional banks.

Lower-income customers have smaller account and transaction sizes, which underscores the importance of reducing transaction costs. Credit scoring and computerization have underpinned many of the important new down-market opportunities, with the result that the boundary between microfinance and consumer finance is now blurring in many places. Retailers, consumer finance institutions, and building societies in some developing countries are adapting microfinance methodologies so they can use their infrastructure to tap the new market of uncollateralized, character-based lending to the self-employed or to households, more generally.

MFIs are beginning to tap into mainstream credit bureaus—an important strategy to increase productivity, improve portfolio quality, and reduce spreads between borrowing and saving rates. This not only reduces risk for the MFIs but also allows their clients to build a public credit history that makes them more attractive to mainstream banks and retailers. For example, more than 80 MFIs in Peru are registered to use Infocorp, a private credit bureau. In Turkey, Maya Enterprise for Microfinance negotiated with Garanti Bankasi, a leading private bank, to gain access to the national credit bureau to screen loan applicants for credit card and other debt. New regulations on microfinance issued by Rwanda's central bank require that MFIs communicate information about their borrowers to a credit bureau.

Creative new delivery channels and new information technology also hold promise for reducing risk and cutting delivery costs. Microfinance providers are now exploring ways to piggyback financial services delivery onto existing infrastructure, such as retail shops, Internet kiosks, post offices, and even lottery outlets. Existing distribution systems may make it possible to provide financial services more cost effectively and, thus, to poorer and more sparsely populated areas. On the technology side, companies in southern Africa are developing low-cost, cell phone–based banking services for poor clients. MFIs in Bolivia, Mexico, India, and South Africa are also making use of smart cards, fingerprint readers, and personal digital assistants to improve efficiency and expand into rural areas. Not surprisingly, the actual performance of such new technologies and strategies does not always match the initial level of enthusiasm generated. But some of these new approaches have proved themselves already, and others will no doubt continue to emerge.

Twenty years ago, the main challenge in microfinance was methodological: finding techniques to deliver and collect uncollateralized loans to "microentrepreneurs" and poor households. After notable successes on that front, the challenge today is a more systemic one: finding ways to better integrate a full range of microfinance services with mainstream financial systems and markets. While it is not yet clear how far that integration will go, the early signs are encouraging. Advances taking place around the world would have been dismissed as unthinkable just a decade or two ago. ■

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