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Microfinance: How Bankers Could Buy Back Their Soul

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Muhammad Yunus was not awarded the Nobel Prize for Economics. He got the one for peace; and so it should be. He is not only being honoured for improving access to credit for the poor but for allowing millions of women in Bangladesh and in poor villages beyond to see a future for themselves. With loans of just a few dollars, poor women could become entrepreneurs, send their children to school, improve health care for their families and protect themselves better from sickness, death, and natural disasters. Ultimately, they could pull themselves out of poverty.

In order for microfinance institutions to reach more poor people they should become an integral part of the financial sector, and develop as sound domestic intermediaries. They should go commercial, broadening their client basis and scaling up their loans to small enterprises. Will it mean that they will loose their soul? Actually no; on the contrary, they will inject more soul into formal banking practices.

Why is There a Need for Microfinance?

Only a fraction of the 4 billion people – households and micro-entrepreneurs – living on less than $1 500 a year, the so-called "bottom of the pyramid", have access to basic financial services. Microfinance has proven very successful in expanding these people's access to credit. Microfinance Institutions (MFIs) include a broad range of financial sector organisations such as banks, non-bank financial institutions, financial co-operatives and credit unions, finance companies and NGOs specialising in serving people who lack access to traditional financial services.

Microfinance: a few characteristics that make it a very accessible and powerful tool

What is Microfinance? Loans, savings, insurance, transfer services and other financial products targeted at low-income clients.

What is Microcredit? A small amount of money offered by a bank or other institution.

What makes it so easy to access to microcredit? It is offered often without collateral to an individual or through group lending.

What is group lending? Also known as solidarity lending, it is a mechanism that allows a number of individuals to provide collateral or to guarantee a loan through a group repayment pledge. The incentive to repay is based on peer pressure.

Why peer pressure? If one person in the group defaults, the other group members make up the payment amount. Individual lending, in contrast, focuses on one client and does not require other people to provide collateral or guarantee a loan.

How are clients followed? There is a network of loan officers responsible for assessing portfolio quality and monitoring clients, for which they are paid performance related salaries. This implies high transaction costs involved and in turn high interest rates.

Do high interest rates damage poor people? Actually no. Poor people who are not "bankable" are willing and able to pay high interest rates, which are anyway much lower than those charged by moneylenders; default rates are much lower than those in commercial banks.

Micro-credit schemes and MFIs have met with huge success. Today, they serve 40 million poor people in over 65 countries. This is still not enough: the challenge remains to meet the huge, untapped demand in credit for cottage industries and micro-enterprises, which are often "unbankable", insulated from formal traditional financial markets and left at the mercy of informal moneylenders.

Microfinance Needs to Go Commercial?

MFIs are potentially useful for filling a gap in short-term financing and avoiding resorting to informal money lenders. They could also become a source of financing for micro-enterprises and SMEs as well as contributing to the development of financial markets, especially in rural areas and amongst the "unbankable".

MFIs have developed beyond being purely a poverty-alleviation tool to financing economic development. They have done so through their proximity to local entrepreneurs. Their successful uptake is due to a flexible formula offered to small entrepreneurs, bypassing stringent regulatory and collateral requirements. For example, Novobanco, active in Africa and Latin America, provides credit to small and medium-sized companies based on no-fee accounts with no minimum balance, informal guarantees (house assets and a guarantor), and a continued relationship with loan officers.

Limited Capacity and Legal Ambiguities

Despite their adequacy to local needs, however, MFIs remain small and fragile. They often lack the skills to assess project proposals or to adopt and develop innovative financial tools. MFIs struggle to follow their clients as they grow, since they suffer from the lack of medium to long-term saving to transform into long-term lending. Furthermore, the refinancing of MFIs through the formal banking sector is limited by the lack of collateral and the high cost of financing. Unlike commercial banks, MFIs have no access to central bank refinancing at low cost and do not qualify for refinancing through venture capital as they are not formally financial institutions. They thus are forced to rely on aid.

Policy Remedies

Agreements between MFIs and providers of non-financial services can ease the MFIs capacity constraint. Business Development Services (BDS) institutions such as PAB (Projet d'Appui des Artisans Burkinabé) in Burkina Faso, have carried out the first selection of project proposals on purely technical grounds; they aspects then pass the file to the MFI (in the case of Burkina Faso PRODIA) to assess the financial viability.

The financial sustainability of MFIs can be strengthened by working more closely with formal banks. Co-operation in Benin between PAPME (Association pour l'Appui et la Promotion des Petites et Moyennes Entreprises) and Bank of Africa based on a transfer of clients to the banks as their financing needs have increased is a good example of a mutually beneficial outcome. Associating informal financial organisations and formal institutions can help the former grow closer towards formality and expand their service, such as saving accounts and insurance. Specific legal provisions may help MFIs to extend their lending activities to SMEs, mainly by increasing the maximum loan amount and by extending the maximum loan maturity. Following such changes, many MFIs are developing into fully-fledged rural banks and are able to finance medium-sized enterprises.

The question is whether MFIs are going to "lose their soul" by pursuing such a growth strategy. If they decide to transform themselves into "normal" banks, who will look after the poor? The answer is still the MFIs. The drift towards commercial microfinance may provide them with just the stability they need to stay in and extend this vital resource for the poor.

Muhammad Yunus saw this potential. Not only did he invent microfinance and established the first MFI institution, the Grameen Bank, but also saw the potential of going further to second-generation microfinance. Now Grameen II is a "diversified conglomerate" with operations in solar energy, mobile phones, health and house insurance and food industry.

The future could be looking brighter than ever for microfinance and its customers.

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