





How Microfinance Really Works

BY JONATHAN MORDUCH



About half of the world's adults lack bank accounts. Most of these "unbanked" are deemed too expensive to serve, or not worth the hassle created by banking regulations. But what may be good business from a banker's perspective isn't necessarily what's best for society. The inequalities that persist in financial access reinforce broader inequalities in the distribution of income and wealth.

This is the opening for microfinance – and also its challenge. Microlending has been sold as a practical means to get capital into the hands of small-scale entrepreneurs who can then earn their way out of poverty. The idea appeals to our impulse to help people help themselves and to our

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conviction that bottom-up development depends on the embrace of the market. By eschewing governments and traditional charities, the sector promises to sidestep the bureaucracy and inertia that have hobbled other attempts to expand the opportunities of the poor.

Microfinance institutions are expected to earn profits, and customers are expected to pay interest rates high enough to guarantee those profits. With profit, after all, microfinance can grow on its own steam, sustaining an ever-expanding virtuous circle. And once it's scaled up, microfinance promises a chance to reach a large chunk of the 2.5 billion adults lacking access to basic financial services.

RHETORIC AND REALITY

There's a problem, though: reality can't match the high-minded rhetoric. Microfinance leaders have, indeed, succeeded in creating viable financial institutions that thrive where traditional banks fail. Microfinance reached more than 200 million customers in 2011, and microfinance investment vehicles held \$7.5 billion in assets. But it's a hard business; microlenders struggle with a version of the same problem faced by Citi, HSBC and other commercial banks that have attempted to broaden the market for their services. It's just not easy to make money when transactions are small and fees are limited.

Analysis of the records of 346 microfinance providers in 67 countries shows that while more than 90 percent claimed they were profitable, half relied on subsidies of one kind or another. Moreover, the institutions serving

the poorest customers leaned most heavily on subsidy. A big question, then, is whether microfinance is worth that external support.

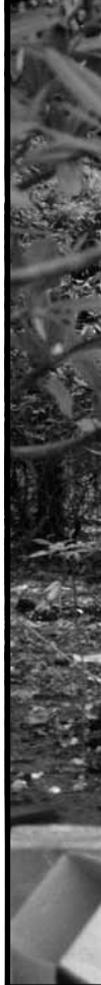
New studies reveal an even more fundamental challenge to the original vision. The evidence suggests that better financial access does give families improved ways to cope with poverty, but – counter to the original microfinance narrative – seldom offers the means to escape it. Small businesses have been sustained, but few have been transformed into substantially larger enterprises.

Moreover, business growth is hardly the obsession for microfinance customers that it is for donors and development experts. Evidence from Indonesia, Mongolia and Bangladesh shows that only about half of all microloans finance business investments. The rest goes to financing household expenses and paying down other debt. That's not necessarily a bad thing (and could be a very good thing). But it does suggest a gap between the way we've looked at microfinance and what it actually is.

A decade ago, researchers began an intensive year-long engagement with about 300 poor and low-income families in India, South Africa and Bangladesh; the findings were published in the book *Portfolios of the Poor: How the World's Poor Live on \$2 a Day*. (I was an adviser and coauthor.) The aim was to track every penny that the households earned and spent, and to see financial choices through the eyes of people struggling to keep their families fed and healthy, and their children in school. Microfinance was not an explicit focus, but the “financial diaries” collected by the researchers did offer a new frame for thinking about it.

The starting point of this frame is the recognition that what microfinance offers most fundamentally is a set of money-management services. Providers offer simple loans, often coupled with basic savings accounts and a bit of insurance. These help customers to obtain

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the money they need in the right amounts at the right times – money for health care, schooling, housing, nutrition, transportation and unexpected emergencies.

The financial diaries showed that business investment is just one use of microloans among many. Thus if microfinance deserves continuing support, it's because poor families deserve reliable, hassle-free ways to save and to borrow along with tools to cope with risk. The hope is that access to these tools will reduce the stresses of everyday life and help families to make big-ticket purchases. The fear is that loans will be misspent and lead to excessive debt.

A FIRST STEP: TURNING TO WOMEN

Microfinance was not the first attempt to lend to poor households, but previous attempts were mainly aimed at farmers. Crops, though, are risky and, outside of Africa, are largely in

the control of men – which both makes aid harder to sell to donors and excludes the chance to serve women directly.

Microfinance succeeded in large part by shifting the focus to nonfarm enterprise and by focusing narrowly on the provision of loans. Earlier microfinance projects, like those of Accion International in Brazil and Colombia combining loans with training, found themselves bogged down by costs and logistics. Muhammad Yunus, the Bangladeshi economist who founded Grameen Bank, sidestepped that trap by brushing aside calls for training. Customers already knew what they were doing, Yunus insisted; what they really needed was a bit of capital to put their ideas to work.

With that sharper focus, the recipe became simpler, and the business model could be organized around a cycle of yearlong loans, followed immediately by another yearlong loan

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and another and another. It also opened up the possibility of lending directly to women, who rarely run farms in Bangladesh but who do work from home. Today, about three-quarters of microfinance customers worldwide are women; in South Asia, nearly all are women.

TWO STORYLINES

Microfinance initially hinged on two storylines. The first was championed by Yunus. Yunus' vision begins with the assumption that the world's poor, especially poor women, are frustrated entrepreneurs. It is a vision in which the women already have the ideas, knowledge and connections to run businesses. What they lack is capital. Investment opportunities are thus wasted – and people stay poor – because banks refuse to lend to customers without assets to pledge as collateral. According to the narrative, the first dribbles of capital – starting at \$100 or so, borrowed for a year – can generate high returns and lead to transformative increases in income. (Yunus has asserted that microfinance brought steady decreases in poverty in Bangladesh, though he has since backed off those claims.)

The second story relates to the financial institutions themselves. The success of microfinance lenders depended on the delivery of bare-bones services. Key elements of traditional banking were discarded, especially the assumption that customers must be served at their convenience at a local bank branch. Microfinance pioneers like Grameen Bank open for business just once a week in each locality, using borrowed space like a school or a village clearing. Thus loan officers bring services to the neighborhood, but don't give customers the option of banking when they want or how they want. This approach makes it practical to handle transactions amounting to just a few dollars at a time.



Cost cutting was accompanied by a focus on revenues. The first story held that customers would make big profits, and the second story held that lenders could tap a share of those gains. The logic justified the idea that borrowers could afford to pay interest at rates that made the business of providing microfinance loans profitable; the typical range of interest rates thus settled between 15 percent and 40 percent per year after inflation. Microfinance promoters claimed that customers were happy to pay these interest rates because the alternative was paying far more to the neighborhood moneylender.

The argument is plausible, but fails to account for differences between what customers look for in moneylenders (quick cash, coupled



with flexibility in repayments) and in microfinance (steady streams of funds with strict repayment obligations). The evidence suggests that customers are sensitive to interest rates even if they are far below those demanded by traditional lenders. When a microfinance lender in Dhaka raised rates from 2 percent per month to 3 percent, for example, the demand for loans was reduced proportionally.

The good news here is that interest rates typically charged are neither high enough to squelch demand nor low enough to make loans feel like gifts. The fact that lenders can maintain high loan volume at interest high enough to cover most costs constitutes a major triumph for the pro-market vision.

The full vision, then, is one in which micro-

finance banks quickly become profitable, while their customers become self-sufficient. In marrying social ends to seemingly hard-headed business models, microfinance became the leading edge of what is now called social investment or “impact investing.”

ECONOMIC THEORY TO THE RESCUE

One key to making this market work has been innovation in loan contracts, which allowed institutions to limit losses without requiring collateral as security. In the 1970s and early 1980s, economics was being transformed by theory that captured how credit market imperfections persist and create economic distortions. The Nobel-winning analyses of the economics of information by Joseph Stiglitz



and George Akerlof drew explicitly on credit market problems in India and Africa. Economists were captivated by the possibility that new sorts of contracts could overcome the two best-known reasons that credit markets fail: moral hazard and adverse selection.

The moral hazard problem arises when borrowers lack incentives to repay their debts. Monitoring borrowers and enforcing contracts is costly, especially when borrowers aren't required to pledge collateral. With no collateral to lose, borrowers are more likely to take imprudent risks, or to fail to make the

effort needed to minimize the chances that their investments won't pay off. Moreover, without collateral on the line, lenders face the problem of adverse selection, in which the demand side of the market is dominated by the prospective borrowers who are the least likely to be able to repay loans.

The problem is thus twofold: banks lack good information on borrowers and have only limited enforcement ability, while borrowers without collateral lack ways to convince banks of their good intentions. But borrowers do have good information about their neighbors – as well as contract enforcement mechanisms not available to banks (notably social pressure).

Hence the logic of “group lending” contracts in which multiple borrowers from the same locality obtain separate loans, but are jointly liable for the others. This allows the bank to take advantage of informal enforcement mechanisms, including social sanctions like shaming. With their incentives aligned with those of the bank, neighbors can be trusted to monitor one another and make sure loans will be repaid. Neighbors can also screen one another to make sure that riskier customers are kept out of the pool of borrowers. In essence, communities took over the costly jobs of vetting and monitoring customers. Stiglitz wrote an early theoretical paper celebrating the mechanism, as did Hal Varian, now best known now as Google's chief economist.

RETHINKING GROUPS

The group-lending mechanism was sold by microfinance leaders as a simple answer to the credit market problems described by Stiglitz and Akerlof. But a few years ago, researchers started rethinking the significance of group lending as a way to get loans repaid. In experiments in the Philippines, they found that repayment rates remained steady even when

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microfinanciers dropped the group-lending mechanism. Grameen Bank, the great pioneer of group lending, formally abandoned it a decade ago, yet appears to be just as strong. So, why then are loans being repaid?

To disentangle the possibilities, researchers created a series of simulations of microfinance contracts in a market in Peru; workers who fit the demographic profile of typical microfinance customers were invited to take part in the simulations. The process allowed explorations of different kinds of contracts and their implications for financial choices. After all the permutations were tried, the one factor that most influenced repayment was the promise of access to future loans (and the threat of being cut off).

If serial lending is the key to microfinance success, it is because the process can be trusted. The cleverness of group lending took attention away from a more fundamental achievement: institutional reliability and credibility. Microfinance institutions succeeded in getting loan officers to show up in the right place at the right time, to dispense the promised money and to follow contract rules to the letter. That was no small accomplishment. There are exceptions, but microfinance has achieved a remarkable level of transparency and standardization in customer transactions. Such reliability stands out in a world in which police officers request bribes before doing their jobs, doctors and teachers moonlight on their employers' time, and electric power can never be taken for granted. Perhaps it shouldn't be surprising that microfinance customers work so hard to maintain access to the reliable flow of loans and other financial services.

But there's a catch: serial lending cannot provide strong incentives forever. Once borrowers have decent alternatives to the first microfinancier, the incentive to work hard to pay back a particular lender weakens. Competition brings many advantages – driving down interest rates, expanding the scale of markets and improving service quality – but it also undermines the serial lending mechanism. Over time, customers become less reliable. In region after region, competition in microfinance has brought overindebtedness and repayment problems.

In Bangladesh, for example, the big three microlenders (Grameen Bank, BRAC and ASA) started vying for the same patrons. Customers ended up borrowing from more than one, taking on more debt than they could handle and eventually dropping out. The lenders only solved the problem through cartelization – that is, by carving up the territory to re-establish a degree of local monopoly power.

Competition can work in this setting, but it requires credit bureaus that make it difficult for debt scofflaws to game the system. One study in Malawi shows their effectiveness. Credit records were being kept, but they made little difference since personal identities were easy to shift. Borrowers in default would simply borrow under alternative names, leaving no traces on their credit records. To combat the fraud, one lender with a local monopoly required borrowers to be fingerprinted, eliminating the possibility of identity switching. A randomized implementation of the new system showed that it sharply increased repayment rates for borrowers who had been deemed to be less trustworthy.

...VELACHERY BRANCH 042...

DATE: 3 JAN 2007

FDO'S NAME	DEM	COLL	REC	BRANCH PROFILE	
1. P. MARIAPPAN	13,200			TOTAL CENTRE	63
2. BALASUBRAMANI	22,740			NO. OF MEMBER	2,881
3. SATHISH GANDHI	15,000			TOTAL SAVINGS	95,296
4. SATHISH KUMAR	4,800			TOT. LOAN ISSUED	2,016,500
5. B. SRINIVASAN	15,740			OUTSTANDING	1,075,150
TOTAL	71,680			WAITING MEM	4532

BRANCH MANAGER. S. ANANDAN.

AN UPDATED VISION

The early narrative centered on women, group lending and business loans – which was exactly what foreign aid agencies wanted to hear. Microfinance rhetoric combined a private-sector sensibility with an activist’s passion to make the world a better place. It was a fit for both the Reagan era’s embrace of the entrepreneur and the Clinton era’s search for “third way” solutions to big problems without big government. The 2006 Nobel Peace Prize awarded to Muhammad Yunus and Grameen Bank was the crowning moment for the vision.

But there are other elements of microfinance that could as easily have been highlighted – and which form the basis for reimagining the goals of providing financial access to the poor.

The move away from lending to farmers was a big step, but it’s now clear that the move could have gone further, abandoning the exclusive focus on business lending. Microfinance loans have always been described as business loans. But, the fact is, they look more like consumer loans – and that opens the way

to thinking more broadly about the customer base. By tethering to self-employment, microfinance institutions prevent themselves from serving wage workers who may need financial services just as much as entrepreneurs.

Typically, microfinance repayments are broken into weekly installments. The structure of weekly installments channels the small sums earned by households into steady payments to the bank. In essence, the microfinance institution is not lending against an investment project (especially since investments won’t typically start generating revenue until long after loan repayments have started) as much as it is lending against expected household cash flows.

In practice, microfinance installments are paid from a combination of wage income, self-employment income and whatever other money can be put together by households. Recognizing this, some microlenders gauge creditworthiness on the basis of household cash flows alone, without considering the viability of the enterprise. This means that loans have a good chance of being repaid even if

investments fail – or if the investments are never made.

The loan repayment process continues according to a clear plan, with individual payments small enough to minimize the drain on household budgets. The weekly schedule of communal meetings with bank employees also serves to keep financial obligations salient for customers. Note that this structure gives poor families the functional equivalent of a credit card or installment plan for making important purchases like a new roof or medicine.

This updated vision is already working its way into the mainstream of microfinance. With a nod to the importance of general-purpose money management tools, policymakers are now replacing the language of “microfinance” with “financial inclusion” – code for providing a broader suite of financial services, including loans, savings, insurance, remittance services and digital transfers.

Despite this opening, the notion of microloans as consumer finance still meets resistance. Skeptics ask: if there’s not a business backing the loans, how will loans be repaid? The answer is that microfinance is *already* commonly financing consumer purchases, and loans will be repaid in the same way as before – in small installments from household income.

That leads to the skeptics’ riposte: how will families ever get ahead if loans are not used substantially for business investment? But again, there’s an answer. Families certainly won’t get ahead if they fail to address emergencies, arrange financing for health care and keep their children in school. Business investments are not the only worthwhile investments for the poor.

WHO WILL PAY?

Microfinance has spread far from its modern origins in Bangladesh, Bolivia and Indonesia.

Today, microlenders can be found in locations as varied as Gaza, Bosnia and Uganda, and increasingly in poor parts of rich places like New York, London and Paris.

How will all of this be financed? Judged in purely financial terms, the microfinance institutions are delivering on their promise to run efficient businesses, and they have proved capable of rapid growth. Yet microfinance investors are seldom driven only by financial returns; they also want to do good. Indeed, they are implicitly subsidizing the sector by not chasing higher financial returns in other investments that are no riskier.

Now we’re back to the question with which we started: are the subsidies worth it? Research so far on the short-term impacts of microfinance on customers’ businesses and on broader measures of household well-being (including household consumption) fails to find the kind of social returns that will keep social investors excited. But few studies have looked beyond two-year horizons and perhaps bigger impacts will show up with longer time frames.

In any event, the analysis presented here suggests that policymakers and impact investors ought to be thinking less about the time frame of social returns and more about the ultimate goals of microfinance. Most of the time, microfinance generates only modest gains for household businesses and doesn’t catalyze great leaps in household income. Rather, improved financial access gives poor people a means to make the most of what they have and to pay for big purchases over time. Financial access may never create the self-employment revolution whose prospect inspired policymakers and investors. But financial access is best thought of as a platform, and it might just be the foundation that billions of poor families need to build more secure lives on their own terms. **M**