

Microfinance: hurdles and key issues

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1. Introduction

It is approaching three years since the foundations of the microfinance industry (and I choose this term advisedly) were severely shaken. This was not so much due to the events in Andhra Pradesh (AP) *per se* – concerning as some stories of alleged client mistreatment were. It was rather the emergence of this negative narrative into the global mainstream press; the contagious perception that microfinance – far from being a panacea for alleviating poverty – was not even meeting the hippocratic threshold of “do no harm”.

This narrative is true in parts, untrue in others. But most of all it is an extremely complex story. The low point came on November 17 2010 when the *New York Times* ran a cover story entitled “Indian Microcredit Faces Collapse from Defaults” – and the die was cast. Almost three years later and the acute crisis has passed. While certain markets continue to struggle with an overindebtedness that had settled deep into the industry, on the whole I hope we can say that the crisis is over.

However, what the 2010 AP crisis (and the specific market crises in Bosnia, Nicaragua and Morocco, among others) gave way to was a series of larger issues about the future of microfinance. Some of these are focused:

- Which social performance management (SPM) framework (the methodologies for determining social impact of microfinance) should dominate?
- Who should be the main providers of agri-insurance?
- What – if any – margin or rate caps are appropriate?

Some are much more general, even philosophical.

Typically, a multi-author book such as this would tuck the ‘challenges’ chapter somewhere in the back. The narrative thus goes from promoting an argument or product and then doing the minimum to say “however...” towards the end. It is pleasing that this chapter has been front-loaded. This means that all the interesting stuff to come – on microfinance investment vehicles (MIVs) and SPM and technology and product innovation – is underpinned by a clear recognition of the challenges to be overcome.

The corollary to this is that it is impossible to address all the issues in more than cursory depth. So this short chapter will introduce some of the challenges ahead, but will equally foreshadow the subsequent chapters of the book, which will address many of the same issues in greater depth.

There is much to be positive about within microfinance today. After almost four decades of back slapping, self-congratulatory complacency about microfinance as a miraculous solution for poverty, realism is having its time in the sun. What might have been heresy only a few years ago is orthodoxy today:

- microfinance is a 'tool', not a poverty panacea;
- the provision of 'one-size-fits-all' credit to the poor probably does not help – and may quite possibly do harm;
- a reliance on heart-warming anecdotes in place of robust and transparent analysis helps nobody;
- savings and insurance are probably more important than credit in bringing the un(der)banked into the financial system in a useful, sustainable way; and
- microfinance is about neither purely commercial access to new markets nor purely social poverty alleviation for the poor. It has dual roles, which sometimes come into conflict and sometimes complement one another.

Only six or seven years ago, the SPM framework that we see today – with Universal Standards designed by the Social Performance Task Force, the Client Protection Principles of the SMART Campaign, the Seal of Excellence for Poverty Outreach in Microfinance being promoting by the Microcredit Summit Campaign, and UNPRI's Principles for Investors in Inclusive Finance (let alone the continued evolution of the rating agencies and the social reporting submitted to the MIX Market) – would have been hard to imagine. Mobile banking (the ability to save, remit and transact money stored on a mobile phone – a phenomenal tool for the unbanked) was barely a glint in the Department for International Development (DFID)/Safaricom's eyes, nor was much of the most exciting work being done within microfinance in livelihood or value chain finance, 'last-mile' energy finance, food security or financial education.

So only a couple years from the 'Chicken Licken' scenario brought about by front-page headlines of Indian suicides and the disaster of the SKS IPO, I am excited about the future.

Of course, you cannot talk about challenges and issues without success or failure – and you cannot discuss these without considering what success actually is. As argued in the introduction, every writer in this book will have a different definition of 'microfinance' because there is no single one. Each will have a different idea of what success for the industry looks like.

For me, it is not about poverty alleviation as a direct objective. I am generally pleased with the sea change which has heralded a focus on financial inclusion. I truly believe that the provision to the poor of appropriate, demand-led, ethical, scalable and potentially profitable financial services, leveraging new technologies and provided in conjunction with financial education is a good thing. Diversifying the industry's funding among government, development finance institutions, retail social investors, savings mobilisation, local bank funding and institutional investors is a good thing. And regulating not only the lenders (the microfinance institutions (MFIs)) but also the funders (investors) recognises the role that a surfeit of cheap funding chasing too few clients – a key driver of the Indian crisis – can have in over-

heating a market and bringing the whole thing crashing down.

However, if long-term success is a stable and sustainable industry of institutions providing quality, useful services to the poor, this remains a long way off: there are risks to mitigate on the journey ahead. Without claiming to be an exhaustive list – and with the caveat that this is a think-piece and not an academic journal article – here are some of the key issues along the way.

2. **Banana skins ahead**

As co-author since 2009 of the annual Microfinance Banana Skins survey, my colleagues and I get a good feel for the risks facing the industry, and the way that perceptions move over time. Banana Skins – an industry wide, forward-looking, qualitative and quantitative survey of risk – asks respondents to predict the risks facing the industry as a whole (although many undoubtedly focus only on their own market) over the coming three to five years. While we try to look beyond the medium to the long-term health of the industry, the results from the last couple of Banana Skins are revealing – and worth a short summary.

Microfinance Banana Skins 2012 (2011 position in bracket)			
1	Overindebtedness (-)	11	Mission drift (9)
2	Corporate governance (4)	12	Back office (13)
3	Management quality (7)	13	Macro-economic risk (17)
4	Credit risk (1)	14	Staffing (8)
5	Political interference (5)	15	External risks (-)
6	Quality of risk management (-)	16	Technology management (11)
7	Client management (-)	17	Too little funding (23)
8	Competition (3)	18	Interest rates (21)
9	Regulation (6)	19	Too much funding (22)
10	Liquidity (16)	20	Foreign exchange (24)

The 2011 survey was conducted in late 2010. As expected, the crisis in India – along with problems in Morocco, Bosnia and Pakistan – dominated responses. Our introduction reflected some of these fears: “In the last two years, microfinance has found its enviable reputation under attack for a number of perceived reasons: its growing commercialism, as evidenced by an increasing focus on size and profitability, a decline in standards, particularly in the area of lending, and a sense that the industry may be drifting away from its original ‘double bottom line’ purpose.”

Many respondents cited AP specifically, and many more expressed concern at the issues being raised there: overconcentration, collection practices, mission drift and pricing.

The 2011 survey showed dramatic shifts. ‘Reputation’ rose 15 places to second overall (out of 24). ‘Political interference’ rose five spots to fifth and ‘mission drift’ climbed 10 to ninth place, revealing an industry paying extremely close attention to

India and concerned about the future. Movement was not just relative but absolute. In terms of severity, respondents felt the risks were getting worse. There was, in late 2010, genuine concern for the future – or the value – of microfinance.

Around the same time, a lot of quasi-scientific speciousness was being trumpeted by Milford Bateman, whose book *Why Doesn't Microfinance Work?* was being widely read – and widely disputed. The UK government's All-Party Parliamentary Group on Microfinance, quoted him thus: "The MF movement... has failed to provide robust evidence that is it meaningfully associated with poverty reduction... many specialists [now believe] that microfinance actually undermines the process of sustainable poverty reduction and 'bottom-up' economic and social development."

What was previously heresy (questioning microfinance's positive impact on poverty) was becoming more prevalent. A DFID study failed to find any evidence of positive impact. The perception that microfinance has failed to do what it should have these past decades – to prove its worth, instead of self-congratulating with heart-warming anecdotes – was spreading. AP did not cause this, but it certainly helped it along.

Just over a year later, the 2012 Banana Skins survey showed much more self-awareness among practitioners and funders. Awareness of risk is, after all, a "precondition to coping" as one survey respondent noted, and a first step in beginning to manage and move beyond the hurdles ahead. The high rankings of overindebtedness, quality of risk management and client management – all new entries – bodes well.

However, despite greater confidence in practitioners' preparedness for challenges and much greater awareness of the Responsible Finance agenda, the survey results did raise important questions about MFIs' capacity to rise to the occasion, and in particular the capacity of management and staff to cope with the complexities of the new operating environment.

According to more optimistic observers though (myself included), microfinance has already begun to emerge from this difficult period and is in a stronger state, having learned (some) lessons and resolving to do better. Nonetheless, questions remain over the industry's direction. Can it find a future which combines its social objectives with the more demanding commercial world in which it operates? As it navigates its way forward, what are the hurdles that it faces? The overall message from the 2012 survey was that the immediate risks posed by the global economic crisis and by the controversy over the industry's mission have eased – but that larger questions about the future direction of microfinance remain. This book addresses many of these larger questions.

The Banana Skins survey has its uses, but looks only to the short to medium term, and is a line-of-best-fit of the agendas of a disparate group of respondents: non-governmental organisations (NGOs), non-bank MFIs, commercial banks, MIVs, development finance institutions (DFIs) and regulators among others – most with a specific geographical focus.

I would like to take a few of the general themes that have been consistently raised, and look beyond the comments of Banana Skins respondents and beyond the medium term. I will briefly look at five key issue areas, 'hurdles' which I think the

industry will have to surmount:

- reputation;
- institutional issues;
- the client;
- products; and
- funding.

3. **Reputation**

Critics see MFIs allowing their business and ethical standards to slip as they pursue business targets, disregarding the interests of their customers, and putting the industry at risk. As well as the reputational consequences of this shift, there is the practical concern that certain investors and donors – DFIs in particular – could become less willing to fund an industry whose main objective is perceived to be profit.

The big money flowed into certain microfinance markets in the mid-2000s, as MIVs scrambled to achieve double-digit returns in new markets, and the recipient MFIs scrambled to find new clients to make the profits to generate that return. That trend, despite the collapse (and now partial recovery) in Indian microfinance, has not stopped. The money is still there, still active, and the question remains: “Is the industry as a unit able to sufficiently keep those destructive flows in check?”

Much will turn on how effective are measures in place to stop future bubbles. The risk is of a combination of reputational fallout with a credit failure. That is, there is only so much more market deterioration that the sector can handle, because it remains hugely dependent on foreign money (with the exception of a few well-developed markets such as Bangladesh, India, Peru and Mexico) from DFIs, social investors, MIVs and multilaterals. That tipping point has not been reached, but there is the possibility that a couple more market disasters, and it will be all over. In an ideal world, savings mobilisations and local bank funding would take up the slack, but reducing dependence on foreign funding takes time – especially in the many markets that are in the early institution-building stages of development. It is ironic that tapping capital markets was supposed to be the great leap forward for microfinance. It may be its undoing.

What would being “all over” look like in practice? If the DFIs lose their appetite for investing in the industry, it will be serious. Microfinance is a small part of DFIs’ portfolios, but this small part comprises a large part of non-deposit microfinance funding. And that’s just debt; equity is also dominated by foreign money, even more so.

Reputation has two sides to it, of course. There is the reputation of the industry as a relatively low-risk, relatively high-return alternative investment class, and there is the social reputation – microfinance’s mission of helping the poor by providing useful financial access (and unshackling them from the much-hated moneylenders). Future empirical evidence on whether microfinance works will affect this social reputation, especially with divergence of view on what microfinance is for. Either way, preserving both reputations – financial and social – will be a big hurdle to overcome for the long-term future.

One Banana Skins respondent put this issue well: "Is microfinance primarily about financial inclusion or poverty alleviation? Is microfinance primarily a business opportunity or a development intervention? Does microfinance really meet both financial and social return expectations? Is it an 'either or'? Or has microfinance many faces? Whatever the answers, the industry's reputation will never be the same."

4. Institutional issues

Over the past decade or two, there has been a general trend from an initially NGO-led sector, to an industry in which non-bank MFIs and increasingly commercial banks are the dominant institutions. The objectives can and should change: now the objective is a full range of useful financial services for those currently unserved or inadequately served. The goal is not to have lots of profitable MFIs. This is like saying you should have profitable departments in a bank, rather than embedding an international perspective in the whole of what the bank does.

There are thousands upon thousands of MFIs in dozens of countries today. But the MFI – typically the non-bank financial institution (NBFI), although we should include semi-formal credit and savings groups, NGOs and some banks in this – need not be the foundation of the microfinance industry. The next stage in the evolution of microfinance will include considering what lies beyond MFIs. This is the osmosis of microfinance products or services into the broader economy and not MFIs for their own sake.

The emergence of the MFI over the past four decades was, as with many organic developments, messy, unplanned and sub-optimal. When anything starts, it begins in its own bubble, away from the rules that disallow it. So while there is some case to make that savings should really have started before insurance, which in turn was before credit, there are perfectly clear reasons why it happened the way it did. Savings are slow and hard. Credit is quick and easy. And people wanted a big impact fast.

However, among the most interesting discussions about what future success (within the definition of 'financial access' I gave at the start) looks like is the institutional issue. Do we want all retail banks to go downscale to reach microfinance clients themselves? Do we want the non-bank MFIs going upscale so they do not have to hand off their best, profitable clients who are just on the cusp of paying back all that investment as a small and medium-enterprise (SME) owner? This is the 'graduation'. The gap between micro and SME-finance remains, for the most part, a chasm.

So who do we want the players to be? Does microfinance become the charitable leftovers for those who mainstream banks fail to reach? Is the goal that everyone is served, and as big a proportion as possible served by private sector, by a bank, with infinite graduation possibility? Or is the goal that the institution looks beyond lending money, calculating its risk and charging interest?

If the goal is indeed to go beyond merely increasing financial access, let me give a short example.

A 'rickshaw loan' given by some MFIs in India is a good example of credit customised for a specific purpose. Eight million livelihoods depend on this low-cost,