

THE ETHICAL DIMENSION OF MICROFINANCE

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Introduction¹

Although microfinance as a practice is probably very old, the term itself is very recent. It started to be used in the 60's and 70's, when organisations such as ACCION International, Opportunity International and Grameen Bank started to grant small loans (less than 100 dollars) to microentrepreneurs, mostly women, backed by a group guarantee, thus overcoming the lack of collateral that was the main reason for the lack of attention paid by commercial banking to the low-income segments of the population.

Since then, microfinance has experienced considerable growth. In 2006, Mohammad Yunus and the Grameen Bank were awarded the Nobel Peace Prize “for their efforts to create economic and social development from below (...). From modest beginnings three decades ago, Yunus has, first and foremost through Grameen Bank, developed microcredit into an ever more important instrument in the struggle against poverty (...)”.²

At present, microfinance has now become one of the standard tools used in development and poverty reduction policies. It is estimated that in 2007 the volume of

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² Cfr. <nobelprize.org/nobel_prizes/peace/laureates/2006/press.html>.

outstanding microcredits in the world stood at about 25 billion dollars, with about 125-150 million beneficiaries (*Financial Times* 2008, 1).³

The social goal pursued by the microcredits gave them an aura of respectability that they have maintained over the decades. However, with the passing of time, critical voices have also emerged: some of the features that made them attractive have been lost or become blurred, such as the joint liability. Other questionable aspects, such as the high interest rates charged by the microcredits, have been maintained, and microfinancial institutions (MFIs) have placed increasing emphasis on their operations' economic sustainability, which has led some to think that they were not being true to their social function and ethical content.

This chapter offers an overview of microfinance and a detailed discussion of the ethical problems associated with them. There is a very extensive literature on microlending,⁴ but the literature that is specifically concerned with its ethical dimension is very limited (Hudon 2006, 2007, 2009, Vakulabharanam and Motiram 2007, Vanroose 2007).

The following sections discuss the concept and scope of microfinance and the features of the microcredits, after which we will turn to issues with a higher ethical content: microfinance's social responsibility, the debate between the MFI's financial sustainability and their social function, and the ethical issues raised by setting interest rates and the MFI's right to earn a profit. The chapter closes with the conclusions.

Microfinance

The shortest definition of microfinance, and perhaps the most comprehensive, is the provision of financial services to poor, low-income people who, in normal conditions, would not have access to them (the *unbankables*). The reasons for this exclusion may be the location (farmers who live far away from towns), the lack of income (which makes it difficult to repay

³ The differences in the figures between the various sources are substantial. Stephens (2008) reports information on almost 900 microfinancial institutions in 2007, with 366,000 employees and more than 40,000 branches throughout the world, more than 64,000 borrowers and almost 32 billion dollars in credits.

⁴ Cfr. summaries in Armendáriz de Aghion and Morduch (2005), Ghatak and Guinnane (1999), Morduch (1999), and Sengupta and Aubuchon (2008), among many others.

the loan) or assets (i.e., they cannot provide any surety), the lack of a financial track record or other reasons, which altogether mean that the potential client is not profitable for a traditional financial institution.

Microfinancial services started with the microcredits, but they also include payment methods (cards, transfers, emigrant remittances), savings instruments (current and savings accounts and other assets), insurance, pension funds, financial leasing, etc. This extension is based on the realisation that microentrepreneurs' needs go much further than credit and may also include training, creation of social networks, education, health, access to land ownership, information, etc.

Microfinancial services are provided by a broad range of organisations: commercial banks, non-bank financial companies, public and development banks, credit unions, etc, both non-profit and for-profit. The institutional landscape is completed with 1) the providers of funds, which may be the clients themselves (through deposits) or other financial institutions, such as unit trusts, private equity, public or private donors, etc.; 2) partner financial institutions that render services to foundations or NGOs, and 3) supranational organisations that create microlending networks, such as *ACCION International*, *Women's World Banking (WWB)*, *Kreditanstalt für Wiederaufbau (KfW)* and *The SEEP Network*.

The goal of microfinance is to eradicate poverty and underdevelopment. It is based on two basic assumptions. 1) The lack of access to financial services is a major (although not the only) cause of poverty. 2) Access to credit is key for the development of entrepreneurial projects that will provide borrowers with a stable income, assets, and also knowledge and skills that will enable them to lift themselves from poverty, thereby extending the impact to the local community (through the creation of jobs and income, the generation of new ideas) and the country as a whole. This assumption implicitly holds another within it: there is a considerable supply of entrepreneurial ability, even among people without any financial resources or specific training.

Microcredits

Based on the practices of the Grameen Bank, microcredits are usually identified as having the following features (Armendáriz de Aghion and Morduch 2005):

- a) They are for small amounts.
- b) The beneficiaries are poor or very poor families and, within them, particularly women.
- c) Their goal is to help the beneficiaries put an end to a state of poverty by generating self-employment activities or entrepreneurial projects and, sometimes, enabling construction or purchase of a dwelling, but not covering day-to-day expenses.
- d) They are not backed by physical collateral or a contract whose performance can be enforced by law but are founded on trust.
- e) In order to obtain the credit, the beneficiary must belong to a group (group lending): considerable importance is given to the creation of social capital among the participants.
- f) The guarantee is collective, with joint responsibility by the entire group.
- g) The microcredit programme develops a distinctive credit selection and management methodology and a personalised system for relations between the MFI's staff and its clients: it is the bank that goes to the client and not the client who goes to the bank.
- h) Interest and capital are paid in regular instalments at frequent periods (every week or fortnight) and in public.
- i) The credits are granted in a continuous sequence. The quantity offered in each new credit increases and is conditional upon prior repayment of the previous loans by all of the group's members.
- j) The lending programme is complemented with compulsory or voluntary savings programmes.
- k) The interest rates stipulated do not seek to provide an attractive return for investors but to guarantee the programme's sustainability. However, the sustainability goal is subordinated to providing a service to the poor.
- l) The loans are usually granted through non-profit organisations or institutions owned by the users themselves (cooperatives), although participation is also open to for-profit institutions.

However, microlending can take on many and varied forms, such that, in practice, there is no unanimous – or even majority – agreement on each of these individual features. These features are discussed in greater detail below.

1. *Amount.* A microcredit is the act of lending a small amount, less than what is usually lent in commercial banking. Its amount depends on the borrowers' ability to use it effectively and, above all, on their ability to pay interest and return the capital in various instalments.

2. *Beneficiaries.* Microcredits usually target people who are close to the poverty threshold (they live on slightly more than two dollars a day), "poor" people (who live with less than two dollars) and "destitute" people (who live with less than one dollar). The ethical problems arising from the microloans' goals and beneficiaries are discussed below.

3. *Women.* Preferential lending to women is based on three assumptions: 1) they are better administrators; 2) the money they receive will have a greater effect on the family's wellbeing, particularly on the children, and 3) in many countries, they are discriminated against in the development of their abilities and the roles they can perform, with the consequence that the microcredits may be a useful tool for increasing their empowerment and improving their status and opportunities. In fact, many microcredit programmes target primarily women (97%, in the case of the Grameen Bank (*Financial Times* 2008), for example).⁵

4. *Microenterprises.* The microcredit's purpose is not to solve occasional problems caused by lack of income but to start up a self-employment programme, or create or expand a microenterprise, buy a business or farmland, etc., in a small industrial or craft business, retail sale, street-selling, a farm, etc. The intention is that borrowers are able to generate future income that will enable them to pay interest and return the loan.

This purpose of the microcredit is based on two assumptions: 1) that poor people have entrepreneurial abilities that they cannot put to good use due to lack of financial resources, so it is enough to provide these resources to enable them to change their lives, and 2) that self-help is much more effective than public or private aid targeting the low-income population.

5. *Other uses.* Rather than restrict the microcredit to an income-generating function, other authors suggest allowing the borrower to decide how the funds are used, which may also

⁵ Khandker (2005) and Smith (2002) provide empirical evidence to support the efficacy of microcredits targeting women; for evidence against this, cfr. Goetz and Gupta (1996). Cfr. Brau and Woller (2004) for a summary of papers on this subject.

include covering extraordinary expenses (a wedding, a funeral or a disease), a temporary fall in income (a bad harvest), finance the purchase of a trousseau or educational expenses, etc. (Nourse 2001).⁶ However, if the microcredit is used for consumption, it may be harder to repay it and its economic impact may be more limited.

6. *Group guarantee.* As we have already pointed out, microcredits are usually not granted against a physical guarantee but on the basis of trust. Accordingly, credit applicants join groups that perform a variety of functions: share information, negotiate together, monitor other borrowers' compliance, and even share in their members' liability, undertaking to pay their debt if the borrower defaults.

The most distinctive feature of microlending, at least in its early stages, was the group liability: as the borrowers have no assets, their real guarantee is replaced by that of the group, whose formation is facilitated by the fact that the members already know each other. These members join the group voluntarily and usually live in the same place. The group's meetings with the MFI's representative are held in public and at these meetings, each member makes his or her payment in the presence of all the others. The fact that it is a group enables members to monitor each other's compliance and bring pressure to bear on defaulters, appealing to arguments such as reputation or shame, or threaten reprisals.

However, many authors also give reasons against joint liability: for example, it raises free rider problems (Stiglitz and Weiss 1981): the fact that liability is accepted jointly may attract potential borrowers with a higher risk (adverse selection) and encourage higher risk behaviours (moral risk). And it may also have a "domino effect", when non-payment by one member of the group induces the others to also default, if the liability they would incur is too burdensome (Schreiner 2003). Therefore, if social pressure is to effectively counteract these perverse incentives, it must be very strong, perhaps unjust.

⁶ In fact, "scattered research suggests that only half or less of loan proceeds are used in business purposes. The remainder supports a wide range of household cash management needs". "What is microfinance", in www.microfinancegateway.org/section/faq%23Q2, no. 5.

7. *Individual guarantee.* In spite of the success achieved with the group credit,⁷ many MFIs do not work with groups and some of those that do are reducing the percentage of their portfolio made up of group loans (including Grameen Bank). This may be for efficiency reasons: many of the advantages discussed above (sharing information, peer pressure to abide by the contract, mutual help, etc.) are the result of the group treatment of credit, without any need for joint liability. It may be appropriate in the programme's early stages but when the group and the MFI have obtained the necessary information on each member and the member in question has already acquired some real guarantees and a greater confidence in his or her project, the individual guarantee may offer more advantages (Drugov and Macchiavello 2008).⁸

8. *Repayment.* When the loan is granted, regular instalments are specified for paying interest and returning the capital (the amount is constant during the loan period). The first instalment is usually a few days (often, one week) after the loan is granted and the instalments are also spaced closely together (weekly or fortnightly) during the loan's term (usually six to twelve months). Using this procedure, the amount of the instalments is low, which facilitates regular payment and reduces monitoring costs.

9. *Bank-client relationship.* The public nature of the transactions and the unique relationship between clients and the MFI also play a major role, which starts with the formation of the group, discussion of the microcredit's terms and provision of the money. It is not the client who goes to the bank but the bank that goes to the client: meetings are usually held at the borrowers' village or town, often in a public place, such as the market square. The MFI's employee comes weekly or fortnightly and meets with each group of borrowers (attendance is compulsory) to discuss any problems that have arisen and review the credit's status. At this meeting, each member of the group pays his or her instalment in the presence of the other members; if a member cannot pay, he or she must say so at this time because the meeting is usually not concluded until the employee has received all the payments, either from

⁷ Empirical studies on the factors that determine high credit repayment rates include Ahlin and Townsend (2007), Cassar et al (2007), Hermes et al (2005), Karlan (2007), Sharma and Zeller (1997), Wenner (1995), Wydick (1999), Zeller (1998).

⁸ As a general rule, the commercial banks that engage in microlending prefer individual liability, while the non-profit institutions prefer group liability. Cfr. Cull et al (2008).

the borrower or from the other members of the group. Under this system, the defaulter is under very strong pressure from the group, which explains, at least in part, the high repayment rates obtained with these loans.

10. Credit scaling. The incentive to repay the loan within the stipulated period is not just based on the social costs (prestige, shame, etc.) mentioned previously but also on the fact that honouring the loan's terms by all of the group's members is a necessary condition for entitlement by any one of them to future loans. These loans usually follow a progressive scale: the first loan is small, which makes it easy to return and reduces the group's monitoring costs. When this loan has been fully repaid, clients may have access to other loans for higher amounts. This is in the interest of each member, because he or she can now ask for larger sums; of the group, because their monitoring costs are now lower; and of the MFI, because their costs are reduced by economies of scale (it is common for the first two or three loans to a client to provide very little return, because the administrative costs are very high compared with the quantity lent) (Roodman and Qureshi 2006).

11. Savings. The MFI's usually encourage their clients to save voluntarily, or impose compulsory saving, which is included in the microcredit instalments. By this means, the borrower shows his or her willingness to abide by the terms of the loan; it provides an additional guarantee for the credit and complements the repayment instalments; it provides an additional source of income for the family; it helps develop habits of austerity, good administration and thinking about the future, and provides an incentive for punctual performance of one's obligations, because non-compliance of the compulsory saving condition may imply loss of the quantity saved and exclusion from future credits. On the other hand, it increases the cost of the credit (due to the differential between the interest rate paid on the loan and the interest received on the savings).

12. Interest rates. The microcredits' interest rates are usually high, often above 100% per annum. This raises efficiency and, above all, equity problems, which we will discuss further on.

The social responsibility of microfinance

Is microfinance ethical? The most common answer is yes: microfinancial institutions' moral legitimacy is given by the goal they pursue. But what goal provides moral justification for a MFI. To help us determine this, we will first consider how they perform their social responsibility and, second, the social results achieved.

The social function of microfinance

In principle, the social function of any organisation is justified by its internal and external mission (Pérez López 1993). The former is defined by its contribution to satisfying those needs that drive its members to pool their effort in a common task: how it rewards the labour and capital provided and how it sustainably and efficiently offers satisfaction, knowledge and skills to employees (while earning a profit in the case of a business enterprise).

The external mission is defined by the needs of clients, suppliers, local community, etc. that it tries to satisfy, including its actions' impact on outside stakeholders. This external mission is specific to each type of company: in the case of financial institutions, it will be the provision of brokerage services that facilitate the flow of savings towards investment (Argandoña 1995, Merton and Bodie 1995). Each MFI will adapt this generic social function to its nature (commercial bank, hedge fund, insurance company, etc.) and the environment in which it operates (e.g., whether it is a developed or emerging country).

Each MFI defines and implements these responsibilities, to a greater or lesser extent, and expresses them in a series of voluntary policies: in the case of the MFIs, the provision of financial services (generic social function) to people who until now were excluded from the system (specific function arising from the nature of their activity and the environment they operate in). This is then implemented using different models: some of them minimally fulfil their social function while trying to maximise profits; others give more weight to social results, although they also try to cover their costs; and, lastly, others emphasise helping the most needy, even if this entails incurring in losses, which are covered with donations. We can therefore say that all of them fulfil, at least in principle, the generic social function of financial institutions but the degree to which they assume their specific responsibilities varies in each case, depending on how they have voluntarily defined their external mission.

Social results

It is not easy to measure the social results of microfinance, because these organisations usually pursue different goals, that cannot be measured by applying uniform criteria, for society as a whole (economic development, poverty reduction, women's empowerment), for their clients (improve the microentrepreneurs' standard of living), or for the lending institution (its sustainability). Which goal is used, or which are combined, is always a more or less arbitrary decision, and the measurement of these variables is also subject to discrepancies.

The empirical studies do not show any agreement on the results achieved, not even in one of these variables, and the methods used in most of these studies are subject to serious criticism. Even so, the best empirical studies support the microcredit programmes' effectiveness in reducing poverty and empowering women.⁹ Dunford (2006) concludes his review of several of these studies by saying that "in sum, the evidence seems sufficient to say that [microfinance] – particularly when provided to relatively poorer women – increases income and savings, improves nutrition and health, and empowers women" (p. 12), and that "many microfinance programs are reaching large numbers of very poor while fully covering their costs" (p. 13). As regards the effects on the direct beneficiaries (microentrepreneurs and their families), there are many, more or less anecdotic cases of very positive results (although it is not possible to generalise from these conclusions).

It would therefore seem that an ethical appraisal of microfinance would give a positive finding, at least as regards their social function and results. But good intentions or positive social results are not sufficient in themselves: like any human organisation, the MFI must also observe ethical criteria in its decisions: fairness in granting the microloans, avoid generating dependence and overborrowing, prudence in management, etc.

⁹ For recent reviews of these studies, see Armendáriz de Aghion and Morduch (2005), Goldberg (2005), Morduch et al (2003), Watson and Dunford (2006). Khandker (2005) is a particularly careful paper, based on three large-scale programmes in Bangladesh; his conclusions are clearly positive.

Sustainability and the fight against poverty

The debate on the ethics of microfinance has been focused recently on the compatibility or not between its economic (cost coverage) and social dimensions (outreach). In this section, we will discuss two issues: 1) Whether the MFIs can and/or should be financially sustainable,¹⁰ and 2) whether they can try to earn a profit like the commercial banks, that is, whether for-profit organisations can take part in microfinancing.

Microfinance has an economic dimension and, as such, it is reasonable that it be required to show efficiency in its management, which will manifest in coverage of its costs and earning a profit. However, it is also an instrument for social policies and some (the “welfarists”) argue that it should subordinate its strategies and policies to its social function: provide the best possible service at a price that can be afforded by the greatest possible number of people, particularly the poorer people, even if this means that it will always be dependent upon donations and subsidies.

On the other hand, the “institutionalists”, while acknowledging the social function (outreach), add that financial self-sufficiency is a necessary condition for the MFI’s survival and for expanding its activity to more potential clients, as its social function requires, without having to resort to a continuous injection of donations –and they consider that both goals should be compatible with each other, at least in the medium term.

The debate between these positions has given rise to what Morduch (2000) calls the microfinance “schism”. This debate can be analysed on two levels: historic development and principles.

The development of microfinance

From the historic viewpoint, the discussion is a consequence of the organisations’ evolution. They started off as subsidised organisations: the product was new, the clients were

¹⁰ Here, sustainability refers to the economic aspect, not the environmental aspect, i.e., coverage of operating expenses and capital costs.

not the conventional clients served by commercial banking and the risk was very high, so that cheap funds provided by subsidies were required to cover start-up expenses. At that time, few people thought that there would ever be a time when these MFIs would be self-sufficient.

But with time, the MFIs learned to manage their business, they improved their procedures, increased their scale and reduced their costs. Sustainability was no longer a utopia and, for some of them, it became a necessity: the growth of their business forced them to look for broader sources of finance,¹¹ while the continuity of donations was no longer assured since it was affected by the appearance of other needs requiring the help of agencies and private donors. “The challenge is not to find a willing lender and endow it with sufficient loanable funds but, rather, to find a production function (a technology) that makes it possible to produce quality financial services at reasonable costs for the micro-client and in a profitable manner for the MFO [microfinance organization]” (González Vega 1998, 7). At the same time, commercial banking has also entered the microcredit business and some non-profit MFIs have now become for-profit organisations.¹²

In order to be sustainable, microfinance requires a mix of yield and risk that gives it appeal. This may be feasible for some organisations but not for all of them. Hence the danger that some may relinquish their social function for the sake of sustainability, e.g., charging very high interest to increase their profitability or cutting back on their portfolio of very poor borrowers to reduce their risk (Conning 1999).

¹¹ In 2007, the 892 MFIs who provided information to Microfinance Information eXchange (MIX) obtained 72% of their funds from deposits or commercial debt and only 2.5% from subsidies (Stephens 2008, 29). The inability to gain access to sustainable sources of funds accounts for the high percentage of MFIs who do not manage to grow (73% of them never get beyond 2,500 clients: “Economies of scale”, in <www.microfinanceinfo.com/economies-of-scale>).

¹² This is the case of *Banco Compartamos*, Mexico’s largest MFI, which was created in 1990 as a non-profit institution. Over the following years, it received 4.3 billion dollars from international development agencies and private donors. In 2000, when it had 60,000 clients, it became a commercial bank; by 2006, it already had 616,000 clients, and it decided to go public in 2007. This operation aroused the interest of investors: 30% of its equity was placed for 450 billion dollars, which gave an annual compound rate of return of 100% (Rosenberg 2007). Some institutions, such as ACCION Internacional, saw a model in this operation that other MFIs should follow but there was also strong criticism from those who interpreted it as a betrayal to the spirit of microlending, as Compartamos charged interest to its borrowers at an annual rate of 120%, compared with 31% charged by similar institutions (Lewis 2008, Yunus 2007).

Microfinance and profit

The debate on principles has focused on criticising those people who seek to earn a profit by doing business with a country's poorest people. However, we feel that this view is mistaken. If someone intends to supply goods and services to those who have nothing (e.g., severely disabled people or children in a state of complete destitution), it is not reasonable to obtain anything from them because they have no possessions. However, if they can give something, it is reasonable to ask them for a little (e.g., people who go to charity-run community canteens should help in cleaning up afterwards), not to obtain a personal profit at their cost but to help them appreciate what they receive, to reduce costs (so that more people can benefit from the service) and to restore their human dignity. And such an argument would be even more justified if they are provided with resources that enable them to improve their situation, as is the case of the MFIs.

Therefore, it seems reasonable for a MFI to require something in exchange from the microcredit's beneficiaries (return of the capital and payment of interest). To say that these institutions earn profits at the cost of the poor, and not by helping the poor, is to ignore the very nature of business activity, portraying it as a predatory activity.

However, this does not give a final answer to the question of the compatibility between sustainability and outreach. "Much of the enthusiasm [about microfinance] rests on an enticing 'win-win' proposition: microfinance institutions that follow the principles of good banking will also be those that alleviate the most poverty" (Murdoch 2000, 617). Obviously, this is true for some organisations but it does not need to be true for all of them: many have not achieved this nor is it likely that they ever will,¹³ either because that is their chosen strategy or because they are prevented from doing so by factors such as the regulatory framework, government

¹³ Among the optimists, see González Vega et al (1997), Hulme and Mosley (1996). Among those who think that it is not possible to achieve both goals, at least as a general rule, Morduch (2000).

attitudes, competition from other financial institutions or the impossibility of gaining access to cheap sources of finance.¹⁴

In any case, a growing number of organisations are trying to make their social function compatible with operational sustainability. This can also mean a rapprochement to the traditional banking model, either as a result of a deliberate decision by the MFIs themselves or because they are forced to do so by the environment in which they operate. We do not know what effects this may have in the long run on the extent, depth and nature of the microcredits.

The ethical problems associated with interest rates

A large part of the debate between *institutionalists* and *welfarists* is concerned with the interest rates charged by the MFIs, which are often very high.¹⁵ This raises three economic and ethical issues: 1) Are these high rates justified? 2) What should be the interest rate stipulated for each operation? 3) If, as seems logical, a high interest rate discourages the poorest clients, does this give rise to a moral duty for the MFI?

Why are the interest rates so high?

The following arguments are usually given to justify the high interest rates (Goodwin-Groen 2004):

1) The alternatives available to microcredit clients also charge very high interest rates: for example, informal lenders and pawnshops may charge up to 20% per day (Lewis 2008, 57).

¹⁴ The empirical studies on the effect of a greater sustainability on outreach are not conclusive; for recent summaries, see Goldberg (2005) and Weiss and Montgomery (2004). Hulme and Mosley (1996) and Copestake et al (2005) show that the poorest people are the least benefitted by microcredit, but Khanker (2005) and EDA Rural System (2004) come to the opposite conclusion.

¹⁵ Cull et al (2008) calculate that the median interest rate charged by non-profit non-government MFIs is 25% p.a., while the interest rate charged by commercial banks on ordinary loan operations is 13%.

2) The profitability of microenterprises in developing countries is probably very high, particularly in the informal economy.¹⁶

3) The real interest rate is high because it includes the risk premium: the lender takes into account the likelihood of a loan not being repaid and increases the interest rate charged on all loans to cover the expected loss. And although the microcredit repayment rate is usually very high (close to 97% in many cases), as a group, the borrowers continue to be high risk, particularly because of their vulnerability to external factors, such as poor harvests, epidemics or recession.

4) The MFIs need funds, which they obtain from private investors, and their cost is high (because it also includes their clients' risk premium).

5) The interest rates must cover operational and transaction costs, which are usually very high: the clients often live at a considerable distance from towns, they are visited frequently and the meetings are lengthy. In addition, the administration costs (study and decision-making, monitoring and enforcement) are not less than those of a traditional financial institution but the amount of the loans is very small so they are unlikely to cover the organisation's overheads (it is just as expensive to process a microcredit for 50 dollars as it is to process a loan for 10,000 dollars).

The conclusion to be drawn from all this is that the microcredits' high interest rates may be justified by the lenders' cost structure and the borrowers' risk. However, the fact still remains that they are very high –and other costs must be added that are borne by the borrowers, such as the monitoring costs by members of their group (including the time spent in meetings), compulsory saving, etc.

The fair interest rate

¹⁶ “For a microentrepreneur, the cost of a microcredit loan represents a small proportion of total business costs. Studies conducted in India, Kenya and the Philippines found that the average annual return on investments by microbusinesses ranged from 117% to 847%.” (“International year of microcredit”, United Nations, 2005; quoted in “What is microfinance”, <www.mcenterprises.org/studycenter/microfinance>). However, Dehejia et al (2005) and Karlan and Zinman (2006) deny that the demand for microcredits is insensitive to the interest rate, at least for low-income clients.

The issue of what interest rate should be charged in a specific operation corresponds to commutative justice (Pieper 1966).¹⁷ In a competitive market, in which the prospective borrower has access to several credit providers with similar terms, the resulting interest rate will tend to be equal to the minimum amount needed to cover the provider's costs and the ethical problem will cease to be relevant. However, in the microcredit market, competition is usually limited so the resulting interest rate will depend on the two parties' relative bargaining power –and as the clients have little power, the interest rate imposed will be high (Hudon 2006).

In this case, fair price theory does not recommend what should be the fair interest rate: it cannot be said that the high rate is unfair but the MFI should remember that this extraordinary profit is not the outcome of its greater efficiency but because of its market power and its corporate social responsibility policies should address the best use that could be made of this profit: reduce the interest rate for all or some clients, allocate the extraordinary earnings to social activities, etc.¹⁸

Exclusion of the most needy

If the interest rate is high, it is likely that some potential clients, probably those with less income, will be excluded from the microcredit system. What should be the MFI's morally correct behaviour in this case?

This is a problem of distributive justice, which addresses the distribution of costs and profits between a group of people (Pieper 1966). There are a number of possible solutions: a lower interest rate can be specified for lower-income borrowers, which is financed by higher

¹⁷ This problem is a variant on the old fair price problem (Messner 1965). Commutative justice is the justice that regulates the relationship between two people: in this case, lender and borrower.

¹⁸ Sen (2006) is stricter when he discusses sharing the benefits of globalisation. For him, it is not enough that the poor borrower does not come out worse off, in absolute terms. In fact, he argues that profit distribution between the two parties should be biased towards the borrower, and increasingly so the poorer the borrower is and the greater the MFI's market power is (cfr. Hudon 2006).

interest rates for those who have more resources (a cross subsidy) or by public or private subsidies from outside organisations,¹⁹ or by waiving part of the institution's profits (provided that this does not endanger its sustainability). As we said earlier, the MFI's external mission should be to establish what needs of what people does it seek to satisfy and this will define its social responsibility on this point.

In any case, it is our opinion that this issue goes beyond microfinance's social responsibility in that it also has a political element: the sector absorbs a not insignificant volume of subsidies, it generates competition between organisations with very different profiles, it receives different treatments from the authorities and, in short, it gives rise to vested interests which often come into conflict, particularly when it must answer the question we asked ourselves here.

Conclusions

Microfinance has undergone considerable growth in recent years and, in general, has enjoyed a very favourable public opinion –which is deserved, at least in many cases. This paper has discussed its economic-financial, social and ethical features –and all of them must be taken into account when judging this reality which is, at one and the same time, an instrument integrated in development policies, a business opportunity and a service given to needy people.

Microfinance rests on certain basic assumptions, such as the role of capital and the importance of access to financial services for economic development to take place; the existence of a large supply of entrepreneurial ability, including among people without any financial resources or prior training; the importance of social networks as guarantors of the borrowers' conduct; the need for economic efficiency (sustainability) as a condition for the MFIs' survival and growth; the possibility and effectiveness of a development strategy devised by private institutions, without requiring any direct public involvement (but with the appropriate legal, regulatory and institutional framework), etc. If any of these assumptions is rejected or challenged, the appraisal made of microfinance will be different.

¹⁹ Sustainability-driven MFIs are unwilling to accept government aid, which imposes constraints on their characteristic flexibility, innovativeness and independence.

Microfinance is important for the institutions that offer it, for its clients, the local communities and society in general. It is based on an ethically correct motivation and its actions are morally good. Consequently, if it is applied with prudence, honesty and reasonableness, it deserves a positive ethical appraisal. It also seems to be positive when judged by its personal, social and economic effects, although there are reasons for being unsatisfied with the results, either because they have unwanted indirect effects or because they are insufficient in some of their dimensions, and also because success or failure depends on many factors that are outside its control, such as a favourable environment for the microenterprise (which is lacking in many developing countries: insufficient protection of property rights, inadequate incentives, lack of infrastructures and basic services, corruption, etc.), adequate regulation of the MFIs and a public policy that fosters it or, at least, does not interfere with it.

These organisations are not a panacea in the fight against poverty and financial exclusion and will not render other actions and development policies unnecessary. They have a lot to learn and improve –and, in fact, they are learning and changing, both in the technical-financial area (sustainability) and in the ethical area (outreach). “There appears to be ample room (...) for a diversity of programs, with competing methods and financial arrangements” (Morduch 2000, 626), and an extensive variety of MFIs, each one of which will leverage its comparative advantages: “For-profit institutions have important financial know-how and are able to mobilize important sums. The state owned institutions understand the local markets and benefit from a strong reputation among the poor. Their social knowledge could become essential to complement the financial knowledge of the for-profit institutions. Cooperatives have the deepest penetration in the market for small deposits. NGOs also can play a key role by helping to create experiments with new frameworks to develop the microfinance schemes. They also provide training and management capacity building in order to stabilize and sustain the growth in this field” (Hudon 2008, 41).

This ultimately implies that there is no point in opposing sustainability to outreach, and even less in defending a “fundamentalist” attitude about what a microfinance programme is and should be (Vanroose 2007). In any case, it is the institution itself that is responsible for this type of decision, since it will have to consider its mission and its goals, its limiting factors, the

intentions of its fund providers (owners, donors, financial markets) and clients, its competitors' strategies and the constraints of the legal and institutional environments in which they operate.

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