Banking on Social Entrepreneurship: The Commercialization of Microfinance

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I. INTRODUCTION

Two separate but equally virulent debates are now raging in the halls of private businesses, non-profit organizations, donor agencies, and academic institutions.

One debate is over social entrepreneurship, and revolves around private gain versus social value added:

- Is it appropriate, or even possible, for a profit-seeking business to have a positive social impact without at the same time compromising its responsibility to generate a reasonable return for its owners?
- Can a not-for-profit organization be run with the efficiency of a for-profit business without at the same time incurring significant mission drift?

The other debate is over sustainable microfinance, and also revolves around private gain versus social value added:

- Can regulated financial institutions, such as banks and finance companies, earn a profit from microfinance operations?
- Are the microfinance operations of non-governmental organizations (NGOs) sustainable without becoming regulated financial institutions?

These two seemingly separate disciplines, social entrepreneurship and sustainable microfinance, not only have matured dramatically over the past two decades, but they have also converged, so that the latter is actually a dramatic example of the successful application of the former.

This paper will first describe each discipline as a self-contained concept, and then focus on their convergence. Next, the paper will explore in greater detail the application of social entrepreneurship to the field of community banking by examining commercialized microfinance through regulated financial institutions. The paper will conclude with a discussion of the importance of

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matching institutional models with their missions, and thus, the continued need for non-commercialized microfinance to complement microfinance via regulated financial institutions.

II. THE CONVERGENCE OF TWO TRENDS

A. Social Entrepreneurship: Creating Both Private Value and Social Value

The term “social entrepreneurship” is extremely fashionable, even if often used imprecisely. For some, a social entrepreneur is a business with a conscience, so social entrepreneurship is synonymous with good internal and external corporate conduct, demonstrated by corporate social responsibility and corporate philanthropy, respectively. For others, a social entrepreneur is someone dedicated to re-engineering society, so social entrepreneurship is used interchangeably with terms such as social reform and community empowerment. Neither perspective, however, captures the unique aspects of social entrepreneurship that distinguishes this term from similar and somewhat overlapping concepts.

J. Gregory Dees of Stanford University’s Graduate School of Business provides a succinct and insightful review of the evolution and current meaning of social entrepreneurship (Dees 1998). He traces the origin of the term “entrepreneur” back to French economics literature of the seventeenth century, where “it came to be used to identify venturesome individuals who stimulated economic progress by finding new and better ways of doing things” and quotes French economist Jean Baptiste Say’s famous depiction of an entrepreneur as one who “shifts economic resources out of an area of lower and into an area of higher productivity and greater yield” (Say 1830).

Others have built on this interpretation of entrepreneurship without changing its core meaning, continuing to stress innovation and creation of value added. For example, Joseph Schumpeter describes entrepreneurs as change agents in the economy due to their radical reform of patterns of production to produce new commodities or old commodities in new ways (Schumpeter 1951), while Peter Drucker views entrepreneurship as the exploitation of opportunities created by changes such as technology, consumer preferences, and social norms, to create value (Drucker 1985).3

3 For more detailed examinations of contemporary social entrepreneurship, see Brinckerhoff (2000), Drayton (2003), and Bornstein (2004).
By adding the word “social” in front of “entrepreneur” we are simply creating a subset of entrepreneurs, namely those with an explicit and central social mission: they still innovate to create value, but the value added must be collective – private value added is either complemented or replaced by social value added. Thus, profitability is not a proxy for success, but rather, mission-related impact becomes the central evaluation criterion. This mission might still include private wealth creation, but it must also comprise achievement of a social objective.

There are three main types of social entrepreneurship: 1) public sector and non-profit reform resulting in significant social impact, 2) commercial enterprises that are non-conventional by being both profitable and creating positive social impact and 3) community-based catalysts for social transformation. All three types of social entrepreneurship embody the two key elements of this term: they exemplify entrepreneurship by creating value added through the innovative exploitation of opportunity, and they are social in their focus on improvement of collective welfare.

This paper will focus on the second form of social entrepreneurship as applied to the financial sector: it will demonstrate how the generation of private surplus and the achievement of social objectives can be complementary rather than contradictory. For readers interested in the first form of social entrepreneurship, Emerson and Tversky (1996) and Dees, Emerson, and Economy (2002) provide comprehensive guidance on enhancing the entrepreneurship and improving the overall performance of not-for-profit organizations; Alvord, Brown, and Letts (2002) offers an in-depth look at social entrepreneurship and social transformation, including several case studies.

B. Sustainable Microfinance: Micro Banking with Macro Impact

Many government officials, donor agency personnel, and commercial bankers think that financial services for the poor cannot be provided without subsidies. This is based on the belief that: it is both impossible and immoral to make money lending to microenterprises because of the operational expense, credit risk, and clientele’s low economic status; microenterprises are not a significant part of the economy, so the potential market is small in any case; and the poor do not and cannot save, so the mobilization of small-scale savings is not viable. They perceive microfinance not as a business with potentially large profits, but rather, as a form of community service. They feel that it is the moral obligation of banks to lend to microenterprises below cost, and that it is the social duty of

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1 This makes evaluation especially difficult, as market prices are often not good indicators of social value added. Total benefits and costs to society are not internalized, so positive externalities are often underproduced because their benefits undervalued, while negative externalities are commonly overproduced because their costs are undervalued.
the public sector to help finance microenterprises. Consequently, these microfinance programs are not sustainable, and are terminated when their financial losses exceed their political and social gains.

However, the poor do indeed save, and microenterprises are the foundation of most economies, contributing significantly to economic output, exports, job creation, and technological innovation. A vibrant microenterprise sector is important not only for economic growth, but also for social equity, as it improves the distribution of income and wealth, improves access to economic opportunities and upward social mobility, and helps to establish the foundation of a market economy 4.

Who are the potential clients of microfinance institutions? The microentrepreneurs are not the “poorest of the poor,” possessing few if any assets and generating minimal income. Instead, they are the “working poor,” sometimes known as the “economically active poor,” who own and operate unlicensed, unregistered, non-tax paying family or extended family businesses. The microsavers are low-income family households who welcome safe and accessible places to deposit their money as alternatives to traditional modes of savings such as cattle and jewelry 5.

Over time, a consensus has emerged that not only is it possible both to make money and provide essential financial services for low-income households and microenterprises, but that whenever possible, microfinance should be done in a commercially based, financially sustainable manner: microfinance institutions should cover all of their costs, including operational expenses, the cost of funds, and loan losses, as well as generate a surplus to provide a profit incentive and for reinvestment in new products, delivery systems, and technology. Government and donor assistance are still important in improving access to, and utilization of financial services, but these should be provided as a complement rather than a substitute for market-oriented financial services 6.

The stress on sustainable microfinance is based on the realization that microfinance institutions with the largest and longest-term impact are those with the financial discipline imposed by the “bottom line” and without the uncertainty caused by dependency on external resources. This emphasis on sustainability also provides the primary positive incentive for savers to deposit their funds (confidence that their savings are secure) and borrowers to repay their loans (continued access to financing). From a macroeconomic viewpoint, sustainable microfinance institutions not only ensure the long-term provision of

4 See Chen (2002) for a comprehensive overview of the informal economy.
6 See Morduch (1999) for a review of the microfinance sustainability debate.
essential financial services to the “unbanked majority,” enabling them to contribute to national growth through the accumulation of assets and the generation of income; they also serve as financial intermediaries integrating formal financial markets with informal real markets.

C. Social Entrepreneurship in Banking: The Commercialization of Microfinance

The development of financially sustainable microfinance is a dramatic application of social entrepreneurship to both mainstream commercial banking as well as NGO microfinance institutions. It demonstrates that banks can “do well by doing good”: they can generate considerable profit while at the same time have a significant positive development impact. Sustainable microfinance institutions are innovative creators of social value in that they pursue business opportunities where financial performance and social impact are dependent on each other rather than a tradeoff between each other. They apply conventional banking precepts in an unconventional manner, creating commercially viable financial institutions that double as social change agents.

III. COMMERCIALIZED MICROFINANCE THROUGH REGULATED FINANCIAL INSTITUTIONS

A. In Search of New Markets: Banks Scaling Down

Three developments over the past decade have motivated banks to search for new markets: deregulation of financial institutions, liberalization of financial markets, and globalization of financial services. These trends have lowered barriers to entry for new financial institutions, increased competition among both old and new financial institutions, and led to saturation of traditional financial markets. In order to remain profitable, and even more importantly, to continue to grow, mainstream commercial banks have increasingly tried to provide core financial services (savings, credit, and transfer/payment facilities) to those they previously considered unbankable. In short, banks have begun to “scale down” to microfinance in the search for new markets.

\footnote{For more detailed discussions of the macroeconomic impact of microfinance, see Cohen (2003), Snodgrass and Sebstad (2002), and the Imp-Act (Improving the Impact of Microfinance on Poverty) web site (http://www.ids.ac.uk/impact).}

\footnote{See Drake and Rhyne (2002) for a collection of essays on the commercialization of microfinance.}

\footnote{Valenzuela (2002) provides a nice overview of the trials and tribulations of commercial bank downscalers.}

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Banks bring several competitive advantages to microfinance, as they are experienced in managing a number of financial risks, including interest rate, liquidity, maturity, foreign exchange, and credit risks; are used to raising their own funds via a combination of savings mobilization, capital market borrowing, and equity contributions; have extensive retail distribution networks of branch offices, sub-offices, and electronic banking outlets; offer a wide range of savings, credit, and payment services; and adhere to prudential norms for sound ownership, governance, and management practices that foster a balance between maintenance of financial soundness and the pursuit of profits.

However, sustainable microfinance requires that banks adapt their operations to an entirely new market. Microenterprises are quite different from larger firms, and micro loans are not just smaller versions of conventional business loans. Likewise, the mobilization of small-scale household savings also requires modification of traditional fund raising modes.

Neither conventional credit appraisal techniques nor standard loan products and delivery systems are appropriate for lending to microenterprises, as they are family owned and managed, with very informal organizational structures and operations. Their businesses are cash based and often entail irregular cash flow, being either cyclical or seasonal. Business records at best might include a cash book, income statements and balance sheets are non-existent. Microentrepreneurs usually do not have credit histories with formal financial institutions, nor do they have conventional bank collateral such as land and buildings with clear legal title in their name. Microenterprises are also highly diverse sectorally and highly dispersed geographically. Thus, if banks do not adapt their lending approaches to the unique characteristics of microenterprises, they will incur an operating loss because of high transaction costs, as well as encounter significant risk of non-repayment due to inadequate assessment and management of credit risk (Rosengard, De Brouwer, and Kawai 2003, 23).

Banks must therefore change the way they make loans if they are to tap the microenterprise market profitably: the design of loan products must meet business needs and projected cash flow of prospective borrowers; loan processing must be swift and decentralized; staff must be familiar with local markets and communities; loans must be priced to generate a surplus after covering all financial, operational, and loan loss costs; and accounting, reporting, and supervision systems must be accurate and transparent.

The microsavings market is also quite different from the markets for conventional savings mobilization. Low-income households do not view savings primarily as “hot capital” in search of the highest return. Instead, they “save for a rainy day” such as unforeseen health emergencies and cash shortages caused by irregular income flows. They also save to accumulate funds for lumpy family expenditures such as long-term investments in education and
housing, unanticipated business opportunities, social or religious obligations, and retirement expenses.

The savings instruments for low-income households need to be designed to address these needs. Low-income savers are more concerned about the safety and accessibility of their deposits than the interest rate paid on these deposits. Thus, a sound bank that offers unlimited withdrawals and no minimum balance requirements or monthly account fees would be very attractive to low-income households, even if the interest rates were relatively low. Lotteries for small-scale savers have also been quite successful in mobilizing funds from low-income households\(^\text{10}\).

The most successful commercial bank downscaler is Bank Rakyat Indonesia (BRI), a profitable, full-service, nation-wide bank that was entirely state-owned until the government of Indonesia divested 40.5 percent of its ownership in a November 2003 initial public offering\(^\text{11}\).

As of 31 October 2003, BRI had 3.1 million KUPEDES (General Rural Credit) micro loans outstanding, totaling Rp 14.3 trillion (U.S.$1.7 billion); and 29.7 million savings accounts, totaling Rp 26.0 trillion (U.S.$3.1 billion). During the month of October 2003, BRI made 244,495 loans totaling Rp 1.8 trillion (U.S.$21.2 million), while portfolio quality remained excellent: the twelve-month loss ratio\(^\text{12}\) was 1.69 percent, and the portfolio status\(^\text{13}\) was 2.29 percent. BRI’s microbanking profits for the previous year (per 31 December 2002) were Rp 1.7 trillion (U.S.$200 million) (Bank Rakyat Indonesia 2003). In addition to being a very lucrative banking operation, BRI’s microfinance services have also had a significant positive development impact on microenterprise financial performance and low-income household standard of living (Rosengard with BRI Survey Team and CBG Survey Advisors 2001).

Despite the potential gains from downsizing, most commercial banks that attempt microfinance are unsuccessful in this endeavor. The most prevalent reasons for failure are: undertaking microfinance as a social mission or compliance activity rather than a business venture to make money, thus ending the initiative when funding is exhausted or regulations change; underpricing micro loans, so that interest rates do not cover the high lender transaction costs

\(^{10}\) See Rosengard, De Brouwer, and Kawai (2003) for a more detailed explanation of these adaptations of conventional commercial bank lending and savings practices to microfinance.

\(^{11}\) See Patten and Rosengard (1991) for a history of the commercialization of microfinance at BRI; see Patten, Rosengard, and Johnston (2001) for a review and analysis of BRI’s microbanking activities during the recent East Asian financial crisis.

\(^{12}\) The total amount due during the last twelve months but not paid, including everything that has been written off, divided by the total amount that has fallen due during the last twelve months.

\(^{13}\) The total amount overdue divided by the total amount outstanding.
of micro credit; utilization of inappropriate lending methodology that is slow and complex rather than fast and simple; inappropriate organizational structure and personnel, resulting in traditional bank culture triumphing over the needs of decentralized decisionmaking by loan officers familiar with local markets; and poorly designed loan and savings products whose terms and conditions are incompatible with the needs of microentrepreneurs and low-income households (Rosengard, 2000).

While BRI is the most dramatic example of a general commercial bank that includes microfinance as part of its core banking services and generates significant profits from its micro banking operations, there are several other examples of commercial banks that have successfully downscaled credit services, savings services, or both. These include Panabo Rural Bank (Philippines), Centenary Bank (Uganda), Standard Bank (South Africa), and Banco Agricola (El Salvador) (Valenzuela 2002).

B. In Search of Greater Impact: NGOs Scaling Up

The downscaling of commercial banks has been complemented by the scaling up of NGOs. As banks have tried microfinance in their search for new markets, NGOs have become regulated financial institutions in their search for greater impact and long-term sustainability.

The primary advantage of an NGO becoming a regulated financial institution such as a bank or finance company is the opportunity this provides for increasing both the scale and scope of operations. This can be achieved primarily through access to new and more reliable sources of loanable funds such as voluntary savings from local communities, large investor deposits, interbank loans, and capital market debt or equity. In addition, the obligation to adhere to strict prudential norms as a regulated financial institution provides an incentive to improve ownership, governance, and management structures, as well as upgrade the quality of field operations, all of which are essential if the institution is to grow substantially. One other significant attraction to graduate from an NGO to a regulated financial institution is the wider range of financial services that can then be provided, such as savings and payment facilities.

The first major case of an NGO scaling up was the transformation in 1992 of the Bolivian NGO PRODEM (Fundacion para la Promocion y Desarrollo de la Microempresa) into a licensed commercial bank, BancoSol (BancoSolidario). PRODEM was established in 1986, and by the end of 1991, was serving 22,743 active clients, and had a loan portfolio of U.S.$4.5 million. By the end of 2000, BancoSol had 60,976 active clients and a loan portfolio of U.S.$77.8 million.
Another example, also from Bolivia, is the transformation of the NGO Procredito, established in 1991, to the private financial fund (a regulated non-bank microfinance institution) Caja los Andes in 1995; its loan portfolio grew from 12,662 active borrowers with loans outstanding of $4.2 million in July 1995 to loans outstanding of $246.8 million in December 2000 (White and Campion 2002 and Rhyne 2002). The most successful scaling up thus far in Africa is K-Rep Bank in Kenya (Rosengard, Rai, Dondo, and Oketch 2001).

The transformation from an NGO to a regulated financial institution is extremely difficult, and poses many strategic, operational, and regulatory challenges. The fundamental strategic issue is fear of "mission drift": Will commercialization and corporatization of an NGO lead to larger loans for wealthier clients to achieve economies of scale in credit operations?14 The most difficult operational obstacles are the result of accepting voluntary savings deposits. Not only must back office and front office operations accommodate numerous, unscheduled, very small cash and accounting transactions, but cash flow and asset-liability management also become much more complex. The regulatory challenges arise from trying to meet the prudential norms and supervisory requirements for banks, including issues of ownership, governance, management, operations, and reporting.

C. Matching Models and Missions: Non-Commercialized Microfinance

Despite the many opportunities presented by scaling down or scaling up, there is still a vital role for non-commercialized microfinance. There are many institutional models for microfinance, and it is essential to match the appropriate model with the organization’s mission. Sometimes the most appropriate model is a membership-based organization such as a credit union if the institution is workplace-based, or a rural cooperative if significant gains can be made from the financing of collective storage and marketing activities. If the activity is very high risk, for example targeting extremely marginalized populations or microenterprise start-ups, a subsidized NGO might be the most suitable institutional model. One size does not fit all: "There is ample room for multiple approaches to the provision of microfinance services. Potential markets are not only large, but also heterogeneous. Competition should benefit the microfinance consumer by lowering costs and improving service. The guiding principles should be institutional diversification, product differentiation, and market segmentation." (Rosengard 2000, 9)

IV. CONCLUSION

Social entrepreneurship can create both private financial profits and social value added. Sustainable microfinance is a vivid demonstration of social entrepreneurship. Institutions like BRI show that concern for the bottom line does not have to mean lack of concern for society's bottom half. Profits and progress can be complementary, not competitors. The most encouraging aspect of sustainable microfinance is that when the profit motive and development impact reinforce each other, and in fact, depend on each other, a powerful synergy is created whereby self-interest and community interest converge. This is the great potential of social entrepreneurship in the financial sector: commercially viable microfinance can sustain both banks and the communities they serve.

REFERENCES


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