Microfinance Institutions: Overcoming the Obstacles

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Abstract
This paper discusses three common problems plaguing microfinance institutions (MFIs), namely high interest rates, sustainability issues, and ability of MFIs to help the poor to generate income. This paper will consider arguments regarding these problems and point to how these problems could be minimized through innovation and cooperation. The high loan costs caused by high risk of financing the poor can be reduced by implementing the innovative group lending model which could help to decrease the default risk. While the dependency on subsidies and external supports which reduces the sustainability of MFIs can be addressed by cooperation with larger financial institutions and improvement of MFIs’ products and operating efficiency. In addition, an improvement of infrastructure and human resources would lead to a more efficient MFIs operation. Lastly, the questioned effectiveness of MFIs to improve their clients’ livelihood can be tackled by educating their clients with basic business skills.

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Introduction
At the present time, microfinance has become one of the most important tools in poverty reduction endeavors. The essential role of microfinance has been well recognized by international organizations, including the United Nations (UN), which have incorporated microfinance as an instrument to reduce poverty in order to achieve the UN Millennium Development Goals, and also the Nobel Prize Committee who presented the Nobel Peace Prize to Muhammad Yunus, the person behind the success of Grameen Bank in Bangladesh (Hermes and Lensink, 2007). Microfinance institutions (MFIs), which are fundamental to microfinance in general, are financial institutions which specialize in delivering basic financial services to poor people who might otherwise have no access to such services (Todaro and Smith, 2006). However, as microfinance institutions develop, it has been asserted that they are not without problems. This paper will consider arguments regarding these problems with microfinance and point to how these problems could be minimized through innovation and cooperation. Firstly, the problem of microfinance’s high interest rate loans will be discussed. Then, the sustainability issues of MFIs will be examined. The final section will address the ability of MFIs to help the poor generate income.

Can MFIs reduce their high loan interest rates?
It has been argued that instead of helping poor people, loans from microfinance institutions often become a burden. These institutions usually impose high interest rates on the loan for the poor. One of the most important considerations of the high interest rate is to cover the high risk of lending money to poor people (Ghosh et al, 2001). These high interest rates mean high loan repayment costs for the poor who are mostly relying on low-return and marginal economic activities. However, recent innovations in microfinance lending models, such as group lending, have been successfully lowering the risk of providing loans to the poor. In group lending, all group members are responsible for the repayment of the loan, thereby decreasing the risk of defaulting (Hermes and Lensink, 2007). Indeed, empirical studies indicate that the group lending model has significantly increased the repayment rates of MFI clients. In
Bangladesh, for example, six MFIs applying the group lending model have an average loan repayment rate of 95% (Jabangir and Zeller, 1995), while in Malawi this model has helped some MFIs to achieve a 97% loan recovery rate (Huppi and Feder, 1990). Therefore, as the risk lowers, MFIs could gradually decrease the interest rates and thus reduce the cost of loans to poor people.

Furthermore, microfinance is important for poor people as it is the most reasonable way for them to obtain a loan. Poor people often find it difficult to access lower cost loans from commercial financial institutions. The commercial banks are reluctant to finance small borrowers, because the value of the loans are small, usually less than IDR 5 million, while administration and operational costs are similar to large loans, and also because few small borrowers have the required marketable collateral to obtain financing from commercial banks (Todaro and Smith, 2006). Another point to consider is that, without microfinance, poor people would have to rely on loans from moneylenders and, even worse, loan sharks. Moneylenders and loan sharks impose higher interest rates than MFIs. Based on a study of informal loans rates in 14 developing countries, Robinson (2001) points out that 76% of moneylenders’ monthly effective interest rates are greater than 10%, including 22% who charge more than 100% per month. Meanwhile, although still higher compared to commercial banks, some well managed MFIs only charge effective interest rates of 3 to less than 5% per month. In comparison, therefore, loan provision by microfinance institutions is the most suitable alternative for the poor.

Are MFIs sustainable?
Another problem often associated with microfinance is the ability of microfinance institutions to provide sustainable financing to the poor. Indeed, since microfinance institutions rely on poor people as their customer base, they often face serious liquidity problems. These problems arise when an MFI is unable to fulfill its obligation to depositors on time (Fernando, 2008). This is particularly true as most savings in MFIs tend to be short-term while the loans are mostly have longer term. In many cases,
these problems have halted the operation of MFIs and stopped them from providing financial services to the poor. However, it has been proved that through cooperation with larger formal financial institutions, the liquidity problems could be gradually solved. In addition, such cooperation is also beneficial to the larger financial institutions as they are able to expand their business at the same time. For example, Swamitra Program of Bank Bukopin assists 448 MFIs in several provinces in Indonesia and also increases the financial performance of Bank Bukopin at the same time (Djanoko, 2011).

Reliance on subsidies is another issue often experienced by MFIs. Even large and successful microfinance institutions, such as Grameen Bank, have had to rely on subsidies in the past (Morduch, 1999). This is not surprising, though, since a large amount of funds is required to run microfinance institutions in order to cover the administration and operational costs. Indeed, a survey shows that the revenues generated by MFIs from their lending and saving business can only cover 70% of MFIs’ total costs (MicroBanking Bulletin, 1998). Unfortunately, covering the cost by relying too much on uncertain external support, such as subsidies from government programs and assistance from international organizations, makes the MFIs to be less sustainable.

There have been some suggestions from policymakers for the MFIs to increase their interest rates and service fees in order to be financially sustainable. Certainly, many microfinance proponents challenge this suggestion. Karlan and Zinman (2008), for example, using randomized trials on MFIs borrowers in South Africa found that such a strategy would be a disaster for the MFIs as it would result in the decrease of repayment rates, decline of their client base, shrink of their revenue, and most importantly no increase in their profits. The results of their study suggest that the MFIs should innovate their loan products by increasing loan maturities. They estimate that increasing loan maturity by one month would result in 15% increase of loan demand. As MFIs disburse more loans, their revenues and, certainly, profits would increase as
well and they can reduce their dependence on subsidies from external sources to cover their operating costs.

In addition, cost-reduction innovations in terms of infrastructure and human resources can also be carried out in order to reduce the operating cost of MFIs. The infrastructure may cover public infrastructure and specific infrastructure directly related to the operational of MFIs. Improvements on the public infrastructure, such as rural roads, bridges, and access to electricity can have substantial impact on the reduction of MFIs’ operating costs. Large government investment on rural infrastructure in Indonesia in the 1970s and early 1980s, for example, have assisted the Indonesian MFIs’ operation as their officers now can easily reach rural areas where most poor people reside (Fernando, 2006). Meanwhile, improvement of the specific infrastructure related to the daily operation of MFIs could be well catered by implementation of simple information and communication technology (ICT). The relatively cheap ICT such as computers with back-office management information system application would certainly help MFIs to manage their business more efficiently (Mathison, 2005). With regard to improvement of human infrastructure, government and general public intervention would be required as it is related to improvement of education sector. Better educated clients would help MFIs to reduce the cost for assisting and monitoring their clients (Fernando, 2006). In addition, better educated society creates better pool of labor. For the MFIs, this means less difficulty to find and recruit better educated officers which will eventually reduce the human resource development costs. While this may take a long time to realize, combining improvement on the infrastructure and human resources altogether would help the MFIs to operate more efficiently and, certainly, more sustainable.

**Can MFIs help the poor to generate income?**

Criticism of microfinance is also concerned with the contribution of MFIs to the improvement of their clients’ livelihood. Based on an observation of microfinance programs in several countries in Africa, Buckley (1997) claims that microfinance
interventions do not have substantial effect on improving the profitability of microenterprises. However, his argument is contended by Karlan and Zinman (2009) who carried out randomized experiments on microenterprises in the Philippines and found that after the micro businesses accessed finance from MFIs, their profits gradually increased.

Another criticism states that financial services provided by MFIs do not really help the poor to generate income, but drive them to indebtedness instead. Hulme (2000) argues that the terms ‘microdebts’ is more appropriate than ‘microfinance’ as the poor tend to use the money from MFIs for consumption rather than to utilize the finance to improve their income. This case commonly occurs because the poor generally lack skills, knowledge, and assets, so they have difficulty to access productive activities. However, a recent experiment on the provision of entrepreneurship training by MFIs to their clients appears to have positive results on the improvement of MFI clients’ income (Karlan and Valdivia, 2009). In this experiment, the provision of basic business skills, such as separating business and household money, recording sales and expenses, identifying and taking business opportunities, have helped MFI clients to significantly increase income from their businesses. This effort shows that innovation on the MFIs services by not only providing financing, which will open the opportunity for microenterprises to access credit, but also offering basic entrepreneurial skills training could substantially help the poor to improve their livelihood.

Conclusion

In summary, as poverty is one of the most common problems plaguing developing countries, various efforts have been made in combating it. Unfortunately, only a few have achieved success in helping the poor exit from poverty. Microfinance is one of the efforts considered to be successful. Its success lies in the fact that MFIs are flexible enough to create innovations and to establish cooperation in order to overcome their problems. In order to reduce the high loan costs burden of the poor, implementation of the innovative group lending model could help decreasing the default risk and hence
MFIs could reduce the high loan interest rates. Meanwhile, the dependency on subsidies and external supports which reduces the sustainability of MFIs can be addressed by cooperation with larger financial institutions and improvement of MFIs’ products and operating efficiency. In addition, an improvement of infrastructure and human resources would lead to a more efficient MFIs operation. Lastly, the questioned effectiveness of MFIs to improve their clients’ livelihood can be tackled by educating their clients with basic business skills. Certainly, as MFIs work better, their contribution to poverty reduction will also increase.
References


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