Abstract

Microfinance has been heading to a global financial crisis? According to the Author this is not going to happen. However he argues that when we look at what has been going on in India and in some other financial markets in fragile Countries, we should worry about unpredictable consequences like two years ago with the crack of big financial institutions.

Microfinance markets could loose attractiveness in terms of investment opportunities while the protagonists of the movement have been loosing charisma and credibility.

The Author found out some parallelisms of current microfinance trend with the experience of the development banks in the eighties years. He concludes that although the situation of some MFI under stress could degenerate, a possible domino effect isn’t a predictable event,

The Author says that microfinance is very appealing tool to tackle both poverty and small enterprise development, on condition that we know how to use it or to distinguish among interventions referring to Basel III regulatory framework. This is a strategic issue that practitioners should have all the time in mind.

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**Bad practice**

1. Microfinance has been heading to a worldwide crisis? In our opinion this isn’t going to happen. However, when we look at what has been going on in some Countries (Bangladesh, Bosnia, Cambodia, India, Morocco, Pakistan and Nicaragua), where some MFI have been struck by financial problems, although with different modalities and intensity, there should be cause for concern.

Looking into the above-mentioned markets, “sustainable lending” seems to be a missing issue, that’s to say not a few credits have been sanctioned without respecting ordinary lending practice and the lending rate has emerged as a recurrent topic. As it is (or should be) known a good repayment of money lent out starts with a very good credit appraisal, a follow-up equal to the task and a suitable money collection mechanism. When this trilogy is respected the overdue loans are at physiological rate.

Microfinance practitioners are aware that the discussions on interest rate have been going on since the day micro credit movement saw the light; only recently it has been recognized the importance to regulate its level further to the public opinion pressure in some Countries.

Which business can support a load of interest rates of 30-40% and may be more? Which borrower can repay multiple loans? The answer is apparent and a non-repayment is a predictable event as well. It seems that this has happened in above markets.

In our field experience that started more than three decades ago, we witnessed situations where defaulting has rarely been due to unwillingness to pay back the money, but to inappropriate lending schemes, poor follow-up, inappropriate debt recovery, bad management and poor governance, which generated defaulting.

The rationale of MFI operations is in the fact that micro lenders, among other things, shouldn’t face the asymmetric information problems and therefore they should have less defaulters and low operating costs. When this doesn’t work it could be supposed that something went wrong on the management side either for failure or closing the eyes, or complicity of the MFI credit decision makers.

Over the years, micro lenders shifted the activities from alleviation poverty to micro enterprise; in so doing they changed their genuine mission. Then, they started paying less attention to poor people and focused on small business. This isn’t a bad move, on condition to be equipped in terms of credit know-how and means. The reality has shown that in frequent cases above rules didn’t apply.

2. What may we learn from Indian microfinance market (epicentre of the problems is in Andhra Pradesh state)? Among other considerations highlighted by the commentators, in our
opinion the problems are about who - the practitioners who made loans available - and how - the credit model adopted. ¹

Incidentally we noticed that in the discussions on above matter, to our knowledge, from the linked persons we didn’t read any wrong doing, the defaulters being the only responsible for the happening.

In the common language, microfinance means everything and the opposite of it. However microfinance practitioners shouldn’t take advantage of an ordinary mystification. In other word the mixture between commercial and social hasn’t been well balanced. This has emerged from a virtual debate we recently joined with some insiders of the Indian financial market (Microfinance Focus (Linkedin web site)).

When under a credit model the money is lent out and from the mechanism put in place a repayment can be expected referring to a valid cash flow forecast, the model is welcome. Under those circumstances we are in presence of a microfinance project; on the contrary, we do have a charity project. So, there is a need to develop a sustainable model to finance farmers, artisans and traders with an affordable rate of interest.

3. The growing of the MFI movement has created great expectations because MFIs have been seen as an instrument to tackle poverty and promote micro entrepreneurship, on the grounds that as grass root organisations they can easily interact with their own environment.

At the same time those expectations have entered into conflict with the survival of the MFI industry itself and all around the world the practitioners have been facing this challenge, namely how to provide target beneficiaries with a “durable” service.

In our view the problem is to look into how much “social” has been included in a given MFI and then to set up a lending scheme in view of achieving a maximum of a social mission on sustainable basis. On the matter it is also a question to look into between declared and actual objectives.

Hopefully, there has been an ever-increasing consensus on the fact that there isn’t contradiction or conflict between financial and social performance. Indeed, in the field experience there are examples that demonstrated that financial and social performance can be conjugated together and, as a matter of fact they complement each other, when respecting a good management practice.

Any MFI while attending a social performance target has to strive and reconcile social goals and financial benchmark. In such equation social performance is function of a good management practice and not vice-versa! This is a very crucial point.

Being successful on outreach side to a detriment of sustainable lending could mean waste of resources; but being successful on sustainability side to a detriment of outreach could mean poor management and lack of vision. In practical terms, both sponsors and ¹ India’s nearly four billion dollar microfinance industry is facing collapse after politicians in one of the country’s largest states called on borrowers to stop paying back their loans. More than five million Indians heeded the call and the crisis is threatening to spread nationally. Host Michel Martin speaks with Senior Fellow David Roodman of the Center for Global Development and Vijay Mahajan, President of the Microfinance Institutions Network about crisis. National Public Radio, 10/12/10.
practitioners should make it clear whether their objective is food security or enterprise development or income generating activities. Indeed, the dilemma between outreach and sustainability shouldn’t exist in the sense that there isn’t a choice to make but to apply a suitable lending practice under the recurrent circumstances.

**Possible implications**

4. Going back to above mentioned Countries, in some MFI the situation could deteriorate and lead to unpredictable consequences like two years ago with the crack of big financial institutions further to the “mistake” to make an easy access to credit. Here some possible implications:

A) Microfinance markets could loose attractiveness in terms of investment opportunities. This could happen in a period when microfinance has been spotted among sectors attracting investors\(^2\). A possible side effect of MFI in financial difficulties could lead to a slow down of the investments in microfinance industry.

B) To understand the negative impact of such situation, it is just a matter to think that amid the world financial crisis, investors have positively judged the opportunities offered by the microfinance industry. The reason behind this judgement relied on the fact that the MFI being closer to the real economy couldn’t be affected by the financial risks.

B.1 Over the last couple of years, bankers and fund managers invested to microfinance because they thought such investment was less risky than to another place. The related flow of funds has been estimated important in the light of the fact that microfinance industry needed fresh resources to expand their market.

B.2 Reducing financial support to MFI in the emerging economies means more unemployment and less poverty’s reduction so that the negative impact goes well beyond microfinance sector. The micro finance providers do business with the real economy and mostly in rural areas; under the circumstances a decrease in their lending capacity would have the following negative effects:

* Small farmers could have either a difficult access to credit or terms and conditions for loans could get worse;
* Parallel (vicious) financial circuits could flourish;

* Agricultural sector could suffer from a lack of financial resources with a possible decrease of the production and offer of foods.
* Country’s inclusive financial system could have a slow down.

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\(^2\) “…Impact investing refers to a small but growing group of public and private funds that finance a specific cause or enterprise, including microfinance, technology, and sustainable agriculture and community development. And while such investments aren't charitable contributions, they attract investors of a certain philanthropic ilk. All in all, the strategy is less about big returns and more about doing the right thing”. J. Benjamin in Investment News, December 2010
C) The fact that the founder of Grameen Bank recently came under criticisms after allegations for transfer of funds could cause lack of credibility on some protagonists of the movement, whatever the end of the story will be.

D) In recent debates some commentators have arisen more than one question on the effectiveness of above mentioned credit model, which has inspired not a few practitioners over the past thirty years. In our view this isn’t a bad news because nothing is perfect and each and every credit model could take advantages from the experience to improve effectiveness.

E) MFI under stress could have negative implications on the capital markets where they borrowed (partner banks) money or the money came from. In other words, the implications could have a negative effect on the investments made by either banks or risk funds or international organizations (World Bank Group, FINCA and Opportunity International, just to mention a few names).

Although the possible negative implications on the financial markets could be of lesser importance and certainly not so appalling like the financial crisis blew up in 2008, in the microfinance industry nothing will be as before. Therefore it is of highest importance that the necessary reviews and revisions of all practices will take stock of the current experiences.

However when practitioners are going to intervene, they should give an answer to the following question: can microfinance sector keep growing without regulations? Like the banking and any other industry, microfinance needs basic game’s rules to be introduced at country level and such rules have to take into account laws, traditions, credit customs, which are strictly linked to the environment. Above question call in cause the government authorities.

Politics

5. In the eighties years the financial markets in the emerging economies were dominated by the wave of the development banks movement. These banks, in spite of the name, instead of financing development projects were entrusted to distribute small credits, which as a matter of fact, currently we could categorize as income generating activities or even food security. As it is well known the money lent out wasn’t paid back and those institutions failed their mission and that situation was particularly true in Africa.

Five years ago we wrote: “MFIs overall performance hasn’t been much encouraging so far and for the majority of them the break-even point could be a dream; under the circumstances a lot of work needs to be done to redress the unbalance between outreach and sustainability. If the trend doesn’t improve, in ten years time we could draw a conclusion that microfinance has been a merely way of wealth redistribution without capital accumulation”. 4

3 M. Baltman – Why doesn’t microfinance work? The destructive rise of local neo liberalism, Presentation at Overseas development Institute, July, 2010

This conclusion is still pertinent and according to our prediction we do have five years ahead to make it happens in the right way! We would like to say that micro credit movement is a way “to help people to help themselves” and not just giving.

From the rapid review on dysfunctions of the above-mentioned microfinance markets some assonance with the development banks’ experience in the eighties have been emerging over the following issues: a) MFIs are seen as a government arm to meet social goals, b) some donors and multilateral agencies act as a guarantor to meet above government goals, c) governments are urged to keep low the lending rate, d) governments are asked to intervene and redress MFI’s financial difficulties. Here it is a question on how to deal with these sensitive issues.

Currently the governments promote, support and endorse micro credit within the frame of privatization and liberalization programmes, which actually target small-scale business. In parallel with this objective the governments are actively involved in fighting poverty by having the Millennium Development Goals (MDG) as an objective to achieve.

In this context politicians and policy makers have dedicated attention to the microfinance industry because the industry is seen as an instrument of economic policy and indeed the industry has a multifaceted impact on the communities and political implications can be found with:

a) Poverty issue because microfinance movement is (could be), among others, an appropriate tool for achieving MDG.

b) The labour market by creating new jobs.

c) The capital market by knocking down the existing barriers between the financial circuits.

d) The local economy with emerging traders and entrepreneurs who are bearers of new interests.

e) The foreign trade with import substitution result and widening the list for exports.

f) The communities’ economic development, by adding value to the domestic production.

g) The power of local NGOs that goes well beyond the economic context and affect the political structures.

h) The policies and the dynamics worked out at intergovernmental level by a variety of organizations such as CGAP housed by the World Bank, USAID, the Special Unit of Microfinance within UNDP, the Microcredit Summit Secretariat, etc.

i) The Basel III proposed regulations would call in cause public authorities in view of regulating country’s microfinance markets.

Because of the above implications, politics will continue to have influence on microfinance movement, as the development banks’ movement had in the eighties.
The possible implications of above could be at the same time a strong point and a weak point of the industry, depending on the modalities the related interventions will be put in place and how the work will be carried out.

Box 1 – Some suggested measures and interventions to take at country level

**Macro level**: a) Regulatory and supervision framework (referring to Basel III), b) Credit policy for a conducive environment, c) Land reform, d) Property rights, e) Market liberalization and privatization, f) Sector’s analysis.

**Meso level**: g) Associations actively involvement, h) Capacity building & institutional strengthening, i) Guarantee funds’ linkages, j) Credit bureaux, k) Linkages between banks and MFI, l) Value chain finance.


We directly witnessed the trend as FAO Agricultural Credit Expert in West Africa where above influence has been strong, particularly in the Francophone Region. At that time a huge amount of financial resources have been distributed without having the expected return either economic or social. By and large, financial resources have been channelled within the frame of a country economic policy with all the negative implications of having social and economic matters wrongly mixed up and using unsuitable channels, namely the development banks.

Again on the parallelism of microfinance finance movement with the movement of development banks, we do think that although some individual financial situations could degenerate, *a possible domino's effect isn’t a predictable event*, on the grounds that currently the decision makers have know-how, instruments and means, which weren’t available thirty years ago, at the time of development banks’ crack. Also the existence of supervisory bodies will make it in time blocking interventions. Here it is a matter of thinking of would have been the negative impacts of situations like in Andra Pradesh, which currently have been monitored and embanked by the competent public authorities.

Currently the role of the government authorities is to enhance interventions in a way to create the conditions for an inclusive financial system. This has been clearly spelled out in the Regulatory Frameworks approved in November 2010 by the G20 in Seoul and incorporated into the so-called Basel III.

Certainly the new proposed rules aren’t compulsory but we don’t think that the responsible institutions/organizations will neglect them. In brief, in our view currently the road has been mapped out to build a solid microfinance industry in each country and the responsible persons for making it happen are aware of what to do.

The government authorities have just to follow those indications to create the conditions to regulate the microfinance industry. The proposed Basel III rules are a condition to pave the way for transparency and good governance in the industry; however those rule need to be integrated in a comprehensive approach at three levels that are interacting each other, as it has been figured out in the above box.
Conclusions

To conclude, we should look ahead with optimism on the grounds of the following: a) the potentialities of microfinance market are absolutely huge; b) associations are actively involved in support of their MFI members; c) there is indication that interest rates shall decrease to affordable levels; d) new products shall be launched; e) the technology shall make it lower in-house costs; f) country’s inclusive financial system shall make considerable progress; g) bad politics has been progressively phasing out; h) Basel III regulations; i) At intergovernmental level there are the Agencies and Departments that either negotiate aid interventions with governments or monitor emerging situations.5

Microfinance is very appealing tool to tackle both poverty and small enterprise development, on condition to distinguish among interventions, which should refer to the Principles for Effective Banking Supervision categories, namely Banks, Other Deposit Taking Organizations (ODTO) and Micro Credit Institutions (MCI). 6This is a strategic issue that both investors and practitioners should have all the time in mind.

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5 According to CGAP, the situation in Andhra Pradesh also highlights the need for appropriate controls:
   o At the institutional level to support a robust business model, including effective incentives and training for staff at all levels to encourage sound underwriting and customer care
   o At the industry level, including information sharing/credit bureaus
   o Appropriate regulation that encourages interest rate and pricing transparency, in an environment in which poor clients are well informed and understand the products, understand how to use them effectively, and have clear means for recourse.

The CGAP paper, Andhra Pradesh 2010: Global Implications of the Crisis in Indian Microfinance.

6 “If we’re really committed to financial inclusion we need to take it to the next level. Poor people don’t need just credit. Savings, micro insurance, and money transfers are all services that poor people demand and that help poor families to manage their household finances more effectively. We need to commit to delivering high quality services to the 2.7 billion people left out.” From CGAP Paper.