WHICH MICROFINANCE? WHICH PRACTICE?

Proposed steps for a sustainable microfinance model

1. BACKGROUND

1.1 Microcredit was born in Western Europe amid the industrial revolution and the interventions addressed workers, craftsmen and neglected people who were taught the importance of savings. The promoters have been charity organizations, rural banks, people’s banks and cooperatives, which started providing some basic credit services to the uncared people of the society. Some of them became powerful banks with worldwide network. The entrepreneurial spirit emerged from a strong individual challenge to break into a locked society. The movement doesn’t belong to Europe only, because other communities all around the world had experiences of informal credit and charity entities/groups (Tontines in Africa and self-help group elsewhere).

Microfinance movement was born in a consumerism era in the Asia Sub-Continent and South America; it emerged when the traditional ways to banking appeared to be old-fashioned and no more suitable in a free market system. In a social context having the individual borrower at the heart of the system, priority has been given to exploring new ways and means on how to make each one and everybody eligible for credit. Microfinance was born at that very moment in time (1).

The growth of microfinance has been rather different in the above mentioned Regions, being relatively successful in Latina America and with dark areas in Asia sub Continent; these results should deserve more investigation.

1.2 Microfinance has emerged as a reaction to no longer acceptable unhealthy and poor conditions of the rural communities and a new term was coined: microfinance, which has flourished on the assumption that tiny amounts of money lent out would have been paid back and believing that everybody was born entrepreneur.

1.3 The imitation effect has provoked an enthusiastic blossoming of MFI and the movement is now an industry. It has been a great moment, which has been endorsed at UN level, since the world leaders established the Millennium Declaration and the Millennium Development Goals in 2000. Later on the UN declared 2005 the year of Microfinance and the following year the Nobel Peace Price was awarded to Muhammad Yunus: in 2013 this controversial figure has got an additional honor, confirming the blend between microfinance and politics (2).

1.4 Microfinance interventions trusted on the integrity of the lenders and the reliability of the beneficiaries. Afterward we learned that the credit contract has been unequal because since the very beginning a variety of field experiences have shown up greedy and incompetent lenders, bad borrowers, sympathetic public authorities and generous donors. Presently we have been counting the losses in terms of massive dilapidation of resources (a consistent number of MFI either making a great effort to survive or close down) sometime with deadly consequences.

1.5 On poverty matter there is overwhelming literature; see for instance Moushumi M. Kan - Microfinance is down but not out – (3) and David Roodman – Microcredit doesn’t end poverty, despite all the hype -. (4). In an article published on Devex, Floyd Whaley has dealt with microfinance, once widely celebrated and cited as a revolutionary intervention, now descending into the messy world of other development practices which are well-funded, but also heavily criticized and scrutinized. (5). “Has microfinance genuinely benefited the world's poor, or are the motives for loans and credit altogether more sinister?” (6).
“Modern financial markets exclude billions of the world’s poor. That’s a failure of those markets and a failure of imagination. A more financially inclusive world would give billions of people living in poverty access to a full range of important financial services, yielding a high rate of return by economic, social, and societal measures. The challenge is how to achieve this in a responsible, sustainable way that provides the greatest number of people with the financial” (7).

2. ANALYSIS

There is a movement on re-thinking microfinance role in the financial market in the picture a new orientations of the development economics (see below § 3.6). Taking from reports and papers and the direct experience in the field along with discussions within a Forum of professionals (8), we carried out an unconventional analysis that led to more questions than answers.

2.1 - Why to stick a new label – microfinance - in a product already in the market?

In our view it was just a matter of widening microcredit’s concept. The banking system all along the centuries renewed the services and the cashless society is nothing else than an evolution of the bank account in IT era. Certainly, the banks haven’t introduced a new terminology when, for instance, proposed the credit cards and in reality the new service have been launched by simply introducing a new mechanism in a product – current account with overdraft facility – taking advantage by the technology.

As far as the use of the term microfinance, we do think that the name could be inappropriate and in some cases incorrect for an improbable task. However here we are not going to add confusion to an existing puzzlement by introducing a new term, but just to contribute to the debate and make microfinance both affordable and sustainable service.

The matter is important because making finance whether prosaic or predictable has created in field a lot of problems on both lenders and borrowers side. In the wave of an easy credit, on the lenders side some developers have changed profession and became lenders (we may recall when sometime in the eighties years amid a new microfinance wave “everybody is a banker”, by simply joining training courses or downloading credit packages); on other side, the borrowers believed to be creditworthy and sometimes they didn’t feel responsible for reimbursement. Who have been the winners and the losers of above situation? Most likely, the former have been those with a bad repayment behavior and the unscrupulous lenders; the latter have been those who provided the resources, mainly donors, governments - the taxpayers - and the good borrowers who have paid the bill of the defaulters.

Over the last three decades microfinance industry has evolved along a trend that, in our interpretation, may be depicted in the below Figure 1. In parallel with the increased sophistication of the services offered (left side of the figure), new management and evaluation methodologies have been applied going through social performance, poverty reduction, responsible finance being the most recent acquisition (right side).

2.2 – Which is the meaning of the terms finance and credit?

The pioneers of microfinance said: “Commercial programs only should use the term credit”. So, which is the meaning of finance and credit?
The term **finance** reminds us a world (powerful financial centers moving billions of hard currencies) far away from people living with US $1 a day. Finance is associated with the notion of capital to be invested and once the resources have been allocated the provider shall expect to have them back with a possible return whether economic or social.

Currently microfinance could include – but not limited to - credit, savings, insurance, wellbeing, climate change, money transfer, health, etc. However, it is not clear who has to pay the bill of the “non financial services” supposed to be provided by MFI. The answer in mostly cases hasn’t been provided and nowadays, we are counting how many millions of hard currencies have been distributed without a return whether economic or social. So, by name, microfinance isn’t exactly a term that can match with these situations, which aren’t a few.

**Credit** means confidence; this does mean that even tough a potential borrower has a very big asset, the lender may refuse a loan because he doesn’t trust the applicant or for whatever reason like the use of the money for different purposes it has been asked for, or lack of capability to use it in a way to expect the money back.

This has been the credit’s basic concept over the last six centuries when some traders-merchants in Florence pioneering the modern banking. In this understanding any word integrating “credit” (micro, macro and so on) has to respect the roots of the term; on the contrary it will mean something else.

### 2.3 Which are the features of a credit market?

By and large what really make it different the credit market from any other market is inherent to the fact that in a loan contract both lender and borrower, respectively, sell and buy money while in all other contracts the money is a compensation to have a negotiation - to buy and sell an item; in other words in the former situation the money is the object of the contract while in the latter it is a means to make it a contract happen.

Moreover, an important specificity of a loan contract is the fact that credit means confidence. This feature is more evident in the micro credit market and, as it is well known to the microfinance practitioners, it plays a crucial role in the decision making process.

### 2.4 **All human beings are innately entrepreneurs?**

This question is closely related to the previous ones. The pioneers of microfinance have told us about a fairy tale of beggars who borrowed tiny amounts of money to buy foodstuff and some of them started their own businesses by selling the goods and in so doing upgraded the position from beggar to vendors-entrepreneurs.

To fight poverty does one need to become entrepreneur? To face poverty’s problems we should look beyond microfinance. The fact is that microfinance and micro credit have been used and abused as instruments of economic policy to fight poverty. Whether micro credit or microfinance alone can do a small part of the antipoverty job; on the contrary, they can add value in a context with a receptive environment and appropriate development policies because an easy credit policy is a doubtful tool without addressing other linked issues at macro and meso level.
2.5 - The lenders are entrepreneurs-scout. Are they?

The role to promote entrepreneurship belongs to other institutions. It is sensible to distribute by random thousands of small loans to find out an entrepreneur? The question is challenging and deserves attention and careful thinking because, again, the answers directly drive to the hearth of microfinance concept.

Social vision in finance should be conjugated using different parameters. By and large, even a genuine profit enterprise achieves a social goal by creating jobs and paying a salary. In this understanding social enterprise does already exist, unless we want to change the etymology of the words. Any MFI has a social mission and it tries to achieve it by using some basic credit management guidelines in accordance of the objectives and means.

In our view there is the risk that the terminology (social enterprise as it has been applied in microfinance) could complicate the microfinance practice.
Instead of discussing about social enterprise, social return on investment, bottom-line, double-bottom line, triple bottom line, etc, it couldn't be better to say, “MFI socially oriented”? Indeed at the end of the day we have to measure the degree of satisfaction and the impact in terms of social achievements and to evaluate the relevance, effectiveness and efficiency of the intervention.

Having said that, in our opinion the problem is to know how much “social is incorporated in an MFI and then how to organise the lending in order to achieve a maximum of a social mission keeping safe the operations’ sustainability.

2.6 - Microcredit basic notions have been missed out?

Asymmetric information and moral hazard are the microcredit’s basic notions and they haven’t been so much emphasized in the “basket tools” of microfinance practice, although it has been said that joint liability has been the successful factor as it minimizes information asymmetry. As it is well known moral hazard in micro credit describes a situation where the lender know very little or nothing about the borrower conditions/intentions and under the circumstances lending could be assimilated to a betting. Let’s assume the following: against a loan of UD $ 100 is requested a 10% interest; if he borrower pays back, the lender gains 10 dollars, but if the borrower doesn’t pay back the lender loss is 100. Sometimes microfinance has been more a bet than a responsible sanctioning.

The financial game is played in different tables like poverty alleviation, enterprise promotion and financial linkages and by groups of players with different interests, objectives and expectations: visionaries, volunteers, developers, bankers, investors, charity houses, governments, funding agencies and private businesses.

In this scenario, sustainability has often been a missing word in microfinance’s structural design, as we witnessed from the practices carried out in various parts of the world.

This is what made it microfinance both “appealing and dangerous game”, used and abused by: - Politicians who may use public budget to finance unsustainable micro projects; - Donors having a benevolent behaviour with whatsoever national lobby; - Greedy lenders charging exorbitant interest rates; - Borrowers unwilling to pay back.

2.7 – The demand for has to be met at any cost?

The growing of the MFI movement has created great expectations 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.

We witnessed situations where the term microcredit has lost the genuine meaning because of the confusion between credit and grant. Moreover, both lenders and borrowers (and here is the welding point between terminology and contents) signed an “unfortunate credit contract”. It happened that some lenders lent out the money, although being aware that the borrowers most likely wouldn’t have respected their obligations for lobby, political pressure, lack of eligibility, lack of capability to manage a credit, etc. Even the borrowers some time have been aware that in case of default
nothing would have happened to them because lack of appropriate law to recover credit, lobby, lack of guarantee, political pressure, etc.

2.8 – Human rights means equal credit opportunity?

Let’s situate apart the different situations, whether a bad management practice or insatiability of the lenders or political interferences made it happened the disasters in India, Bosnia, Nicaragua, Pakistan, Morocco and elsewhere. One thing seems to be sure: the insiders have been frequently questioning on the effectiveness of the genuine credit model for poverty alleviation.

In brief, microfinance’s idea sometimes has mystified the concept of the rights of the people to have an equal opportunity within the community with the right to have access to credit. Where is the divergence between the two? The former belongs to the government and the latter to the lender. Credit should be sanctioned when there is reasonable reason that the money lent out will be paid back. However, anybody can distribute credit, on condition to make it clear where the resources are coming from and who will pay the bill. On the contrary lend out money hasn’t anything to do with finance and credit.

3. MAIN FINDINGS

3.1 From the analysis has emerged, among other matters, the disproportion between resources allocated to fight poverty and tangible results, which has been worldwide recognized and highlighted in the reports produced by the major funding agencies. A lesson that we can take from these experiences is the following one: to reduce poverty, governments have to create jobs and a sustainable finance only can do it. The most recent trend on how to achieve MDG is on sustainable development as the converged discussions among the world leaders have confirmed in the first Earth Summit in Rio de Janeiro last year. Microfinance can’t ignore the new context.

3.2 The UN active involvement could deserve a wider discussion although for the time being a little thought may be done:

- Beginning year 2000 promoting microfinance at UN system has been much more than a noble gesture, because of the massive resources invested in. As a matter of fact, the hands-in of UN has confirmed the national governments’ failure to tackle poverty and this is why the anti poverty flag has been handed over to micro financiers with a social vision.
- This perspective could also justify why the movement strongly emerged in a Region with the highest concentration of richest and poorest people of the world.
- Moreover, it should be given a reason why in the field the practice has been carried out with confusion and mystification and why the pioneers haven’t responsibly clarified the difference between credit and grant.
- Again, it should be investigated on the unconvinced role of microfinance as a means to fight poverty, which got the unconditioned sponsorship of donors and the major funding agencies. But now the situation has been changing.
- Some time microfinance has been proposed as a new credo to accept without arguments and with an extraordinary and unexpected worldwide media support, which has been granted before evidence.
3.3 There has been an ever-increasing consensus on the fact that there isn’t contradiction or conflict between financial and social performance. Indeed, the field experience, among the other lessons, has demonstrated that financial and social performance can be blended and, as a matter of fact they complement each other while respecting a good management practice. Moreover, having in mind a given management benchmark, the social enterprise objectives can be achieved referring to informed decisions.

3.4 In our perception of the trend (8) the crisis that stroke microfinance sector has been specific to singles MFI and not systemic like the financial crisis blew up in 2008. Indeed, looking at glance the situations in some Countries where the MFI’s failures have been acute, the crisis blew up for “improper” individual MFI management (unsuitable policy, misconduct, greedy, delinquency and unprofessional conduct), contrary to what happened five years ago when the financial crisis had a domino effect.

*The effects of the crisis in 2008 should be ascribed to the fact that the microfinance sector hadn't benefited of the excess of liquidity.* As a result the collapse of the industry in some Countries and the following lack of credibility along with bad publicity (from abovementioned disasters) the financial crisis has restrained the interventions in a fewer appealing markets.

We haven't been alone in such interpretation: “While, initially, it was assumed that the industry’s problems were caused by the financial crisis and the subsequent recession, a consensus is now emerging that problems were rooted to a large extent within the microfinance industry” (9).

3.5 Within above scenario, the need to regulate the microfinance market has been urgent and perhaps vital. To face the microfinance markets’ challenges and make order on uncontrolled growth of the industry, the national monetary authorities have been issuing regulations to canalize and monitor variegated realities of the MFI (10).

There isn’t a universal management formula for microfinance industry’s regulatory framework, but a set of rules to be conceived in harmony with a particular environment such as existing law, credit services tradition, unwritten procedures, and so on. This is why three years ago we welcomed (11) the Consultative document produced within Basle III, as a great opportunity to provide a suitable answer to the future of the industry.

In February 2010 Basel Committee published a Consultative document defining Microfinance “the provision of financial services in limited amounts to low income persons and small businesses offered by a variety of formal financial institutions including banks and non-banks, either as their core business or part of a diversified portfolio”. We do agree with this definition.

3.6 It has been widely acknowledged that the objective to halve poverty by 2015 will be hard to achieve. Consequently, at UN level new approaches and objectives have been fixed up “to pave the way toward a global framework built on lessons learned from the Millennium Development Goals, which expire in 2015”. (12)

After Rio+20, U.N. Secretary-General Ban Ki-moon created a high-level panel on the post-2015 global development agenda as well as a working group on sustainable development goals (13). Both will present recommendations this year in an effort to pave the way toward a global framework built on lessons learned from the Millennium Development Goals, which expire in 2015 (source Devex). There is more than one
reason that in the near future there will be a move from MDGs to Sustainable Development Goals (SDGs).

We are convinced that the movement will affect microfinance and recently we have noticed that discussions on poverty matters don’t emphasize so much microfinance interventions. In the new context the time of visionaries is over and experienced practitioners should lead the industry.

What has produced MFI failure in poverty alleviation? Two important and dangerous results: (a) the escalating influence of Politics, (b) the devaluation of the concept of credit. The effects of (a) are under everybody’s eyes; the effects of above (b) could be more dangerous on the grounds that it distorted credit’s meaningful, namely confidence.

3.7 On methodological side, the offer side approach has been privileged to the detriment of the demand for. This approach should be reversed and actually this seems to be the new trend in microfinance.

4. DESIGNING A SUSTAINABLE MICROCREDIT MODEL

At the end of the analysis we will try to provide an answer to the questions: which microfinance? Which practice?

4.1 Any model should be conceived referring to some assumptions, which in our case are: (a) microfinance alone can do a small part of the antipoverty job; (b) poverty can be reduced by creating durable jobs and responsible finance only can do it; (c) shift from offer of (whatever) service supposing that there is a need, to a demand for approach, which is represented by a variety of niches to be investigated; (d) the services for humanitarian aid and enterprise promotion shouldn’t be in the same “hub”’. Whatever the choice, the sources of capital and decision making process should be different along with policy and management.

4.2 When we want to design a credit model, at institutional level it is important to elaborate it within a country regulatory framework; also, a credit model can’t ignore tradition, law, credit habit, financial market features, etc. Indeed, without any background or referring to a failed model, nothing will be added, but a continuing a failure.

Here we can’t refer to any specific environment, but we may refer to the above-mentioned Consultative Document. By the way it seems to us that the national credit authorities have been following those proposed guidelines, while regulating or issuing microcredit laws.

This paper defines three groups of institutions: banks (B), other deposit taking institutions (ODTI) and microcredit institutions (MCI). We fully agree with this approach because eventually microfinance isn’t no longer considered as a distinct market but a component of the entire financial market, which comprises many circuits. Among other considerations, such approach favors the achievement of a country financial inclusion.

Although this categorization has been conceived for regulatory purpose, it can be taken as a good reference for positioning the MFI in the market: this is what we have done (13). However within the group MCI there are various types of organizations ranging from income generating activities to enterprise development.
We do have to consider that MCI group comprises both profit and non-profit organizations. This is a crucial point. In the current trend of microfinance industry, all MFI have social objectives as a common denominator. Although any MFI is social oriented the degree of achieving a social mission could be quite different whether the MFI is in the segment of Enterprise Development (ED, accumulation), Income Generating Activities (IGA, increase family income) and Food Security (FS, distribution of basic food to very poor people).

Although all the financial circuits should be under a unique umbrella, when we are going to manage & evaluate an individual MFI we shouldn't use the same yardsticks for Other Deposits Taking Institutions and Micro Credit Institutions.

In line with this reasoning, the different strategies to achieve a social goal are function of the below depicted equation where the social performance is function of three big variables. Accordingly, the results – MFI performance – will be given by the weight assigned to each variable.

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\text{Social performance} = F(\text{ED}; \text{IGA}; \text{FS})
\]

4.3 In this context the next step is at management-organizational level, by translating into a policy how to address the groups of people representing the target.

The three categories of MFI require different management policy and evaluation indicators. Once this point has been clarified it will make it possible to position the concerned MFI and accordingly to set out resources, objectives, scope, means, credit policy.

4.4 At methodological level, we have to abandon the idea to provide whatsoever non-financial services, which are assumed to be necessary. On the contrary, we have to move to the demand for approach and inquiry with a field survey on the target population’s needs and prioritize them. A participatory approach is highly recommended.

A very recent CGAP’s paper inform us that “there are an estimated 500 millions smallholder farmers in low-income countries”, people living in extreme poverty having been estimated at 1.2 billions. The size of this data confirm the variegated niches of populations and the need to investigate into the demand for, which shouldn’t be treated as a unique, as we have demonstrated in above Analysis.

Here we may operate as follows: (1) assume the categorization we have proposed (see 4.2); (2) take from the segmentation proposed by the CGAP’s paper, namely (i) noncommercial smallholders, (ii) commercial smallholders in loose value chains, and (iii) commercial smallholders in tight value chains; (iii) combine above proposals.

Whatever avenue we follow, demand for shouldn’t be treated as a unique, but represented by variegated requests that may be summarized into two types: (a) People who every day wake up and have to invent a way to arrive at sun set without starving and (b) people who wake up with an idea for a new product or a new process of production.

In the first case, the lender is in presence of either income generating activities or food aid while in the second case the lender is in presence of enterprise development and in such a case there is accumulation, which should be evaluated as a venture capital.

It could happen that in the first case one day the same borrower may go to the lender and ask for a larger amount that goes well beyond the daily cash flow; well, here the
request is quite different and the lender should finance an idea and it is his own risk whether to accept or not. Where is the difference from the lender side? The difference is in the sources of capital he will use, which shouldn’t be the same and the way he handle with the request for additional credit. This makes it the difference between a banker, a developer and a philanthropist.

4.5 Once above points have been clarified and stakeholders have agreed on unambiguous objectives, the practitioners will use the credit model with competence equal to the task, which isn’t easy: (a) Management can translate the agreed objectives into appropriate benchmarks, (b) Fund raising campaign can be launched and investors can evaluate the risk.

We do think that the proposed approach could help to achieve **responsible inclusive finance** where each one and every provider will have a place to play his role and every niche of population will have its financial counterpart.

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