A challenge to flat earth thinking in microfinance

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The intensive promotion of microfinance worldwide as a palliative if not a panacea for poverty started in the mid-1990s with initiatives like the establishment of CGAP, the Microcredit Summit Campaign and various national level apex agencies often sponsored by multilateral or bilateral development agencies like the World Bank and the regional development banks. Led by CGAP, as the main international technical agency for the support of microfinance, a strong message on the principles of good microfinance practice was propagated worldwide. These principles included (but were not limited to) the following

- MFIs must adopt the principle of "zero tolerance of delinquency" in order to minimize default
- There must be a continuous effort to limit operating costs in order to deliver microfinance at the lowest possible price to low income clients
- Microfinance services must be offered by specialist MFIs in order to ensure that there are no conflicts of interest that confuse MFI managements, staff or borrowers
- MFIs should focus on growth in order to maximize outreach to the vast numbers of financially excluded families across the globe.

This note argues that while **these principles may have been appropriate at the time when they were formulated** (in the mid-1990s) **their time passed a few years ago** and **the entrenchment of these principles as microfinance orthodoxy is now damaging the development objective** – financial inclusion to serve the needs of poor and low income people, and facilitating income enhancement – **for which the microfinance movement was propagated**. Therefore, the time has come for a concerted effort to swing the pendulum back to equilibrium.

While considerable efforts have been made in this direction via the focus of the past few years on social performance this effort needs to be strengthened, and certainly needs to percolate down to some of the less celebrated organizations in many places in Asia; organizations that are not privy to the international conference circuit. Even by those MFIs that do participate in international conferences, the message of social performance is seen mainly as an overlay to the practice of microfinance but has not been adequately integrated into microfinance practice. In any case the effort is still too limited to overthrow entrenched attitudes. MFIs need to be reminded that successful development activities need a rounded approach.

1 The tyranny of "zero delinquency"

The principle of zero tolerance of delinquency is one that was most successfully emphasized at the turn of this century. Within a few years, it became so entrenched in the minds of all with an interest in microfinance that, despite all the efforts of recent years to draw

attention to the potentially damaging human consequences of the blind application of this principle, it continues to hold sway in many places. Operations Managers of many MFIs – from Pakistan to the Philippines – continue to report zero delinquency with satisfied smiles on their faces; when their attention is drawn to the possibility of clients being in genuine difficulty, their expression changes to bewilderment. Well may they wonder what these international experts want when they (the MFIs) have so faithfully applied zero delinquency as a cardinal principle of microfinance.

Yet, it is apparent how the Operations Managers' principle can become tyranny for microfinance clients in genuine difficulty; many MFIs use loan officer delinquency rates as part of the formula for calculating staff incentives. While some delinquency crises and repayment revolts (Lahore, Pakistan 2008 & southern Karnataka, India 2009) were a direct consequence of the resulting tyranny, the political interventions of Andhra Pradesh and Nicaragua were also provoked by the perception, if not always attributable evidence, of such tyranny. The Social Performance standards developed by the SPTF and the Smart Campaign on Client Protection include principles that have indeed been devised to address precisely this issue. However, the message of **humane interaction with clients** has to beintegrated widely in microfinance practice, so as to ensure that aggressive behavior towards, if not downright coercion of clients by loan officers does not continue. Too many MFIs – even in countries such as India directly affected by crisis – see the application of social performance standards more as routine obeisance necessary to gain access to funds rather than as integral principles of microfinance practice.

2 "Continuously lowering operating expenses" causes oppression of clients and repression of staff

The pressure to lower operating expenses has also been established as a key principle of microfinance operation. The theory on which the principle is based is unexceptionable; lower operating expenses should result in lower total expenses enabling a reduction in the price of credit (interest rates and fees) charged to clients. In practice, many studies have shown that lower expenses do not necessarily result in a reduction in interest rates; MFIs operate as local oligopolies and, from the client perspective, competition in microfinance works through greater convenience and more conducive access conditions rather than through price. By and large, clients compare product characteristics other than price.

Lowering operating expenses then becomes more a concession to funders/lenders and raters as a claim to growing efficiency. Equally importantly, the lowering of expenses leads to an increase in returns on assets, boosting profits for investors providing internal surpluses to be used for further investment. On account of the pressure on MFI expenses median operating expense ratios (OER) in a number of Asian countries reduced for a number of years (see **Figure 1** below). However this was attributable not so much to the achievement of economies of scale as to a reduction in the time spent by loan officers on group formation or group development processes resulting in an oversimplification of the relationship between MFIs and clients. By comparison with the almost instant lending taking place now, in the late 1990s a self help borrower group was often expected to be in existence for a minimum of 6 months before it became eligible for an MFI loan. Even a Grameen type solidarity/joint liability group was required to meet regularly for a minimum

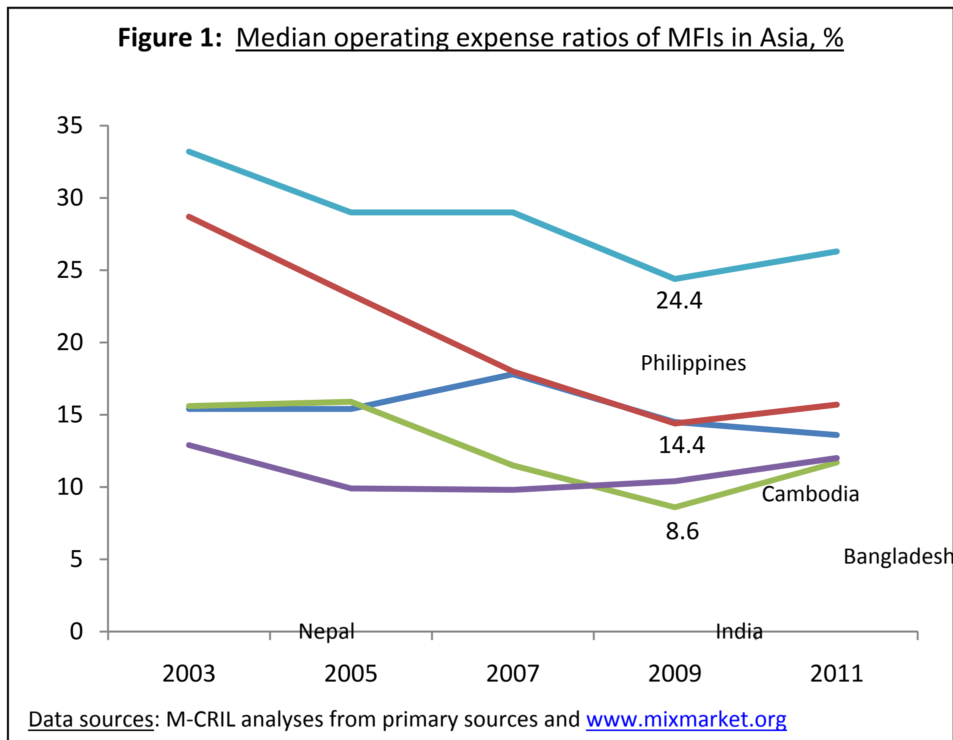

Figure 1: Median operating expense ratios of MFIs in Asia, %

Data sources: M-CRIL analyses from primary sources and www.mixmarket.org

of 8 weeks before it could receive an MFI loan and crucially, in order to be eligible, members were required not to have a loan from any other source.

In the hectic world of microfinance that evolved by the late 2000s, there was no longer time for loan officers to get to know clients and certainly no room for human interaction beyond the minimum required for loan transactions. And in some places, loan officers were required to work long hours, at low wages in sometimes abysmal conditions whilst **microfinance clients were required to take loans and repay these without regard to personal circumstances**. A heartless application of the zero delinquency principle can create a machine-like environment that results both in the repression of staff and in the oppression of clients.

It is true that both politicians and the "middle class" public expect microfinance delivery to take place at unrealistically low interest rates but, as argued above, lower expenses do not necessarily lower interest rates. Ultimately, it is political pressure rather than lower expenses that has lowered microfinance interest rates in some countries. As **Figure 2** shows, microfinance yield increased in India for a number of years even as the OER declined. It is only over the past couple of years that yield has declined in response to political and regulatory pressure; in the meantime, OER has actually gone up due to a cooling in the microfinance environment

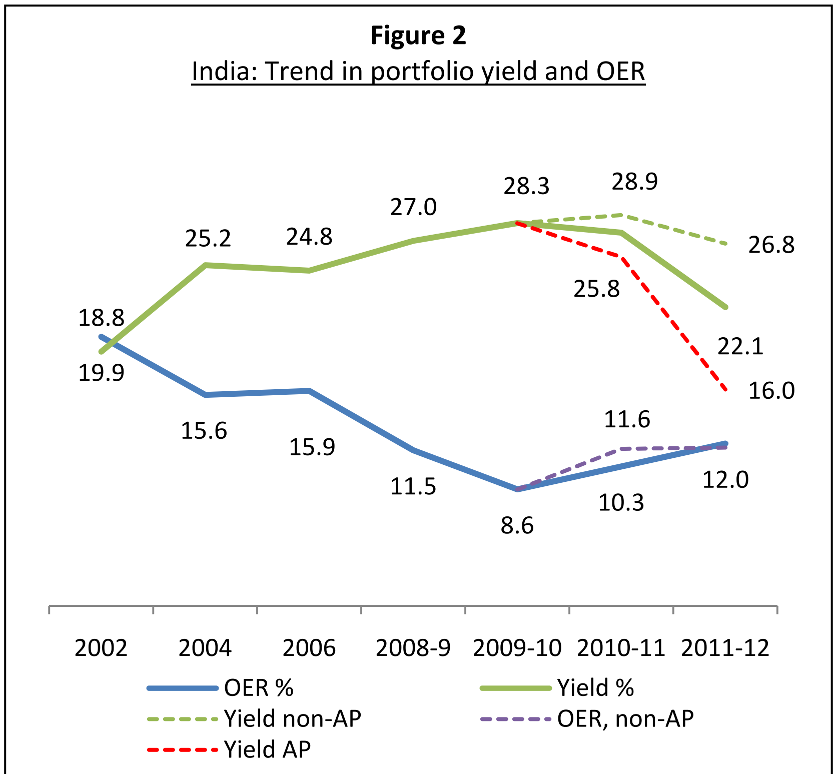

Figure 2

India: Trend in portfolio yield and OER

resulting in lower client-loan officer ratios, and **on account of the expense incurred in meeting regulatory requirements to limit the indebtedness of clients**. It is also apparent from **Figure 1** that median OERs in Asian countries with active microfinance sectors have increased over the past couple of years, largely due to similar pressures.

The message to be communicated to MFIs worldwide and to those who invest in them or lend to them is that **their objective should be lower effective interest rates for clients in an environment of responsible microfinance** not the inexorable pursuit of lower OERs at the cost of the client. Managing the OER would follow logically from the need to ensure sustainability and achieve respectable (not mind-boggling) profitability.

3 "Separation of microfinance" from livelihood promotion limits the income enhancing impact of microfinance

The idea that microfinance (read mainly micro-credit but also deposit services) *per se* can lift people out of poverty has become thoroughly discredited; nowhere more so than in the poorest Asian countries where its need is greatest. Yet the idea that microfinance must be practiced in isolation from other developmentally relevant services persists. This idea is a legacy of the lessons learned from the credit-cum-subsidy rural development programmes of the 1980s and 1990s. At that time, too many development initiatives attempted to mix credit with livelihood support *in a framework of charity*. The message communicated to recipients was that "the funds provided are for your benefit and we will support you whatever the consequences". The net effect was the establishment of a welfare rather than a self-help mentality amongst recipients and providers alike. In that context, the separation of the lending activity from livelihood support and welfare services was sensible.

Now, however, that time has passed. The credentials of microfinance as a no-nonsense lending operation have become established, too well established as argued above in the discussion of the zero delinquency principle. It is essential now to bring microfinance and livelihood support back together so that finance becomes available to support the efforts of programmes that promote value chains with high participation of low income families – incorporating technology transfer and skill development, input supply and marketing efforts. This argument is not for the delivery of finance and business development services by the same personnel but for a more collaborative effort that supports the production and marketing activities of low income families without giving the impression that it is a "cradle to grave" welfare operation.

The orthodoxy that microfinance services cannot co-exist with livelihood promotion has limited the incomes of low income microfinance clients for long enough. It is time for the pendulum to swing back, albeit in a more considered and knowledgeable manner than in the 1980s. Not only CGAP (as argued earlier by the author) but the entire international community of practice needs to embrace the need for livelihood promotion as a key feature of meaningful and sustainable assistance to the poor.

4 The mantra of "high growth" gives free reign to over-weaning ambition amongst microfinance promoters and their investors

The sad case of the SKS Microfinance of 2005-10 and its "highly successful" IPO is well known. But it was not SKS and its clients alone that suffered from the excessive ambition of its promoters. At least 5 other large and perhaps a dozen smaller MFIs in Andhra Pradesh suffered huge losses on account of the AP government's response to the perception (if not necessarily the widespread practice) of coercion by MFI field staff in the state. While the largest ones, essentially too big to be allowed to fail due to the huge losses likely to be suffered by their lenders (the large commercial banks – both Indian and foreign), have survived, some of the smaller MFIs have effectively been wiped out. At least six million clients too have lost in the financial inclusion stakes but each client individually is too insignificant for anyone to care.

Yet, it is not in India alone that this has been an issue. The major crisis suffered by an MFI in Pakistan in 2008, and problems in Morocco, Bosnia, Nicaragua too have resulted directly from the excessive ambitions of promoters encouraged by the *mantra* of high growth propagated in the late 1990s and early 2000s. This, as we know, was combined with the assumption that commercialization was essential for widespread outreach. Significant issues of client overlap leading, at least partly, to delinquency crises in Nepal and Cambodia have been less noticed because MFIs were forced by lenders in the former and investors in the latter to pull back from the brink. A similar developing crisis in Bangladesh was averted essentially by the quiet good sense of the leaders of a couple of their mega MFIs; some of the smaller MFIs continue to push for growth but are hampered in their ambition by the dominance of the large ones.

The issue of high growth is well known to microfinance observers, and is reflected in the Universal Standards for SPM. Yet, so far, beyond piecemeal responses in individual country markets there has been no concerted international effort to change the unfortunate perception that high growth is desirable *without reference to country or context*. Thus, some leading MFIs in India continue to pursue substantial growth apparently unrestrained by lenders or investors. In some of the newly liberalized democracies of Asia where microfinance has been discovered more recently, the multilateral agencies continue to embrace such thinking unmindful of the lessons of the rest of the world.

Consider the following recent conversation with a senior local staff member (Ms Wendy, *name changed*) of a multilateral development agency that is the main funder of X Micro-finance, the largest MFI in the country

Author: "How is X Microfinance doing?"

Wendy: "Very well, very well, have 500,000 microfinance borrowers"
[This in a country with less than one million microfinance clients]

Author: "Sure…what is the performance of X MFI like?"

Wendy (with a wide smile): "Excellent, have zero delinquency!"

Author: “So what is their relationship with their clients”

Wendy: “Good, good, zero delinquency and disburse many funds”

Author: “…and do we know about the impact of X microfinance on their clients?”

Wendy (loses her smile): “Er…no information”
The author’s information on X Microfinance suggests that its staff are feared in the villages for their aggressive behavior towards clients who run into repayment difficulties. Needless to say, the MFI has no livelihood interventions, records a low OER (for that country) and has been encouraged to grow without much concern for its development impact.

Where do we go from here? The point of this note is not to criticize the international community for propagating the messages of the late 1990s at that time; the point is to make **a wake-up call** to work harder to correct those messages now. To ensure that MFIs realize that the lessons of the late 1990s having been learned there is now the need for a more nuanced approach to microfinance practice if the development objectives of the activity are to be achieved. The Universal Standards for SPM as well as the Pro-Poor Seal of Excellence incorporate useful and important new messages that must be spread widely.

This correction needs to be made with the same assertive intent that the earlier messages carried. Such a correction through seminars, conferences, training programmes and research papers is needed both in the countries new to microfinance as well as the old ones. Without it, microfinance will continue to run into the sand as it has been doing over the past 3-4 years. The old ideas have become akin to the sixteenth century assertion that the world was flat; yet **it did gradually became established that the earth was round after all, microfinance needs to be rounded too.**

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