

## **'Induction to Microfinance' Essay**

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LSE BSc Economics, 2013

Note: This essay is written for a course in Microfinance organized by The Student Initiative, a student-ran UK charity focused on development.

### **In your opinion, will Microfinance progress in its existing format or will it change substantially, taking into consideration the issues of sustainability and scalability?**

Microfinance, being a young and growing industry, has much evolution to go through before it becomes mature. It should progress with some changes, carrying on the trends that have started. It may change substantially as a result of government intervention and the socio-political dynamics that are currently reshaping public perception of Microfinance Institutions (MFIs). The core concept behind Microfinance has persisted because of its sustainability and if allowed to carry on, should gradually expand to support the poor in more ways and hopefully, reach out to more people.

This essay considers the current trends in Microfinance, exploring how they might play out in the future. From there, we speculate the format Microfinance might come to take on in the near future as it begins to catch the eyes of investors, regulators and social activists.

### **Financial Services**

MFIs started out mostly as lending organizations rather than deposit-taking ones as a result of both the belief that the poor do not save and the regulatory framework in many countries that forces deposit-taking institutions to be regulated as formal banks, which complicates matters and requires both higher capital and legal support, both of which is not present in the MFIs. Microcredit turned out to be just one of the financial service that the poor needs.

As Stuart Rutherford has emphasized in *'The Poor and Their Money'*, the fact is poor do save and they want to save their money. In West Africa *susu* collectors are paid up to 40% interest for providing a means of saving for rural folks. Microloans themselves are seen as a means of savings for those who are unable to muster the discipline required to save regularly.

The provision of deposit-taking services would gradually be a significant aspect of MFIs. Grameen has demonstrated how MFIs can be funded mainly from the deposits of the poor themselves and they are sufficient to support the credit functions of the institution. This would reduce the need to rely on capital markets and relieve pressure on MFIs to generate higher returns on their investments. Bill & Melinda Gates Foundation has been offering

incentives for MFIs to search for a sustainable business model that would ensure provision of saving services. Perhaps more significantly, saving products are often more scalable compared to credit, where there is a need to tap on social and community network to recognize new, creditworthy clients.

CGAP conclude in their briefing about mobile financial services for the poor by suggesting the presence of a latent demand for saving services. One important obstacle to this, however, is the presence of government regulation that prevents deposit-taking, a point to be covered later in the essay.

## **Financing of MFIs**

MFIs have started out mainly as part of NGOs operations in the developing economies, a means of dispensing aid money; therefore the original source of funds of MFIs were largely donations gathered in the developed economies or aid money from the government for the poor. Microloan Foundation began serving the rural poor in Malawi through donations canvassed from the United Kingdom while Grameen Bank grew from a research project into a full-fledge organization with the support from Bangladesh's Central Bank.

A new breed of pure MFIs is hoping to secure financing through capital markets by turning themselves into for-profit, publicly-listed entities. Following Mexico's Compartamos' footsteps, SKS Microfinance from India raised about \$350 million in 2010. While the Initial Public Offerings (IPOs) of these MFIs have become statements of sustainability and self-sufficiency in the Microfinance social enterprise, it has also attracted much criticism. There are much fears of microlending being abused, with borrowers charged extortionary interest rates and coercive recovery practices to ensure high repayment rates. Nevertheless, for-profit microfinance doesn't have to mean higher interest rates, citing that there are much scope for cost-trimming and interest rates can even be reduced as a result of growth.

Financing of MFIs through capital markets need not be bad as Microfinance obviously is an industry with economies of scale and faster growth through public investments would allow them to expand rapidly. This expansion means reaching out to more poor and the ability to provide more services. Turning for-profit could also encourage more innovation and higher service standards. We can envision a future where MFIs are largely for-profit, offering more and more professional services mainly for those who are hovering above the poverty line while non-profit MFIs try to serve those marginally below that.

## **MFI Regulation**

After the suicide of some of SKS's clients in late 2010, Andhra Pradesh state government in India imposed curbs on MFIs, arresting SKS's field workers despite the fact that none of these clients were in default. The regulation in India also prevents MFIs from taking

deposits, reducing an important avenue of financing. MFIs attract regulators and politicians' scrutiny because of a variety of reasons.

For a start, MFIs are in a line of business closely related to banking, which is traditionally closely regulated and these organizations often work closely with the governments in the developing economies where the MFIs are found. Without regulation, there is a perception that MFIs are nothing more than organized rural loan-sharks. Governments might be genuinely concerned about the well being of poor rural folks borrowing at interest rates that go up to 45% or more annually. MFIs growth has, to some extent, discredited governments' rural development policies. At the same time, there are other disruptions that MFIs introduced, particularly for India, the growth of MFIs has reduced politicians' ability to use rural credit as a tool of patronage.

Yet, interest-rate caps might potentially hurt new entrants into the field of microfinance and reduce investors' interest, stagnating its growth. The MFIs will face greater challenge of having to overcome more regulatory obstacles to reach more people and their work will be impeded. In many ways, going public is a means of getting around the problem. Getting listed enforces some reporting standards and enhances financial transparency; that would in turn raise social pressure for the organizations if they begin abusing microfinance.

## **Conclusion**

Aggressive regulation or government take-over poses as much threat to microfinance as an emphasis on profits over their social goals. Radical changes in the microfinance landscape can take place if either of these were to come to dominate. Both these paths are unsustainable: government control of these organizations could transform them into tools of political patronage; and profits would eventually be eroded if the social goals were compromised as the poor struggles to fulfill their debt obligations.

MFIs should largely progress along the same lines it has been moving along since its birth; it would grow much more rapidly from now and would expand to fulfill other needs of the poor through saving products and possibly more money transfers services. Microfinance is not a panacea for poverty – it often fails to serve the ultra-poor and its borrowers would not necessarily do much better just because of microloans or microsavings. It does, however, provide opportunities and serves the entrepreneurial ones very well.

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