

Introduction and Overview: An Inquiry into the Mismatch in Microfinance

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Microfinance — a set of financial practices designed to serve the unbanked poor — is seen by some as a magic wand against poverty that is supposed to solve it all. For others, microfinance is no more than a new wave of usurious practices reframed and glorified. These extreme views can, to a certain extent, be validated by convincing stylised facts, case studies, and, in some instances, by rigorous academic research. From our standpoint, however, the reality is to be found in nuances and perspectives. As it is often said: “The devil is in the details”. Our main objective in this handbook is thus to present some of the most recent findings and research in microfinance in order to build, step by step, a nuanced perspective of microfinance where positive and negative aspects can be looked at in an attempt to deliver an objective and balanced view via a collection of articles. While these might at first glance seem scattered — reflecting polarised views and controversies at times — our stand is that the entire set of articles contained in this handbook is strongly linked to one single idea, which we have coined “mismatch”. Our choice is more than pure semantics, as it will recurrently surface in the reminder of this introduction.

Most recent estimates suggest that microfinance has reached one hundred and fifty million individuals worldwide.* The number of the unbanked poor is however estimated by some authors to be around two and a half billion.¹ Put simply, microfinance could therefore be seen as currently serving a meagre percentage of those people who are excluded from access to financial services. There are, of course, debates on the relative importance of this failure to expand outreach.² To some, the meagre numbers alone are *prima facie* evidence of the failure of microfinance to include the poor. We disagree. From our standpoint, if well-designed, microfinance has the potential to improve the living standards of millions of unbanked poor throughout the world.

A strong criticism of microfinance, however, is that it has been around for over 30 years now, and numerous observers are rightfully beginning to wonder: “Why is it that a renowned and well-funded innovation such as microfinance is letting so many unbanked poor down?”

One answer is that the poor prefer to turn to informal sources of finance — friends, family-members and moneylenders, to mention a few. A second one is that microfinance only attracts a minority of entrepreneurial poor — savvy business individuals, for example — who are able to produce handsome returns. These returns enable such individuals to repay relatively high interest rates. A third one is that donors and socially responsible investors are obsessed with self-sustainability, forcing supply of microfinance products to be limited only to profitable and relatively safe products. Small loans to women, in particular, seem to be microfinance institutions’ best bet in order to meet self-sustainability objectives.

All these answers and many more might be the right answers. We however believe that there is a mismatch between microfinance products and what the unbanked poor really need to finance their investment and consumption needs on the one hand, and to save and insure themselves against idiosyncratic (and aggregate) shocks on the other. Take the example of microloans for women. A vast majority of these borrowers are petty traders who would rather borrow and repay daily because demand is uncertain, supply from

*See, for example, S. Daley-Harris (2009), State of the Microcredit Summit Campaign Report 2007. Washington, D.C.: Microsoft Summit.

¹See, Kendall in GGAP Report, <http://microfinance.cgap.org/> or Chaia, A, A Dalal, T Goland, M J Gonzalez, J Morduch and R Schiff (2009). Half the World is Unbanked. Financial Access Initiative Framing Note.

²See for instance the CGAP Newsbrief, Are We Overestimating Demand for Microloans? (April 2008).

traders is often unreliable, and because the best way to preserve a good credit record is by repaying immediately after sales are completed if only because their ability to pay is often hindered by theft — in many instances from the women’s own family members. Some women would also like to take their profits home to pay for food and/or unforeseen contingencies — idiosyncratic shocks such as having to spend for the illness of a family member or a friend. Others might prefer to save their savings while they are covered by health insurance. The best microfinance deal women often get, however, is a three-month loan, weekly repayments on that loan, savings facilities with limited withdrawals, and health insurance for themselves but not for their family members.

Why is there such a huge mismatch between a limited microfinance menu and the demand for financial services by a highly heterogeneous population of more than two billion unbanked poor? Imaginative minds might come up with myriad answers. We believe that this is an exceedingly complex question requiring informed responses from academics and practitioners alike. And this is precisely what our main objective in *The Handbook of Microfinance* is.

Over a 30-year period, microfinance has transformed itself drastically. Thanks to field practitioners, microfinance innovations have grown exponentially. Started initially by what is often referred to as a “civil society”, microfinance was largely built upon initiatives from non-governmental organizations (NGOs), and cooperatives. BancoSol of Bolivia, for example, started as “Fundación para la Promoción y el Desarrollo de la Microempresa”, a small NGO, in 1986. BancoSol is now a commercial bank serving over one hundred thousand clients in Bolivia. BancoSol exports technological know-how to a handful of Latin American countries. Another example is the well-known Grameen Bank. It started as a small pilot project with NGO-features in Chittagong, Bangladesh, in 1976. That is nearly 35 years ago! The Grameen Bank is now a well-established financial institution under the legal status of a cooperative serving over six million clients in Bangladesh, with hundreds of replications worldwide. Added to these well-documented examples from Latin America and Asia, are the often neglected but recently revived cooperative networks in Western Africa. The Réseau de Caisses Populaires de Burkina Faso (RCPB), for instance, launched in 1972, gathers over 100 financial cooperatives. The RCPB is now serving over half a million members in the entire country.

Such initiatives, alongside a thousand more, were fairly disconnected. Yearly summits, microfinance platforms, and regular practitioners’

conferences worldwide have facilitated diffusion of technology and expertise across numerous microfinance initiatives. At those gatherings, strategic alliances between commercial banks and microfinance institutions, savings banks, donors, CEOs of commercial microfinance institutions, and NGOs interact. Simultaneously, think-tanks organize regular encounters with experts and academics active in the field. These world-wide gatherings in recent years point in the direction of at least five well-defined trends.

First, a change in lending methodology. At the beginning, microfinance gained popularity for having introduced solidarity groups and village banking with joint liability, mostly among women borrowers. Today, there are many more approaches. Individual lending seems to be getting most of the attention. At the same time, the excessive focus on women is being questioned.

Second, a change in the supply of financial products. Microcredit has traditionally received most of the attention, and it still does. Over the past decade, however, the almost exclusive attention on microcredit has evolved into a broader vision — as captured by the use of the word “microfinance” instead of “microcredit”. The former takes into account the fact that the unbanked poor need an array of financial services other than just credit. These include savings, insurance, remittances, and many more.

Third, a larger and a more diverse pool of suppliers. In particular, microfinance clients are no longer being served exclusively by NGOs and cooperatives. Added to these traditional suppliers, the so-called downscaling banks — local commercial banks which are responding to demand for microfinance products such as consumer credit — are on the increase. Trends towards commercialization are also in crescendo. These were initially NGOs which have transformed themselves into fully regulated microfinance banks. Socially responsible investors are also contributing to an increased supply of funds available for financial intermediation via the so-called Microfinance Investment Vehicles (MIVs).

Fourth, a radical transformation in supervision and regulation. In most countries, microfinance institutions are prevented from monopolistic practices. Local authorities are no longer turning a blind eye. In particular, local governments are trying to foster competition, and stringent supervision for fully regulated suppliers is being set-up in many countries. If and when more competitive microfinance practices do take place, proactive local authorities are making it happen.

Fifth, a fundamental change in financial priorities. Focus on self-sustainability does not seem to be the greatest challenge anymore.

Microfinance has demonstrated that it can not only be self-sustainable, but also generate handsome returns. And the focus of attention is increasingly shifting towards how (if at all) those profits are being shared among different stakeholders. Questions are raised pertaining the share accruing to the operational staff, and, most importantly, to the microfinance clients themselves.

When looking at these relatively new trends, a deeper understanding is needed for the microfinance industry, which seems to be at a crossroads. Practitioners on the one hand are well aware of the need to increase outreach, but the problem is how: By re-balancing from urban to rural? From women to men household-heads? From loans for income generation to consumer loans? By the enhanced financing of agricultural activities? On the other hand, commercialization trends are posing new challenges for the microfinance industry in general, and for local authorities in particular. This is especially worrying if such trends are meeting outreach objectives, but are biased against the poorest.

Time has come to reflect upon where microfinance stands, and what its future will be 10 years down the road. Ideally, donors and socially responsible investors would like to see the industry meeting outreach objectives at a faster pace without compromising its social mission, namely, contributing to poverty alleviation. *The Handbook of Microfinance* is intended to address hundreds of questions that the industry's participants are asking themselves at this delicate juncture. And our principal objective is to shed light on what hides behind the mismatch between the demand and supply of microfinance products and thereby address critical questions.

Our inquiry begins with Part I titled "Understanding Microfinance Practices". In this section we first present context-specific survey data gathered with the main objective of measuring impact. Dean Karlan and Nathanael Goldberg provide a comprehensive review of methodologies and interventions which touch upon the mismatch problem in micro experiments carried out in Africa, Asia, and Latin America. However micro-climatic such experiments might be, the results that the authors describe deliver partial solutions, some of which can better serve the poor without compromising self-sustainability objectives. But context-specific experiments are designed through the lens of theory, a point that is nicely framed in the chapter by Greg Fischer and Maitreesh Ghatak. In their article, the group-lending methodology — the starting point of microfinance in Asia's solidarity groups and Latin America's village banking — is explained and questioned, in order to shed light on recent trends towards individual lending methodologies.

Such methodologies, in some cases, can more adequately serve a vast majority of the unbanked poor.

To better understand microfinance as it is often perceived these days, however, the historical roots of group lending methodologies are well explained in a follow-up chapter by Timothy Guinnane on the 19th century German cooperatives. This article not only delivers important insights on group lending, but also on recent trends to include existing cooperatives in the microfinance movement. Isabelle Guérin, Solène Morvant-Roux and Jean-Michel Servet in a follow-up essay remind us that in order to constructively push the limits of microfinance further, we must understand how ancient informal financial institutions operated. Their article borrows extensively from the financial diaries — a compilation of stylised facts from World Bank field researchers — a useful stepping stone for understanding the demand for financial services by the poor. This is complex indeed. But the key issue here is the swift response to the poor's demand for liquidity, which represents a gigantic challenge, if only because microfinance already faces exceedingly high transaction costs.

These costs are, however, not the only reason why microfinance institutions often charge relatively high interest rates when compared to those rates charged by commercial banks. In particular, the transformation of large microfinance institutions from non-governmental organizations into commercial banks has led to monopoly pricing of financial products. The poor are forced to endure usurious interest rates, for example, because there are few or no other alternatives out there. In a thought-provoking article, which closes this section on a silver lane, Marek Hudon severely questions microfinance institutions' malpractices — monopoly pricing — on ethical grounds. In a nutshell, Hudon's essay sends a warning remark to donors and socially responsible investors supporting microfinance outreach and innovations. Is donor's support justified in light of unethical behaviour by institutions which, at least in principle, are meant to serve the poor?

Part II, titled "Understanding Microfinance's Macro-Environment and Organizational Context" contains a series of articles on competition, regulation, management and corporate governance. These issues are country and institution-specific, but lessons can often be drawn. In reading this section, one is able to understand more clearly that outreach growth correlates with country-specific supervision and regulation on the one hand, and with institution-specific management and governance on the other.

Based on various case studies, Robert Cull, Asli Demirgüç-Kunt and Jonathan Morduch open the debate by explaining how regulation, competition, and financing interact. The researchers highlight that microfinance involves trade-offs: maximizing social objectives on the one hand, and financial performance on the other. Framing these trade-offs is clearly crucial to make critical policy choices. Jay Rosengard complements their analysis by reviewing the choices. Rosengard's focus is on regulation and supervision. He argues in favor of maintaining coherence: "to favor regulating what should be supervised while making sure to supervise what is being regulated".

The section then moves on to assess the overall impact of macro conditions on institutional performance, nicely spelt out in two complementary contributions. The first one, written by Niels Hermes and Aljar Meesters, provides an analysis of how macroeconomic, financial development, institutional and political variables may influence microfinance institutions' success. With the use of a large set of variables, the researchers provide an overall vision of macro conditions. In their view, the development of microfinance can only be understood within the context in which microfinance institutions operate. And, in particular, within context-specific financial systems as well as country-wide macroeconomic environment.

Claudio González-Vega and Marcelo Villafani Ibarnegaray follow the same path by reviewing in great detail the exceedingly interesting case of Bolivia. Their analysis clearly illustrates the need to adopt a "system's perspective" when studying institutional development. In the particular case of Bolivia — a leading innovator in the field — the approach proposed by González-Vega and Villafani Ibarnegaray sheds light on how Bolivian microfinance moved from being an alternative market to becoming the most vibrant segment of the Bolivian financial system.

The last three contributions in this section touch upon management and governance. Guy Stuart proposes a "strategic management framework", the main objective of which is to make a clear link between the constraints imposed by the government, the "public value" and the operational capacity needed for institutional success. Using a "value-creation approach" and stakeholder analysis, Stuart spells out "a triangle" with the main purpose of clarifying our understanding of the management conditions which, he argues, are needed to support sound and successful growth.

On governance, Valentina Hartarska and Denis Nadolnyak question the way external control mechanisms can actually help microfinance institutions to achieve their objectives. The researchers deliver an interesting review of

various empirical studies, and show that such controls might be misleading, for it is unclear whether the mechanisms on governance that they analyze assist microfinance institutions to fulfill their missions. Marc Labie and Roy Mersland then close this section. They first deliver a literature review on corporate governance. Next, they suggest “a framework”, which should be viewed as the lens for discussing corporate governance in microfinance. Their main message is that the issue of corporate governance in microfinance is under-researched and exceedingly complex, necessitating various sets of mechanisms. Their article suggests eight different venues for further research in this promising area.

In the third section of this handbook, readers will find a collection of articles related to commercial microfinance. Part III is titled “Current Trends Toward Commercialization”, and begins with an article by Jean-Michel Servet. This article delivers a snapshot of corporate social responsibility which might be realistic but portrays a rather pessimistic scenario. To strike a good balance — and a less pessimistic view of corporate social responsibility — the second chapter in this section by Erna Karrer-Rüedi focuses on the experience of the Credit Suisse. It delivers a practitioners’ view on how socially responsible investors view themselves. Banks in the developed world “link” a pool of socially responsible investors’ savings and lend those savings to microfinance institutions of their choice. Microfinance institutions in turn lend those resources to the poor. Interestingly, spread variations across microfinance institutions are not in the picture, which in turn leaves the reader intrigued on whether the size of such spreads, which are presumably large, could be taken as a metric of corporate social responsibility.

The next chapter by Beatriz Armendáriz and Ariane Szafarz explores mission drift. Contrary to common wisdom, the researchers argue that average loan size alone does not represent a benchmark for judging whether microfinance institutions are moving away from their poverty alleviation mission. In particular, Armendáriz–Szafarz present a theoretical framework which makes an interesting point: the difference between mission drift and cross-subsidization is blurred at best, misleading at worst. If depth of outreach is region-specific, do investors have to sacrifice monetary returns in order to serve the poorest? This question is taken up by Rients Galema, and Robert Lensink in an essay where the trade-off faced by socially responsible investors between risk and return is well articulated. Specifically, the researchers show that socially responsible investors must endure lower returns or take a higher risk in order to increase portfolio outreach. This negative correlation, Galema and Lensink argue, has never been quantified.

And this first trial should be viewed as the tip of an iceberg in terms of how much social investors are willing to endure in order to offer financial services to approximately 94 percent potential clients.

But the trade-off can be somewhat mitigated if microfinance institutions become more efficient. Marek Hudon and Bernd Balkenol remind us about the importance of what they call “efficiency”, namely, outreach maximization for a given set of subsidies. Suppose for a moment that a relative lower return that social investors have to endure for the sake of opening financial access to the poor is like a subsidy. Because we live in a world of limited resources, those subsidies must be selective. A straightforward way of allocating subsidies across microfinance institutions by means of social investors is to be guided by efficiency. Yet, Hudon–Balkenol would argue, this is easier said than done, for microfinance institutions differ quite widely. Not only do such institutions review different production functions, but they also offer different financial products, from microloans to savings and insurance. These differences are multidimensional, and make resource allocation of subsidies exceedingly difficult — even if productivity parameters were the only focus of scarce resource allocation.

To complete the picture, this section closes with an interesting article by Carlos Serrano-Cinca, Begoña Gutiérrez Nieto, and Cecilio Mar-Molinero, which reminds us of the so-called “double bottom line”. That is, microfinance institutions are mindful not only about financial performance (or efficiency, as described in the Hudon–Balkenol essay) but also by social indicators. Econometric analysis is used to assess financial performance, and guidance is provided for extending the analysis to social performance indicators.

Finally, the fourth section aims at reviewing how unmet demand can be attended properly. It is analyzed from three different angles. The first one focuses on the challenges posed by agriculture. It starts with a contribution by Solène Morvant-Roux who clearly establishes the limits and constraints of microfinance when dealing with rural and agricultural financing. Her essay shows that even if more attention were to be devoted to agriculture lately, the market conditions experienced by a vast majority of small farmers still tend to exclude agricultural producers from financial services. The analysis is then completed with a contribution by William Parienté. Focusing on a rural area in Serbia, he shows the limitations of microcredit in order to resolve the specific needs of rural populations. Reviewing current approaches to deal with agricultural financing is portrayed as an imperative.

On an optimistic note, Johan Bastiaensen and Peter Marchetti deliver an important contribution which, albeit context-specific, shows a promising

way for moving forward on the agricultural financing front. Borrowing from the experience of the Fondo de Desarrollo Local Nitlapán, and other institutions in Nicaragua, the authors show the importance of proactively promoting agricultural “value chains” in microfinance: alternative to top-down development policies, which contribute to create synergies between financial and non-financial actors in order to offer better services to small farmers. These chains, Bastiaensen and Marchetti argue, enhance efficiency, social inclusion and gender justice.

The second angle in this section concerns gender. Gender is a widely used parameter to assess social performance, that is, an indicator of social performance based on the percentage of women in microfinance. Women are not only the poorest, but also the main brokers of health and education within the household. Emphasis on women is therefore not surprisingly an important social indicator of how faithful microfinance institutions adhere to their social objectives. The numbers are striking: eight out of 10 microfinance clients are women. Somewhat paradoxically, however, women face severe saving constraints. Women’s unmet demand for savings, Armendáriz argues in her essay, is due to the fact that women demand security, flexibility and commitment. None are being adequately met by microfinance institutions. Women therefore have a tendency to turn to microfinance for loans and to the informal market for savings. A follow-up paper by Stuart Rutherford focuses on the poor’s savings in Bangladesh. Rutherford shows that instalment plans whereby the poor save bite-sized amounts combined with other innovative plans can boost the poor’s capacity to save.

Savings are, however, only one part of the equation. The poor in agriculture, relative to their counterparts in urban areas, are more exposed to risks due to drastic changes in weather conditions, low levels of sanitation, and infectious diseases, to mention a few. Craig Churchill sheds light on this interesting topic. In his paper, he first highlights the importance of taking a broad view of microfinance with a built-in health insurance component. He illustrates nicely some latest state-of-the-art developments in microinsurance for protecting the heavily exposed poor.

In a follow-up article, David Hulme, Karen Moore, and Kazi Faizal Bin Seraj remind us that poverty is a multidimensional problem. Largely based on a Bangladeshi BRAC programme, which is specifically designed to target the ultra poor, the authors of this interesting piece document how a combination of asset delivery and skill provision can reduce poverty and vulnerability. While the authors portray BRAC’s programme as exceedingly successful at reaching vast numbers of ultra poor via its carefully designed

Targeting the Ultra Poor (TUP) program, they warn us on TUC being context-specific, with limited policy implications which could easily be replicable in other regions.

The third angle in this last section is education. Not because we consider education to be unimportant. On the contrary, we think that education is in high demand by microfinance clients, particularly the poorest. But it is probably here where the mismatch is most acute. In her paper, Isabelle Guérin documents rather nicely how appalling the design of existing microfinance products is relative to what the poor actually would like to see on offer. This is a very difficult problem to tackle in the context of West Africa, she argues, because, among other problems, clients are highly heterogeneous. Gender issues are part of the equation. Linda Mayoux, in particular, delivers a “gender protocol for financial services”, which touches upon normative statements for women’s empowerment. The handbook closes on an appropriate note, thanks to the interesting contribution by Asif Dowla on higher education in Bangladesh. In Dowla’s own words: “. . . there is a mismatch between what potential clients demand and what microfinance can offer in terms of financial products. Prior to the introduction of education loans by Grameen Bank, a student, specially a female student. . . would probably have received a general education in the local college. . . Now, thanks to the education loan of Grameen Bank, she is self-confident, independent, helping other people”.

Microfinance success is a long and winding road. Quite a lot has already been accomplished. Much more remains to be done. Can smarter funding from donors and socially responsible investors help resolve the mismatch? Or, are stronger efforts in the field of innovation from practitioners needed? Can insights from academics help to accelerate the pace at which the mismatch gap can potentially be closed? After reading this handbook, we are left with the impression that a concerted action between the three might do the trick.