

NEW VOICES IN PUBLIC POLICY

Volume III
Fall 2008

Is Small Beautiful? The Microfinance Movement Challenge

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Introduction

There is a growing consensus that microfinance is a proven tool for helping the poor to break the cycle of deprivation and finally achieve increased levels of financial well being. This movement towards broad implementation of microfinancing¹ services is mainly being promoted in developing countries. In 2005 the United Nations celebrated the Year of Microcredit, which indicates the increased popularity of microfinancing strategies and operations.

“Microfinance” is often defined as financial services for poor and low-income clients. In practice, the term is often used more narrowly, referring to services delivered by self-described ‘microfinance institutions’ (MFIs) who usually use techniques developed over the last three decades to make and manage tiny uncollateralized loans. These techniques include group lending and (group) liability, pre-loan savings requirements that test clients’ willingness and ability to make regular payments, graduated loan sizes, and most importantly an implicit guarantee of quick access to future loans if present loans are repaid promptly.²

Small, medium and large businesses utilize debt financing for a range of reasons . . . For microbusinesses- small entities with less than five employees-this is no less true. Yet due to a combination of factors including . . .the reluctance of formal lenders and financial institutions to work in these markets, microbusinesses do not have access to traditional sources of business financing.³

Despite the growth of microlending, questions remain regarding its financial sustainability and the true scope and breadth of its economic impact.⁴

This paper seeks to assess the scope and economic impact of the microlending phenomenon and its long term economic viability. While millions of individuals have benefited from microloans, it does not appear that the numbers of individuals served are sufficient to register measureable economic improvements on the scale of an improved national Gross Domestic Product (GDP) or increased income per capita measurements.⁵ For this reason, the importance of microfinance to economic growth in developing nations hinges both on its sustainability and the ability of microfinance to grow and serve a significantly larger percentage

of the populations in those economies.

The capital base of over 90% of all microlenders to date has been provided by philanthropic organizations. This paper will also assess whether MFIs are likely to remain dependent upon donor capital over the long term. If so, this would negatively impact the ability of the MFI sector to grow sufficiently enough to impact a nation's macroeconomic output. This paper will also address whether MFIs will be able to adopt new technologies and more efficient business models that allow them to reduce operating costs so that MFIs can systematically tap and productively utilize the vast reserves of financial capital that reside inside the commercial banking systems of nearly every developing nation. The paper will explore whether microlenders can be expected to serve as a conduit between the developing countries' underutilized financial reserves and the populations residing at the bottom of the economic pyramid who currently have no access to finance.

Historical Context of Microfinance

While the practice of microfinancing first peaked in the 1960s and 1970s, there are examples of much earlier attempts to aid the financial needs of the poorest entrepreneurs. The earliest case is the *montes pietatis*, credit organizations for the poor that were established in Italy in the 15th century and later endorsed by Pope Leo X as merciful organizations for the poor.⁶ Another of the earliest organizations, the Irish Loan Fund system, was initiated in the early 18th century and provided small loans to the Irish rural community.⁷ At its peak, the organization provided short-term loans to up to 20% of all Irish households annually.

Several other efforts, in the form of more formalized credit unions and people's banks, spread through Europe and North America. These new institutions developed from banks for the

poor owned by the poor, into sustainable traditional financial organizations.

In the early 20th century, Latin America developed variations of the original credit unions created in Europe. Unlike its European counterparts, the Latin American organizations were usually owned by the local government and/or private banks. This approach to ownership was fatal and most of these early microfinancing organizations became increasingly inefficient.⁸

In the 1950s, some development organizations started to introduce the concept of lending programs in developing regions. These programs, however, were in large part subsidized and usually unsuccessful. Subsidized lending eroded the capital base of most of these projects and resulted in inappropriate lending practices to non-poor borrowers and substandard repayment discipline.⁹

In the 1960s and 1970s, several experimental microlending programs were primarily initiated in Latin America and Asia. These programs focused on very small loans to woman-owned microbusinesses, with special emphasis on the very poor. These early microlending programs were designed around solidarity circles. Each solidarity circle was formed by a group of several borrowers, and each borrower guaranteed the repayment of all the other members in the circle. The creation of these solidarity groups contributed to the high repayment rate of microloans.¹⁰ The most successful of these early microlending enterprises were, and still are, ACCIÓN International, the Grameen Bank, and the Self-Employed Women's Association (SEWA) Bank.

By the 1990s, some of these microlending organizations proved to be capable of long-term sustainability and large outreach, based on the high repayment level and cost-recovery interest rates (see next section for more detail).¹¹ As they became sustainable, many microlending organizations expanded their services and transformed into full-service commercial

banks or non-bank financial institutions, which has enabled them to offer more products and services. Many of these microfinance organizations now offer services such as savings, insurance, health services, business advice and counseling. As the inventory of services and the outreach to a larger pool of borrowers increases, new financial strategies need to be developed and implemented. In order for the institutions to be financially sustainable over the long term, their funding sources need to become more diversified and their capital needs to be affordable. Since most MFIs do not have access to interbank lending they must either tap into the secondary capital markets, where the cost of capital is higher, or they can attempt to mobilize small deposits, which have their own cost implications as well as infrastructure and staff requirements.

Current Cost Structure and Sustainability for MFIs

While some microfinancing organizations have demonstrated long-term sustainability, an increase in services and client outreach may require new approaches, including partnerships with well-established traditional banking institutions.¹²

Comparing average costs of MFIs to formal sector financing structures demonstrates that tremendous challenges lay ahead if MFIs are to appeal to decision makers in international banking circles.

Table 1. Comparison of costs for microfinance, credit card, and housing finance products.¹³

Cost Category	Microfinance¹⁴	Credit Cards (U.S.)¹⁵	Housing Finance (U.S.)¹⁶
Operating Costs	29.10%	1.35%	1.60%
Funding Costs	18%-60%	5.96-6.10%	6.47-6.88%
Loan Losses	1.6%	4.09%	4.95%

As Table 1 demonstrates, the operating cost of microlenders is currently still very high, and the cost of funds for those microlenders whose capital is not provided by donors is unusually high. Clearly, the cost structure of microlending is daunting. “Microfinance represents more than a new product line or client segment; it is a new way of doing business. It requires changes in organizational culture, decentralized operations, and service that is sensitive to clients’ needs.”¹⁷ But if this “new way of doing business” does not adopt new methods and technologies that drive down costs, the hope of microfinance bringing financial access to the “bottom billion”¹⁸ will not be achieved. Commercial banks must be convinced of the profitability of this “new way of doing business” before they commit their capital to a venture that requires a new organizational culture and decentralized operations.

Challenges for MFIs in achieving sustainability

Many MFIs are classified as a sector located within socially oriented institutions which include postal, agricultural, savings banks, and government-operated institutions. Unlike traditional commercial banks, these socially oriented financial organizations are rarely overseen and thus tend to be less efficient, providing low quality service and loss of profit. It is the current understanding that a dramatic increase in impact, effectiveness, and outreach of these socially oriented institutions, and in particular the less successful MFIs, can be achieved if they start operating on a for-profit business-like approach.¹⁹

Financial sustainability of MFIs needs to be based on sound financial and businesslike practices. Dr. Yunus, the founder of Grameen Bank, is a believer in the central basis of capitalism and its potential to help development.²⁰ From his perspective, the economic system must be competitive, since it is competition which drives innovation, technological progress, and organizational enhancement. Additionally, he endorses profit maximization to increase social

impact and to promote financial sustainability of any microenterprise (microlenders as well as the borrowing microenterprises).

From the perspective of sustainability, the Consultative Group to Assist the Poor (CGAP) in its Strategic Directions for 2008-2013 focuses on building efficient local financial systems that work for the poor. CGAP defines efficiency as achieving enhanced international and local financing by helping local institutions improve their performance and lower their transaction cost via technology, streamlined operations, and increased competition.²¹

In the strategic plan, CGAP targets the promotion of product and delivery diversity in the microfinance arena, as well as its integration with mainstream financial institutions. The fact that today there are five times as many profitable MFIs as four years ago and that brand new MFIs are breaking even within two years from launching could encourage more mainstream financial organizations to aid microfinancing enterprises.²²

The world of microfinance is not new for the traditional financial markets as

Commercial banks began to enter into the microfinance arena in the mid-1990s. The experience thus far shows that to succeed, bankers interested in entering the microfinance market must understand the real challenges and means to achieving growth and profitability of microfinance in their institution.

...They must be convinced of the profitability of the product (in terms of net operating margin), have realistic growth expectations (in terms of total portfolio and, hence, absolute net income) compared with other lines of business and make the investments required to scale up.²³

In other words, even if bankers become convinced that microlending can achieve the economies of scale needed to become profitable, they must also be convinced that the sector can make a sizeable contribution to the bank's bottom line, and that those contributions to profitability will grow at a rate comparable to other sectors of the bank.

Once the decision is made to enter the microfinance market, banks must constantly balance three pillars of successful microfinance: high volume operations, quality client service, and risk management systems. On the surface, these three pillars may appear similar to general banking practices. However, the unique characteristics of microfinance present important implications.

- Volume is achieved by reaching thousands of clients, each with numerous, small and short-term transactions.
- Service is delivered to meet the socio-economic needs of clients often living in the informal economy and traditionally marginalized from formal financial institutions.
- Risk is managed by people and systems customized to the high-volume of operations and informal nature of the clients, incorporating policies and procedures to eliminate, mitigate, off-set, and control risks.²⁴

So, while the gross profit margin on microlending may appear high, net profit margins are low due to the high transaction costs. Even if these net margins are managed such that profitability is assured, the “micro” nature of the sector may prevent microlending from ever becoming financially competitive with traditional opportunities available to commercial banks. Further, if the scale of profitability is overcome such that profits from microlending become significant on a scale relevant to commercial banks, organizational cultures, processes and procedures required for microlending are so different from those required for commercial lending that housing both forms of banking under one institutional roof may prove unrealistic.

Profitability remains a significant challenge to MFIs in the U.S. “...despite the interest in the sector and the subsidies that have flowed into mission-oriented MFIs, it appears challenging to make an MFI viable over the long term. One survey found that 30 % of domestic microfinance programs operating in the U.S. in 1996 were either no longer in operation or were no longer lending capital two years later.”^{25,26}

“International counterparts appear to have fared better, but it is quite difficult to compare the different sets of market conditions. Developing nations typically have a strictly tiered banking system, a higher proportion of microbusinesses in their economy, high demand for

microloans, less access to formal banking and a large tier of informal lending channels.”²⁷ “As a result, international MFIs operating in countries such as Bangladesh and Bolivia have experienced much greater scale of demand for lending services and have facilitated the flow of capital to several million microbusinesses owners.”²⁸

While international development and philanthropic organizations contribute to microlending in order to achieve social goals, such as the alleviation of poverty, banks outside the U.S. participate in microlending based on its profitability. A Harvard Institute for International Development (HIID) study of 148 banks outside the U.S. currently making loans to micro and small enterprises were asked, “What are the main reasons for the bank to start making loans to this sector?” 49% of the banks indicated “the profitability of micro and small loans and 44% indicated that “the changing market conditions and increasing competition in lending to large/medium enterprises” were the most important two reasons for entering small and micro enterprise finance.²⁹

“It has been well researched and documented that the financial liberalization policies in the 1980s and 1990s which allowed foreign banks to operate in domestic markets and freeing interest rates have indeed increased competition in the banking sectors of many developing countries around the world. Many of the domestic banks lost their large clients to the international foreign banks hence, they began to look for new creditworthy clients from small and medium sized enterprises.³⁰

Nonetheless, when the 72 banks included in the HIID survey were asked about their reasons for not making loans to micro and small enterprises, they indicated that it was “the higher administrative costs of making these loans (40%).”³¹

Commercial banks outside the U.S. are already engaged in the microlending sector, and

competitive pressures continue to compel more banks into the microlending sector as a result of increased foreign bank competition in the medium and large enterprise lending area. Therefore, the degree to which innovation and technology can help microlenders and borrowers drive down the operating costs in this sector may well determine whether microfinance succeeds in becoming a factor that impacts the economic performance of developing nations, not just individuals.

Impact and Reach of Microfinancing

It is estimated that 3,000 MFIs are currently serving over 100 million people worldwide. There is still the need to reach and serve an estimated 1.2 billion individuals living in extreme poverty (people living on less than U.S. \$1 per day).³² Therefore, it is imperative to develop new strategies that would allow viable financial services to reach all potential clients while ensuring profitability, and thus sustainability, of the financial institutions engaged in microfinancing. As the CGAP advocates, sustainability of microfinancing organizations is key to reach a large number of the poor, and as a result, achieve an impact of significant scale.³³

The issue of microlending practices being able to impact macroeconomic performance of countries versus just impacting the incomes of individuals is still the focus of debate and further study. The World Bank Policy Research Report “Finance for All? Policies and Pitfalls in Expanding Access,”³⁴ answers some of these issues. The initial summary of this report points out that while broader access is still a critical need, challenges lay ahead to allow both the market and direct government intervention to address this need. While market forces and the financial markets may not be sufficient to provide access to finance for the “bottom billion,” direct government intervention has often proven unsuccessful. A similar view is promoted by the CGAP in its “Key Principles of Microfinance,” which states that governments should be enablers of microfinancing but not direct providers.³⁵

Increased competition among microlenders would likely help to achieve a broader access for microborrowers, and thereby contribute to greater financial sustainability of the MFIs.³⁶ Competition pushes incoming MFIs to seek out innovative ways (financial, administrative, operational, and technological) to provide services to new clients. This competition, however,

needs to be accompanied by adequate regulatory policies in order to avoid undercapitalized expansion or predatory lending practices.

Most advocates of microfinancing agree that the poor need financial services that are “convenient, flexible, and reasonable priced” if they are to break from a life of destitution.³⁷ A recent study on the performance of microfinance organizations in Tanzania states that microlending has definitely improved the livelihood of the borrowers. It mentions, however, that “out of the 352 loan clients surveyed, 93.8 % of loan recipients said the interest rates and loan amounts were constraints to their businesses, making it difficult for them to generate sufficient profits for rapid growth.”³⁸ In Tanzania, micro and small enterprises contribute to 32% of the national GDP, so if these constraints (small loan amounts and high interest rates) were mitigated, microfinance could possibly impact the economic performance of a large sector of the Tanzanian economy.³⁹

However, the macroeconomic potential for microfinance is uneven. In South Africa, for example, where microenterprises compete against well-established larger manufacturers, these tiny informal businesses provide about 20 % of all the jobs but contribute only about 5 % of the national GDP⁴⁰. Therefore, the question still remains of what is the actual and potential macroeconomic impact that results from microfinance. A precise answer to this question provides an opportunity for further research and analysis.

CGAP in its 2nd edition of the “Good Practice Guidelines for Funders of Microfinance” states that more testing and evaluation is needed before microlending can become mainstream while maintaining high success rates. CGAP proposes the following support areas for donors: provide grants for social safety nets (e.g., insurance) and training programs, experiment with models to prepare the poorest for microfinance, develop cost effectiveness measures, and create

barriers between grant and loan programs.⁴¹

Past experiences demonstrate that subsidies to microfinance enterprises used to promote sustainability and greater outreach resulted in unsatisfactory returns: inefficient organizations, inappropriate lending practices, and substandard repayment rates. There are, however, some proponents, such as Zeller and Meyer who recommend subsidizing MFIs in order to reach large numbers of the poor.⁴² This group argues that “broader and deeper outreach to the poor may require a tradeoff in financial sustainability.”⁴³ Multilateral and bilateral development organizations tend to disagree. For example, the report “Finance for All? Policies and Pitfalls in Expanding Access” argues that the issue of subsidizing microfinancing requires a comparison of the costs and benefits of subsidies in this sector versus those in other areas such as, infrastructure and education.⁴⁴ The report states that “Within the financial sector, the case for subsidizing savings and payments services, with can be seen as basic services necessary for participation in a modern market economy, seems stronger than that for credit.”⁴⁵ Subsidizing credit has proven to have negative incentive effects on loan repayment and on the adoption of market-based and technological innovations.

As many other experts such as Dr. Yunus, Zeller and Meyer promote the use of technology to increase efficiency and profitability of microfinance enterprises the increase in profitability will ensure sustainability.⁴⁶ Perception of actual sustainability will also promote the number of clients seeking these services, and thus increase the reach and impact of microfinancing activities.

Can Technology Transform the Microfinance Industry?

The cost of delivering microlending services to populations living on between U.S. \$1 and U.S. \$2 dollars per day is high. Populations in those markets tend not to have credit histories,

and often live in remote rural areas. Originating and servicing portfolios of small loans is labor intensive, particularly in rural, remote, and spread out communities without access to internet and communications technologies (ICT). “MFIs with operating costs of 12-15% of assets are considered efficient, while the similar ratio for banks rarely exceeds 5%.”⁴⁷ “Banks will not aggressively target the poor as market until they find ways to serve these customers profitably. This will require delivery channels that are inexpensive to set up ...and the ability to handle transactions at a low cost.”⁴⁸

In developed countries, financial institutions use the internet and automatic teller machines (ATMs) to increase their efficiency and reduce their operating costs. For example while the cost of a bank transaction using a teller costs about U.S.\$ 1.05-1.45, transactions using ATMs cost about U.S.\$ 0.25. Costs of mobile phone transactions in countries like South Africa are of the order of U.S.\$ 0.03 per transaction⁴⁹. Thus the potential that mobile technology offers to help lower operational costs of MFIs in developing countries is promising.

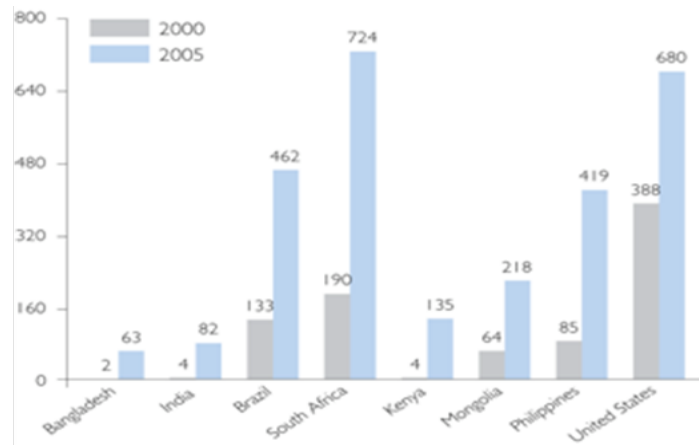
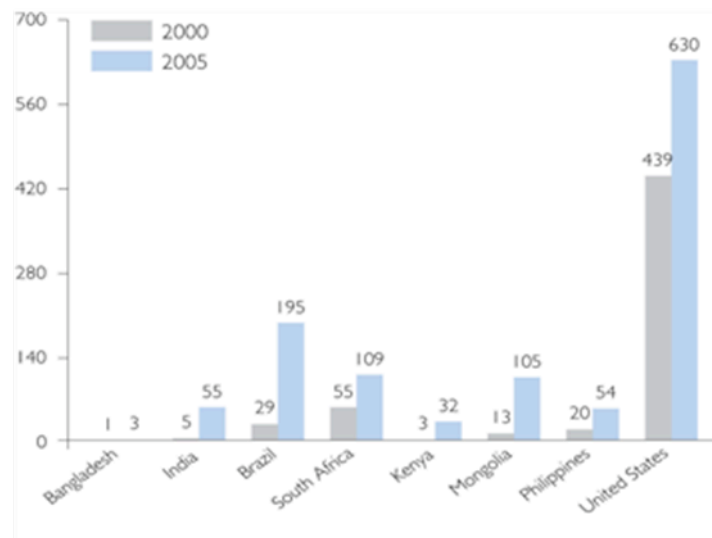
The ability, however, to successfully deploy technologies such as mobile banking to borrowing populations often lacking basic services such as reliable electricity, phone service and internet connectivity is unclear. “Most MFIs are not well suited to develop technology delivery services. They lack strong core management information systems, substantial financial and management resources, and membership in electronic payment associations required for such initiatives.”⁵⁰

Table 2. Current technology channels used by MFIs

Technology Channel	Number of Institutions
ATMs	46
Point of Sale (POS) bank card readers	35
Internet Banking	26
Mobile Phone Banking	10

“In a recent CGAP survey, 62 financial institutions in 32 countries report using technology channels to handle transactions for poor people. Nearly 75 % of the respondents (46) were banks that operate in both large markets (e.g., India, Brazil, and South Africa) and small markets (e.g., Malawi, Namibia, and Guatemala).⁵¹ Table 2 lists the number of institutions using specific technology channels for their current operations.

With the exception of internet banking, each of the above ICT options is increasingly becoming available in developing countries. In areas where poor electrical service and poor internet connectivity prevail, mobile banking is increasingly accessible. “From 1999 to 2004, the number of mobile subscribers in Africa grew from 7.5 million to 76.8 million, an average annual increase of 58 percent.”⁵² This year, the number of mobile phone users surpassed two billion. It is widely expected that bulk of the next billion users will come from developing and low income countries. The potential for intersection of mobile phone utilization and MFI penetration is impressive. As Figures 1 and 2 illustrate, mobile phone utilization is growing dramatically, particularly among populations that do not enjoy internet access.

Figure 1. Mobile phone subscribers (per 1,000 people)⁵³Figure 2. Internet users (per 1,000 people)⁵⁴

“Technology has also made advances. In cooperation with hardware manufacturers, VISA International developed a battery-powered wireless point of sale (POS) scanning device suitable for rural areas. The device costs U.S.\$ 125; most POS devices in developed countries cost about U.S.\$ 700.”⁵⁵

“POS devices typically are used to handle payments transactions. The device can be a

card reader, mobile phone, personal computer (PC) barcode scanner, or any hardware that can identify customers and receive instructions for the transfer of value. Where transaction volume is expected to be high, or where wireless Internet access is available, PCs may be used, although most POS devices are card-reading terminals.”⁵⁶

“Mobile phones and other types of POS devices may be used to deliver a wide range of financial services when paired with a human attendant, for example, at a retail or postal outlet. ...In the first model, banks or payment processing companies lease POS devices to retail outlets to generate fees from processing electronic payments only, such as when a customer purchases groceries with a debit or credit card. This is how most banks around the world...use POS devices.”⁵⁷

However, the POS model above can be expanded:

“Faulu, an MFI in Kenya, recently began a pilot project, called M- Pesa, which allows customers to receive or repay loans through a mobile phone. In partnership with Safaricom, an affiliate of Vodafone, the MFI credits loans to the borrower’s mobile M-Pesa bank account: the borrower can then exchange the credit for cash at a Safaricom dealer. Similarly, the client can repay a loan by giving cash to a dealer, who sends instructions to Faulu via a mobile phone text message, to credit the customer’s loan account. In this second model of delivering service through a POS channel, clients usually visit a branch to open an account or fill out applications available at the retail outlet. In some cases, a new account can be opened using the POS device itself. Customers of Banco Popular in Brazil can open an account simply by keying their tax identification number and postal code into the terminal.

In the third model, banks use the POS channel to effectively replace a bank branch by providing nearly all the products and services, plus loans, which a bank branch would provide. However, banks are still figuring out how to deliver credit to borrowers who may not have a credit history without the services of a loan officer.”⁵⁸

Mobile phone banking is not limited to East Africa. Mobile Telephone Networks (MTN) in South Africa and Globe Telecom in the Philippines are offering banking services. Underdeveloped countries with poor electrical and landline telecom infrastructure may be able to leapfrog the need for expensive payment systems and expensive financial service delivery mechanisms.

In addition, by lowering operation costs and streamlining reporting, the use of technology is helping reach new customers. The use of biometrics, for example, is proving to be a potential solution for customer identification where other means are unavailable (in areas where large segments of the population are illiterate and have no legal form of identification). Opportunity International, for instance, is promoting the use of biometric fingerprints combined with smart cards⁵⁹ in its African partner organizations. The combined biometrics/smart card registers digital face photos and fingerprints, and account information (account type, balance, etc) for the owner of each bank account. This technology is easy to use, lowers transaction costs, and provides an increased level of security. Mr. Dale Dawson, chair of the President's Council of Opportunity International and board member of the Opportunity Bank of Rwanda, explains that access to financial services and technology-driven identification has greatly benefited and empowered women, by allowing them to raise and save capital without the fear of having their savings raided.⁶⁰

Prodem Fondo Financiero Privado (FFP), an innovative microlender in Bolivia, is using similar biometric identification and transaction technologies. As reported by the Microfinance Gateway, Prodem FFP has deployed these types of technologies to 54 offices around the country and is reporting customer satisfaction.⁶¹ Although deployment of some of these technologies

may be sometimes challenging, their potential advantages for reducing operational cost and improving client outreach are worth further exploration and promotion.

Commercial Partnerships

As commented by Littlefield and Rosenberg, MFIs need to become fully integrated within the mainstream financial systems in order to achieve their full potential.⁶² One of the goals of the UN's declaration of the year 2005 as the International Year of Microcredit was to promote the integration of microfinancing into the formal international financial segment. The incorporation of microfinancing services into commercial banks, and the evolution of MFIs into formal banks are two of the approaches for this integration. A third approach is the creation of commercial partnerships between MFIs and formal banking organizations which would allow for a sustainable growth of the microfinancing industry.⁶³

One of the primary promoters of commercial partnership is ACCIÓN. ACCIÓN uses several approaches to promote microfinancing services and partnership with commercial banks. The main approaches are the creation of internal microfinancing units within the bank, creation of financial subsidiaries, creation of private service companies, and creation of new MFIs with bank co-investors⁶⁴. ACCIÓN's methodology consists of "linking select MFIs to commercial banks and capital markets through the guaranteeing of loans and the issuance of fixed-income instruments."⁶⁵

Alexandra O'Rourke argues that commercial partnerships would permit MFIs to benefit from the capital base, lower transaction costs, investment alternatives, and security measures of the commercial banks.⁶⁶ In addition, to ensure institutional sustainability, these partnerships would also allow MFIs to enhance their inventory of services and increase their reach to a larger population of the poor. O'Rourke describes three specific advantages to this type of partnership: greater sustainability from increased access to capital, lower transaction costs which would allow

lower interest rates for the borrowers, and better client reach and services as the result of the use of technology and efficient operations typical of commercial banks.

Questioning how commercial banks could benefit from such partnership is to be expected. To answer this question, O'Rourke maintains that this type of partnership would allow commercial banks to reach into new and unfamiliar market for formal banks and benefit from the well-established expertise of the MFIs. A second benefit to commercial banks is the hedging potential provided by MFIs. O'Rourke provides the example of microlending repayment during Indonesia's and Bolivia's financial crises to demonstrate that MFIs have proven to be less risk-sensitive than other financial institutions during economic crises. One of the main obstacles for the proliferation of this type of partnership is the apprehension that many non-governmental organizations (NGOs) have towards commercial (for-profit) institutions. This is a key barrier since most of the current MFIs are run by NGOs. A more definite barrier for the propagation of these partnerships is the high initial risk that commercial banks need to assume when partnering with MFIs. As of 2006, only 1% of MFIs were sustainable. Although a specific investment into an MFI may prove successful, commercial banks view this type of investment as quite risky. O'Rourke proposes to alleviate this unilateral risk via insurance incentives, effective partnership structures, and increased oversight of MFIs.

The tension regarding priorities and operational processes that exists between commercial banks and (mostly NGO capitalized) MFIs needs to find a balance in order to undertake successful partnerships. Multiyear sustainability will only be achieved if champions promoting this balance are found on both sides of the partnership.

A different strategy, the creation of formal MFI banks funded through donor capital, is the "greenfielding" approach preferred by Opportunity International. This organization, which

operates as a non-profit in the U.S., funds and sponsors the creation of local for-profit microfinancing banks in developing African countries.⁶⁷ Profits from the financial operations are reinvested in the local bank for increased growth and long-term sustainability. Thus far, this approach has proven to be successful in countries such as Malawi, Mozambique, and Rwanda, where financial services to the poor include savings, micro entrepreneur loans, seasonal loans, and insurance, among others. Based on this strategy, Opportunity International, working together with Microinsurance Agency has become the largest providers of microinsurance in the world, covering 3 million lives through their insurance program.^{68, 69}

Whether long term sustainability of microfinancing could be best achieved via the creation of for-profit MFI banks or by commercial partnership with formal banks remains to be seen. The powerful message of the former approach (creation of local for-profit banks), is that long-term self-reliance of local markets rather than continuous dependence on foreign donor capital or institutions. If this can be accomplished using transparent and uncorrupt local practices, microfinancing could not only help economic development but also institutional development in some of the poorest countries.

Conclusion

As a result of successful examples such as, the Grameen Bank, ACCIÓN International, Opportunity International, and FINCA, microlending and microfinancing have taken front stage in the global fight against poverty. Successful MFIs have demonstrated that microloans are an effective tool to help the poor achieve improved financial status. While some successful MFIs have reached self-sufficiency and growth, current statistics demonstrate that only about 1% of all MFIs are sustainable. In order for microlending to reach the vast populations of poor individuals that need these services, existing MFIs need to achieve sustainability and growth. The new MFIs

that enter the market need to build on sustainable business models developed by successful MFIs.

Most experts conclude that sustainability of traditional MFIs can only be achieved by a combination of institutional, administrative, and technological improvements. The promotion of commercial partnerships with formal banking systems and the creation of for-profit local banks should be encouraged. Some experts question the effectiveness of government and donor subsidies in the microfinance sector, but as long as donor and government based incentives are needed in this sector, they should be continued.

The promotion and increased use of new technologies are currently producing solutions that make microfinancing more efficient and accessible. Increased efficiency gains through technology can help make MFIs more sustainable, while increased accessibility will help them expand their scope and reach.

Although microlending and other microfinancing services may not be the answer to all the poverty-related issues, there is sufficient evidence to suggest that with improved operations that lead to greater scope and scale, microfinancing could help alleviate some of the most basic needs of the world's poor.

Acknowledgements

The authors want to specially thank Mr. Dale Dawson of Opportunity International and Bridge2Rwanda, and Nhu-An Tran of the U.S. Agency for International Development, and the Washington and Manila staff of Chemonics, International for their generous assistance while gathering information for this paper.

¹ Microfinance refers to the delivery of financial services, including credit, savings, insurance, and fund transfers, to low-income customers. The widely used term microlending refers only to credit services.

² The State of Microfinance – Outreach, Profitability, and Poverty; Adrian Gonzalez (MIX/CGAP), Richard Rosenberg (CGAP), presentation delivered at Access to Finance: Building Inclusive Financial Systems, World Bank Headquarters, Washington, DC, May 30-31, 2006.

³ The Question of Sustainability for Microfinance Institutions; J. Jordan Pollinger, John Outhwaite, Hector Cordero-Guzman. Journal of Small Business Management. Milwaukee: Jan2007. Vol. 45, Iss.1: 19 pgs.

⁴ In this paper “sustainability” refers to financial and operational self-sufficiency of the MFI.

⁵ A possible exception is Bangladesh.

⁶ Smith, P. and Thurman, E.; “A Billion Bootstraps: Microcredit, Barefoot Banking, and the Business Solution for Ending Poverty;” McGraw Hill Companies; New York; 2007

⁷ “The History of Microfinance” <http://www.globalenvision.org/library/4/1051/> (October 4, 2007)

⁸ Ibid.

⁹ “About Microfinance: Overview” www.cgap.org (October, 2007)

¹⁰ “Microfinance: An effective poverty reduction strategy” www.grameenfoundation.org (October 3, 2007)

¹¹ “The History of Microfinance” <http://www.globalenvision.org/library/4/1051/> (October 4, 2007)

¹² CGAP: Phase III Strategy http://www.cgap.org/docs/CGAP_III_Strategy.pdf

¹³ Next Generation Access to Finance – Setting the State; Peer Stein, IFC, Conference, September 17, 2007, Washington, D.C.

¹⁴ Microfinance: a) Operating costs as a % of loan portfolio information obtained from 2006 MIX Market data for 798 MFIs in 96 countries around the world. B) Estimates vary depending on local conditions. Source: Hawser, Anita. Sector Report: Big Banks Eye Micro Market, Global Finance, Volume 21: Issue 6, June 2007. C) Loan losses data obtained from MIX Market. Average write-off ratio based on 2006 information from 798 MFDs in 96 countries around the world. More information available at www.mixmarket.org.

¹⁴ Credit Cards: a) Operating costs: % of operating costs of card portfolio to total loan portfolio one of the largest credit card lenders in the U.S.. Source: MBNA 10-K, 2006. B) Funding costs: Based on World Bank, JP Morgan Structured Finance estimates and Bloomberg Markets. Funding costs estimated at 3 month LIBOR + 30-45 bps, where 3 month LIBOR = 5.65. c) Loan Losses: Average charge-offs over three quarters, for six major credit card issuers in the U.S.

¹⁶ Housing Finance: a) Operating costs – Estimate is net cost to originate loans, which is defined as total operating expense, less mortgage loan servicing related costs, plus yield spread premiums, less points and fees collected, all prior to any deferrals of origination costs. Accredited Home Lenders 2006 10K, pp 66-67. B) Funding costs: Based on World Bank, JP Morgan Structured Finance estimates and Bloomberg markets. Funding costs estimated at 3 month LIBOR + 82 – 123 bps, where 3 month LIBOR = 5.65. c) Loan Losses – Based on 4th quarter 2006 results for the U.S. residential mortgage market as collected from the Mortgage Bankers Association’s National Delinquency Survey. Available at: <http://www.mortgagebankers.org/Newsandmedia/PressCenter/50974.htm>.

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⁵⁵ Ibid., Ivatury, Focus Note number 32, page 3.

⁵⁶ Ibid., Ivatury, Focus Note number 32, page 3.

⁵⁷ Ibid., Ivatury, Focus Note number 32, page 4.

⁵⁸ Ibid., Ivatury, Focus Note number 32, page 5.

⁵⁹ The term smart card refers to an electronic banking card that maintains a record of digital photos, fingerprints, and account information of the owner.

⁶⁰ Information based on conversation of coauthor Monica Starnes with Dale Dawson (October 26, 2007)

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