Microfinance: Getting Money To the Poor or Making Money Out Of the Poor?

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Les économistes affirment que, pour briser le cercle vicieux de la pauvreté, il faut une force extérieure qui injecte de l'argent, afin de libérer la force de travail de l'économie familiale.

Microfinance institutions are currently experiencing very high repayment rates of between 95-99%. Coupled with growing loan sizes by clients, these institutions are even making profits. No wonder there seems to be a good reason for the world to celebrate the microfinance revolution. It is not necessarily wrong to reduce poverty and make some money on the side. The question however arises as to whether that is indeed what is happening with microfinance.

What is microfinance and what does it promise

R. P. Christen (1997) defines microfinance as the means of providing a variety of financial services to the poor, based on market-driven and commercial approaches. These services may include savings, insurance, money transfers and credit. However the microfinance movement to date has generally favoured microcredit, which is the provision of small loans to households who are perceived to be too poor to qualify for loans from formal financial institutions. This essay mainly discusses microfinance to these very poor clients who cannot even borrow as individuals, but must borrow through a joint liability group.

Poor households are caught up in a vicious cycle of poverty, where labour, their best resource, is 'locked up' due to different constraints including a lack of liquidity. The household's productivity as such is limited to a level whereby the available household income is insufficient to sustain good standards of living. For example a poor household may have family members who are willing to work in the family garden to grow sufficient food crops. However if they cannot afford improved crop varieties and farm inputs then it will not be possible for the family to grow enough food. The household's labour is therefore said to be locked up due to a liquidity constraint among other constrains.

Many governments and donor communities believe that the liquidity constraint is the most important constraint impeding poor households and that if it is addressed it will be possible for households to escape poverty. Economists argue that to break the vicious cycle of poverty, there needs to be an outside force that will break the vicious chain by injecting some liquidity, thereby

unlocking the household labour. Microfinance promises not only to break the vicious chain of poverty but also to initiate a whole new cycle of virtuous spirals of self-enforcing economic empowerment that leads to increased household well-being.

La microfinance promet non seulement de casser le cercle vicieux de la pauvreté, mais aussi d'initialiser un nouveau cercle vertueux s'appuyant sur un potentiel économique générateur de bien-être.

Misleading assumptions

Such is the model that has promoted the microfinance institution and given it the 'polite and respectable' image it currently enjoys. With all due respect, it is worth raising some questions regarding the underlying assumptions of such a popular model.

In the first place, proponents of the model assume that many poor people can become micro-entrepreneurs. Entrepreneurship skills and managerial capability are assumed as given, thus the ability for microfinance to create employment even if self-employment. Secondly, even if the first assumption were correct, the model continues to assume that there is going to be a vibrant market for goods and services and that it will be possible for all micro-entrepreneurs to gain access to markets for their products; otherwise how else can incomes be improved from entrepreneurship if there were no markets? Thirdly, the supporters of this model also assume that as long as the poor can repay at market rates, or slightly above market rates, it is a good indication that they are doing well financially. Ironically, one of the major reasons why it was felt so justified to bring more 'formal' financial services to the poor was because it was assumed that the local money lenders were exploiting the poor by charging extortionate interest rates. Yet the poor were paying even then!

L'important est de comprendre la microfinance comme un outil pratique de redistribution des ressources et, de même qu'avec n'importe quelle politique similaire, il est important d'avoir à l'esprit les présupposés sous-jacents, parce que si ceux-ci ne sont pas fondés, les objectifs poursuivis peuvent s'avérer irréalistes.

The point is that microfinance should be understood as a resource reallocation policy tool and, just like any other such policy, it is important to keep close watch of the underlying assumptions, for if they are not valid, the policy objectives may not be realized.

The main objective of this essay is not to challenge, prove or disprove anything, but rather to bring to light the realities of what the poor people have to cope with in order to repay their loans promptly. The goal is to bring the social and financial costs associated with microfinance instalments to the awareness of the policy maker.

Keeping loan repayments high

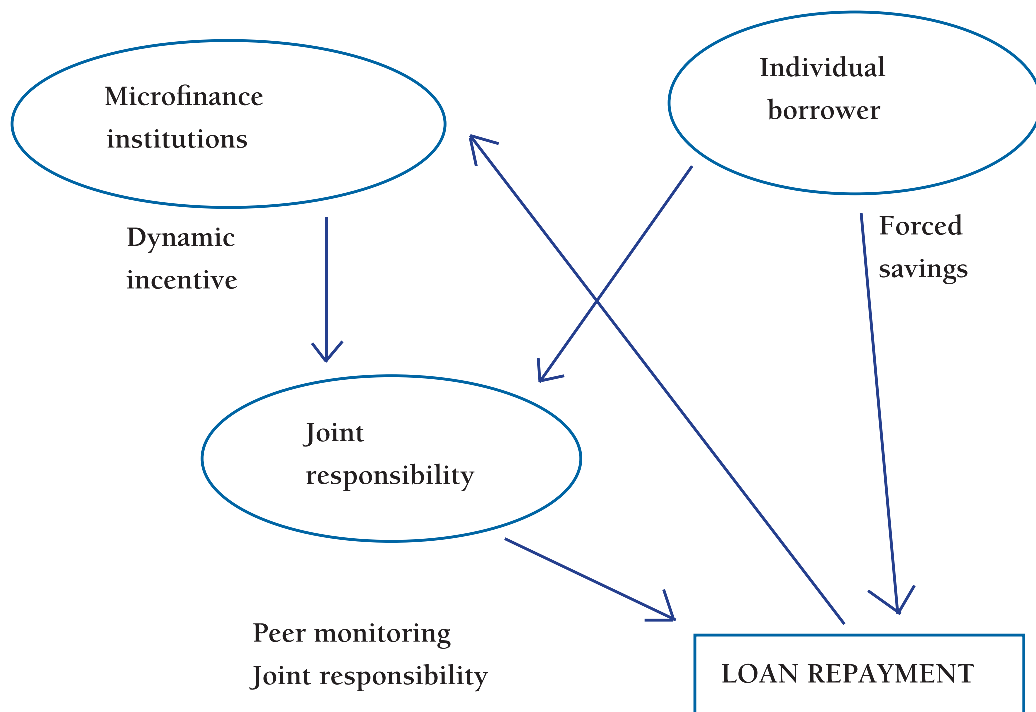
Over 120 million people currently benefit from the services of over 10.000 microfinance institutions paying interest rates of between 15 and 35%. In November 2006 the official Microfinance Information Exchange, Inc. released some thought-provoking statistics from the leading microfinance institutions. The most profitable microfinance institution in 2006 was in Africa, with an average of 30.90% return on assets, followed by another in Asia with an average of 30.2% return on assets. On average the top 100 most profitable microfi-

Ici, l'objectif principal n'est pas de poser des problèmes, de prouver ou désapprouver quoi que ce soit, mais plutôt de mettre en évidence les pressions auxquelles doivent faire face les pauvres pour rembourser leurs emprunts rapidement.

nance institutions worldwide have an average of 10.44% return on assets. The second largest microfinance institution after Grameen (in terms of client outreach) is ASA, with over 4 million clients. ASA has a 14.53% return on assets and it is among the top 15 global microfinance institutions in terms of profitability.

The top 5 Microfinance institutions in terms of outreach are all in Asia where high population density is the norm, coupled with a high level of poverty and lack of alternative finance. These unfortunate social characteristics are the ones that make Asia a prime market for microfinance. D. Roodman and U. Qureshi (2006) argue that the real genius in microfinance is not because they firmly believe that the poor can pay, but rather it is because they have been able to come up with clever solutions to the problems of building volume, keeping loan repayment rates high, retaining customers, and minimizing scope for fraud, and being able to deliver cost-effective microfinance to thousands and millions of poor clients.

Figure 1: Loan repayment by the poor



Les institutions de microfinance ont innové en reportant deux obligations bancaires traditionnelles sur les emprunteurs. Premièrement, c'est les pauvres qui décident de la solvabilité des emprunteurs, entre pairs. Deuxièmement, c'est encore les pauvres qui se chargent du recouvrement de la dette d'autres membres du groupe, dans le cadre de contrats novateurs qu'il serait trop coûteux de dénoncer.

L'histoire la plus connue en microfinance est celle de M. Yunus, le fondateur de la Grameen Bank qui a inspiré de nombreuses institutions de microfinance à travers le monde.

Microfinance institutions have innovatively shifted two classic banking obligations to the borrowers. Firstly, it is the poor who decide the credit worthiness of borrowers through peer selection into the borrowing groups. Secondly, it is still the poor who impose debt collection from peers while being governed by innovative contracts that are too costly to breach.

Four principles for repayment

The popular explanation of how the poor repay their loans is based on four principles. The first is the principle of dynamic incentive to loan repayment. This means that the lending institution will offer the prospect of a larger loan once an individual borrower has been able to repay the current loan.

This alone is supposed to be an incentive to the clients to finish repaying their current loan and qualify for a larger one. Proponents of joint responsibility borrowing argue that dynamic incentives make microfinance for the poor operate in a similar fashion to the credit card in developed countries, whereby clients repay because they want to access more credit in the future. Other writers have argued that the same dynamic incentive is a great incentive for providing bridging loans to poorer households in order to clear their earlier debts. Poor microfinance clients are therefore likely to get locked up in a vicious debt cycle, contracting more debts to repay microfinance debts in order to get more funds and hopefully offset the debts so far incurred. The clients keep borrowing to repay, until the ultimate face to face with excess debt. Excess debt can deplete household capital assets and other basic livelihood assets, thereby leaving the household exposed and vulnerable.

The second is the principle of joint responsibility borrowing. This means that a group of borrowers rather than the individual is responsible for repaying microfinance loans. If the individual borrower defaults, the whole group is held responsible. The third is the principle of peer monitoring and peer pressure. The individuals within a group monitor and bring pressure to bear on each other to ensure that all loans are repaid on time. In case the individual is not able to repay due to having made wrong investment decisions or for some other reason, then all the members of the group have a moral obligation to help in the repayment. Finally, joint liability borrowing is purported to thrive due to the principle of forced savings. Individual borrowers are forced to save a fixed regulated amount of money every month.

Neither the group nor the individual can access the forced savings at will, but they can be used as security for future loans and can only be paid back if the individual borrower is dropping out of the project and has been cleared by all members of the group. The forced saving is not only a partial security for loans bor-

rowed by an individual, but can also be seized by the microfinance institution if any other member(s) of the group defaults on their loan repayment.

La Grameen Bank a aujourd'hui à son actif un Prix Nobel, 1'700 succursales, 16'000 employés et 6 millions de clients dont 96% sont des femmes.

A success story…

The best-known story in microfinance is that of Muhammad Yunus, the founder of the Grameen Bank who has inspired many other microfinance institutions worldwide. The Grameen Bank started in the aftermath of the country's war of independence. At this time Bangladesh was plagued by desperate poverty aggravated by very high birth rates. The economy was still very rural, coupled with a government that was perceived to be weak and corrupt. In order to deal with the poverty situation, there was a strong preference for non-bureaucratic 'grass roots' and other collective approaches. This prompted the formation of self help groups for equally disadvantaged groups in order to pool resources for the mutual benefit of the group members. It was in this environment that Muhammad Yunus, an Economics professor at the University of Chittagong, began an experimental research project, providing credit to the rural poor of Bangladesh. He began by lending people a little money out of his own pocket and soon realised that it was enough for villagers to run simple business activities like rice husking and bamboo weaving. He later found that borrowers were not only benefiting greatly by accessing the loans but they were also repaying reliably even though they could offer no collateral. Later, with the support of the Central Bank of Bangladesh and donor support, that humble experiment developed into the world's most famous microfinance institution, the Grameen Bank, and institutions that replicate its pioneering methodology worldwide. The Grameen Bank today boasts a Nobel Prize, 1.700 branches, 16, 000 employees, and 6 million customers of which 96% are women.

Cependant, l'histoire de la microfinance ne se passe pas toujours aussi bien.

… not always that good

However, the microfinance story does not always have such a good track record. A study carried out by the International Food Policy Research Institute (IFRI) that focused on the Malawi Rural Finance Corporation came up with rather 'unconventional' results (Diagne, 2000). The results were in sharp contrast to conventional wisdom and assumptions regarding the informal advantage of the joint liability and its implications of incentives for peer selection, peer monitoring and peer pressure with respect to loan repayment. The findings did not support the widely held assumption that joint liability is responsible for the high repayment rates of the successful group lending programs. In particular the study found that no effective peer monitoring was taking place in the credit groups because of the associated social costs.

M. Schrieder (2003) constate qu'une coresponsabilité des emprunteurs peut mener à un effet domino, dans lequel des emprunteurs qui auraient pu payer décident de ne pas le faire, sachant qu'ils n'auraient de toute façon pas accès à de futurs emprunts à cause de l'insolvabilité d'autres débiteurs.

Another important finding of the same study is that peer pressure took place less frequently than im-

Contrairement à l'Asie où la honte, l'honneur et la réputation sont des motivations importantes pour que les clients pauvres dans un groupe remboursent leurs emprunts, cela importe peu au Kenya, alors qu'il est possible pour un client d'emprunter de l'argent et de partir pour un autre village ou une autre ville, sans être trop stigmatisé socialement.

Confrontés à l'insuffisance de la confiance dans les recherches de solutions, les groupes d'emprunteurs solidairement responsables ont imaginé des mesures drastiques pour traiter ceux de leurs membres qui ne coopèrent pas.

plied by the joint liability, and when it did in most cases it failed to induce defaulters to repay their loans. M. Schrieder (2003) argues that joint liability borrowing may lead to domino effects, in which borrowers who would have repaid, choose to default because they would lose access to future loans in any case, due to the default of others. In reality joint liability may not cut the cost of lending but rather shift it from lenders to borrowers.

A study by J. Kiiru and J. Mburu (2007) found that joint responsibility borrowing in Kenya today does not necessarily mean zero collateral loans. Peers no longer agree to guarantee each other's loans based on sociological ties and trust alone; rather they demand a tangible guarantee that the loans shall be repaid. Unlike in Asia where shame, honour and reputation are important incentives to loan repayments by poor clients in the groups, those are of no great importance in Kenia, while it is possible for a client to get a loan and move to another village or city, without being much concerned about such social stigmas.

On the contrary D. Roodman and U. Qureshi (2006) write: 'even MFIs (in Asia) that do not employ either joint liability or regular group meetings for transaction purposes tap into this sensitivity to reputation for delinquency control: XacBank in Mongolia posts names of clients and their instalment repayment reports on the walls of its branches. Peer pressure, [...] is pressure arising from public transactions in communities where individuals worry about reputations. And the discovery is not really new to micro credit; money lenders too have used public honor to motivate repayments. When interviewed, a woman street vendor who was a client of a group of moneylenders called "the Bombays" in the Philippines noted that the Bombays always picked the busiest hour of the day to collect so that there would always be witnesses to her embarrassment'.

Trust is not enough

Faced with the fact that trust does not provide systematic solutions, joint liability borrowing groups have invented drastic measures to deal with un-cooperating peers. In the study by J. Kiiru and J. Mburu (2007), the joint liability groups studied had included two preconditions for prospective new members that had to be met before being admitted as members of the group.

The first precondition is that a prospective member will have to formally sign a contract with her peers, guaranteeing her future loans with collaterals; the assets used for this kind of transaction are basic livelihood assets such as livestock, household furniture and cutlery; also accepted are capital assets such as sewing machines, and electronic equipment and the suchlike.

Secondly, the prospective member must also provide an acceptable guarantor for her loans. The guaran-

Les institutions de prêt de microfinance infligent des pénalités financières aux groupes qui ont du retard sur le remboursement d'un acompte. Ces pénalités retombent de manière égale sur tous les membres du groupe. Cela donne une motivation aux membres du groupe d'exclure les ménages ou les collègues très pauvres qui présentent de mauvaises perspectives de remboursement, de manière à minimiser les conséquences en cas de non-remboursement.

tor's acceptability is based on his or her ability to repay. This person is obliged to sign documents accepting responsibility for defaulted loans by the borrower.

The same study revealed the existence amongst all solidarity groups of a rigorous administrative structure to ensure that every loan is repaid on time. For example, in order to minimize the risk of non-repayment by some poorer borrowers, solidarity groups advise their weaker members to start submitting their loan instalments to the group's treasurer on a weekly basis. There is need for research to help understand the extent to which forced savings and weekly loan repayments lead to undercapitalization of small enterprises and to what extent this undercapitalization compromises returns and therefore incomes.

Microfinance lending institutions impose financial penalties on groups that delay the remittance of a loan instalment. These penalties are borne equally by all group members. This gives an incentive for group members to exclude very poor households or colleagues who have a bad debt repayment record, in order to minimize the risk of penalties in case of default. The financial penalties also have the effect of making peers extremely aggressive when dealing with a colleague who is not in a position to meet her immediate financial obligations. In many cases such instances lead to strained relations in social networks. Again there is a need to understand the extent to which strained social relations lead to a depletion of the social capital in poor communities.

Group meetings are held on a weekly basis, and are usually attended by a loan officer to ensure that all due instalments are collected. In some cases the loan officer will not agree to end a meeting until all the instalments have been repaid. It frequently means the groups' officials (chairperson, treasurer and secretary) are obliged to use the groups' pooled fund.

From harassment to loss of property

These funds are raised through group registration fees, and regular contributions to a pool. Usually this money is not banked, but held by the treasurer of the group. In the event of there not being enough money in the pool, the officials may resort to borrowing from friends; and if this is still not adequate, they may even choose to borrow from the local money lenders to avoid the consequences imposed by the microfinance institution, and to keep their records clean with the institution. Once the group has 'cleaned' its records with the microfinance institution, they may take possession of the assets of the defaulted borrower until every cent of the debt has been repaid.

Currently the only way to avoid repaying a loan and get away with it (at the risk of the forced savings only) is if all members of the group decide to do the same. However mi-

Selon l'étude de J. Kiiru et J. Mburu (2006), au moins 60% des clients de microfinance ont connu certaines formes de harcèlement par des membres de leur groupe, mis sous pression pour leur faire rembourser des emprunts qu'ils n'auraient pas pu assumer en regard de leur situation financière réelle.

Les animaux domestiques, les meubles, les objets électroniques et parfois les vêtements ont été parmi les principaux objets vendus ou confisqués aux pauvres pour rembourser des emprunts.

crofinance institutions already have taken measures to minimize these kinds of eventualities. They do not grant loans simultaneously to every member of the group, but rather do so on a rota basis. In this way, at any given time, there are those members who have already begun repaying and have almost finished their repayments. This group will rationally exert pressure on the others to repay. In this case it is almost impossible for the entire group to default, and leads to the likelihood of all loans being repaid. D. Roodman and U. Qureshi (2006) observe that through an interaction of human ingenuity and evolutionary dynamics, microfinance leaders have found a set of techniques in their product design and management, that solve the fundamental problems of microfinance of cost control, building volume, keeping repayment high, and preventing internal fraud, while operating in a poor country.

In the study by J. Kiiru and J. Mburu (2007) revealed that at least 60% of microfinance clients had experienced some form of harassment by fellow group members in an attempt to convince them to repay loans on which they would otherwise have defaulted, given their current financial capability. 4% had had some of their property confiscated by group members to settle loans on their behalf, while another 17% had actually sold some of their preexisting assets in order to meet their repayment obligations, and a further 2% had to borrow from friends and relatives to meet their repayment obligations. Domestic animals, furniture, and electronic goods and sometimes clothing were some of the major assets sold or confiscated from the poor to repay the loans.

There is a greater than ever need to set up a regulatory framework for microfinance that would protect existing property of the borrowers. As expected, such a regulatory policy is likely to change the operations of microfinance institutions in an attempt to reduce the risk to their clients. However this should not be viewed negatively, as microfinance is a policy tool for resource reallocation. And like any other such policy, subsequent adjustments are inevitable, to ensure that the policy intervention tool continues to be relevant to the objectives for which it was devised.

A call for regulatory policy

Just as personal bankruptcy should not be a reason for banning access to credit cards or mortgages in richer countries, it is also not rational to denigrate the whole idea of loaning to the poor. It is nevertheless important to realize that in the quest to alleviate poverty, it is possible to capitalize on the benefits of microfinance, while minimizing vulnerability to crisis, by improving debt management capacities of the poor and by setting up clear regulations in the microfinance sector. There is therefore a need to create policies that increase the demand for goods and

services in rural areas; otherwise the benefits of entrepreneurship to peoples' livelihood cannot be achieved.

It is not necessarily wrong for the poor to borrow to meet basic food needs. However savings rather than microfinance would offer a better alternative. This is because it is unsustainable to depend on excess debt for consumption purposes. This calls for innovative yet cheaper technologies to meet the very basic needs of food, health and education. All this should be neatly wrapped together with responsible governance, in terms of resource mobilization and reallocation. This should be developed to ensure that households would need credit for reasons other than for meeting basic consumption needs, but rather to use for income-generating activities that bring about real increases in income. This would provide an efficient way of lending money to the poor, since only those who can make best use of it in terms of entrepreneurship will require access to credit.

Il est donc nécessaire de mettre en place des politiques pour augmenter la demande de biens et de services dans les campagnes ; autrement, la qualité de la vie ne pourra pas être améliorée par l'entrepreneuriat.

Finally there is currently a receptive attitude within the national and international community to microfinance instruments and, by and large the microfinance institutions still have a 'polite and respectable image' among many donors and governments. It is also true that there is no major apparent crisis or emergency in the microfinance institutions. But there are signs of cracks in the overall impact that microfinance has had among poor borrowers. These borrowers continue to operate under such tight debt schedules that it is a real struggle for them to build business volume and therefore growth for the enterprises, let alone escape poverty. This calls for regulatory policy, and it is important to note that policies implemented in tranquil times can help prevent major problems in the future. •

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