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Microfinance : Making Profit for the Poor?[1]

Marc Labie[2]

Abstract : Over the last 25 years, microfinance has been developing tremendously. A major part of this development has been done through some commercialization approach. However, even today, the supply of microfinance services is much too small to face most of the potential demand. So, today, as part of the millennium goals process established in order to fight poverty worldwide, there tends to be a big push in favour of stimulating further commercial microfinance in order to reach some massification of the services provided. This paper will try to see to what extend this choice is legitimate. It will first try to clarify what really covers this idea of "commercialization of microfinance". Second, it will identify what are the strengths and weaknesses of this approach. Third, it will try to suggest some policies implications.

Introduction

Microfinance is a field which has received tremendous attention recently. The major reason for this is probably that when working well, microfinance institutions are able to produce some improvements for its beneficiaries while at the same time allowing for the development of sustainable institutions. Unfortunately, what can be obtained from microfinance is often exaggerated. Many international organizations, NGOs, governments, officials of all types tend to present microfinance to the general public as a major means to reduce (extreme) poverty. When looking at impact studies this seems obviously overstated. Microfinance is indeed doing something against poverty but not in the way people often think.

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[2] Marc.Labie@umh.ac.be, Centre de Recherche Warocqué, Université de Mons-Hainaut

Having neither access to social security services nor to regular employed jobs, many people in developing countries are forced into microentrepreneurs activities. In order to do so, they have to find access to financial services. Usually, regular commercial banks won't provide it and therefore, the major source of financial services will be informal moneylenders which, for many good and bad reasons, are usually very expensive. What microfinance institutions are doing is to provide to these people comparable financial services (and sometimes better ones) at a cheaper price, reducing the financial costs supported by these people to develop their business. As such, this is already an improvement and it certainly has a good impact on people's life. However, there is no clear proof that the changes generated are really having a global impact on poverty as often advertised.

On the other hand, some people are really starting to oppose microfinance (and more than anything else its commercial version) saying that not only it does not make any major change but it increases people's debts.

This position may also be considered exaggerated. Indeed, we can hardly deny that if tens of millions of people have – freely – started credit and/or savings relationships with microfinance institutions, it may be because it does respond to some of their needs. Besides, as most microfinance institutions only finance existing businesses (and it is in fact one of their limitations – but that's another story), what is really occurring is changing an informal source of financial services by a more formal one.

What are we talking about when talking of "commercialization of microfinance" ?

There has been a lot of literature over the last few years on "commercialization of microfinance". Three aspects are usually stressed.

First, the legal statutes. In many part of the world, microfinance was developed either by pure non-profit organizations (mainly NGOs) or by cooperatives. It was seen as a tool for empowering people and for improving their conditions of life. Some of these programs failed, some succeeded. Those which succeeded rapidly faced huge demand for their services. At the beginning, this was perceived as good news. After a while however, it appears that the traditional financing structures of those institutions (subsidies for NGOs, membership fees for Coop) were not able to keep up with what was needed. This is how commercialization came out through two mechanisms now known as "down-scaling" and "up-scaling". Down-scaling is the fact that some commercial banks realized that there was obviously an unserved and profitable market with microfinance services. Some of them therefore decided to try to enter this market either by creating specialized entities or through the integration of "microfinance windows" in their regular branches. Upscaling is the process by which an NGO is transforming into a regulated institution in order to have the right to collect savings from the public. All together these two mechanisms have changed the typical profile of the average MFI which is now much more profit oriented than NGO used to be.

Second, competition. Some people think that what went wrong with microfinance is that by creating so many institutions, competition emerge, forcing organizations into fighting against each other for potential clients and looking to much for profit. Well, to some extend, this is true but it is far for obvious that the overall impact of this was negative for the microfinance clients. Indeed, in some cases, it turned out that thanks to competition, MFIs have had to improve their management and procedures in order to be more cost effective. Efficiency has thus allowed for a decrease in the interest rates charged to the clients (some countries like Bolivia or more recently Peru offer good examples of that). Now to be totally honest, it should also be said that in many other examples we could question this process. What is sometimes happening is that even though there are various institutions, there is really a market segmentation and each institution benefits from a local monopoly (or oligopoly). So, in this case, it could be argue that the problem is the lack of clear and transparent competition (with an adequate regulation framework to make sure that we are talking of a fair competition) rather that too much of it.

Last but not least, cost coverage and profit making strategies. When people talk about organizations which are having a commercial approach, what they often really mean is that we are talking of organizations which are charging interest rates to their clients allowing them not only to cover all their costs but also to generate some margin/profit. In those cases, interest rates tend to be fairly high because four things needs to be covered : the cost of funds, the administrative costs, the provisions for arrears and write-offs as well as a margin high enough to allow self-supported growth (necessary to face the increasing demand of the clients if the program is successful).

When debating those three issues, some people will rather focus on the first one (the statutes) saying that when changing from one category to another, the mission of the institution will have to be adapted (implying less social concern) and management and governance practices will evolve in a business way which will lead the organization further away for its original roots than what would otherwise have happened. As for the competition issue, it comes down to the usual debates about knowing if or when a market mechanism is best suited to organize economic exchanges. In the case of microfinance, like in many others, we have experiences showing that when the market is working properly, it can bring improvement to the industry forcing each institution to be as efficient as possible. However, we also have examples when markets have been imperfect and competition unfair leading to damages to MFIs and their clients (f.i. the Bolivian crisis at the beginning of the 2000s).

That leaves us with the last item : cost coverage and profit-making. We believed that this is the key issue which can justify commercial approach for microfinance. There is a huge unsatisfied demand in many countries. Some estimates say that even today market penetration for microfinance is not higher than 3 to 5% on average (Ramirez, 2005)[3]. Others are more optimistic. But all agree to say that there is still a hugged untapped demand which needs to be served and is not. Facing such a challenge, the only way microfinance organizations could answer those needs in the long run is by becoming sustainable, which implies the coverage of all

[3] Alvaro Ramirez, IDB, presentation during the 2005 Forum on Microenterprise, Santa Cruz, Bolivia.

their costs and the generation of enough margin to allow some growth to happen, entering therefore what is called "commercialization".

Now, the conclusion does not have to be that all microfinance institutions should have to adopt a commercial approach but rather that the existing demand will only be satisfied if enough of them do so. Which leads us to another question, even more interesting : when should a commercial approach be favoured and when could it be put aside ? The next section of this paper will try to answer to it.

Strengths and weaknesses of commercialization in microfinance

When they adopt commercial practices (covering costs, adapting legal statutes when necessary, facing competition when existing), microfinance institutions can benefit from three major advantages : a better access to sources of funds, being from commercial banks or from capital markets, the possibility to mobilize savings and an improvement in the quality and the price of their services.

As we can easily notice, the first one is due to costs covering, the second one (mainly) to legal statutes changes and the third one to competition (at least when it is fair and well regulated).

As for the weaknesses (not to say shortcomings) of commercial finance, it can be sum up in four points : it increases the exclusion of some beneficiaries (often the poorest ones), it tends to standardized procedures and management around a set of pre-established best practices, it can generates excessive interest rates when the MFI has a local monopoly and last but not least, it may induce a change in the mission which may conflict with the organization original culture.

If we put those characteristics into perspectives, we can suggest the following way to differentiate between when commercialization should be applied and when it should not.

Commercialization should be favoured when MFIs want to provide what could be considered a "classical standard offer of services" – meaning : existing businesses, "stable environment", beneficiaries around poverty threshold (but not the poorest), provision of working capital and/or small capital investment, short or medium term, traditional microfinance methodologies (as for guarantees, scaling up of the loans, regular repayments and direct follow-up by the credit agent) and in areas with a high enough density of population.

The reason why commercialization should be favoured in those conditions is that they represent the standard case of microfinance practice and it has been proved all over the world that in these conditions, it is perfectly feasible to provide microfinance services on a commercial base. There is therefore no reason why subsidies should be used to support non-profit in those cases.

On the other hand, when MFIs want to work with the poorest people, with new methodologies (or new products), in a longer run, in areas with a low density of

population, with start-ups or for agricultural loans (not to be confused with microcredit loans in rural areas), there is very good ground to support subsidized nonprofits to take over as no commercial oriented MFI would so far be able to deal with those features.

Policies implications

Based on what we have tried to show in the previous sections, we think that the first major conclusion should be that underestimating what commercial approach can bring to microfinance would be a major mistake as it might be the best chance to eventually face actual demand. At the same time, overestimating it by advocating that all microfinance organizations should evolve towards commercial schemes would also be a mistake because there are many things that we are still unable to do in microfinance; making commercial approach the only standard would therefore means giving up on issues as important as agricultural loans, long term home improvement and most of all really inclusive financial systems.

Next to this general conclusion, we could also stress that as microfinance markets are often far from perfect, it would make a lot of sense to invest into improving the regulation and supervision of the industry. This could include: analyzing the existing regulation and their impact on MFIs, training superintendencies staff, adopting specific regulation (when needed), supporting rating agencies, establishing credit bureaus, among others.

Concluding remark

Microfinance is still a young field and as such it is far from perfect; it still needs innovations and improvements. It is no time for a single, unique, supposed to be best model. But at the same time, the final objective should not be forgotten: providing cheaper and more efficient financial services to all the people who really need them. So, we must look for solutions that can be applied at very large scale. In this sense, commercial approach to microfinance can be part of the solution.

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