

Challenges to Microfinance Commercialization

by Anita Campion

Abstract: This paper was presented to audiences in Vietnam, Indonesia, Singapore and the Philippines through a World Bank multimedia distance education program in October 2001. The presentation addressed some of the core obstacles to microfinance commercialization, defined here as the application of market-based principles to providing financial services to the poor. The paper discusses some of the challenges to microfinance commercialization, such as inappropriate donor subsidies, poor regulation and supervision, and limited management capacity of microfinance institutions. Given the initial target audience of primarily World Bank employees, the paper concludes with a discussion on what donor can do to move microfinance commercialization forward in a positive direction.

Introduction

As Marguerite Robinson describes in *The Microfinance Revolution*, the 1980s demonstrated that “microfinance could provide large-scale outreach profitably,” and in the 1990s, “microfinance began to develop as an industry” (2001, p. 54). In the 2000s, the microfinance industry’s objective is to satisfy the unmet demand on a much larger scale, and to play a role in reducing poverty. While much progress has been made in developing a viable, commercial microfinance sector in the last few decades, several issues remain that need to be addressed before the industry will be able to satisfy massive worldwide demand. The obstacles or challenges to building a sound commercial microfinance industry include:

- Inappropriate donor subsidies
- Poor regulation and supervision of deposit-taking MFIs
- Few MFIs that mobilize savings
- Limited management capacity in MFIs
- Institutional inefficiencies
- Need for more dissemination and adoption of rural, agricultural microfinance methodologies

This paper addresses some of the challenges to microfinance commercialization and concludes with a discussion of the types of donor support needed to ensure that the industry meets these challenges in the years to come. Chemonics is currently working on a project with the Asian Development Bank to document the commercialization of microfinance in four Asian countries. The findings of that study, which will be available in 2002, will offer additional insight into the specific obstacles to commercialization faced by microfinance institutions in Bangladesh, Indonesia, the Philippines, and Sri Lanka.

Inappropriate Donor Subsidies

One of the greatest obstacles to commercial microfinance is the continued subsidization of the industry by donors. The industry can credit donors with helping to support the initial pilot projects, institutions, and research that together led to the development of sound lending methodologies for microfinance. However, as the microfinance industry matures, it has become less clear how donors can support the continuing advances in the industry without discouraging natural market mechanisms. While donor support for institutional capacity building is still needed, the availability of grants and soft-loans for on-lending keeps microfinance institutions from pursuing more commercial sources of capital, including savings mobilization and commercial debt and equity funding. For example,

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the Grameen Bank continues to be donor dependent, reporting \$16.4 million in direct grants and \$126.5 million of implicit subsidies in 1998 (Robinson, 2001, p. 95). This focus on donor support has kept Grameen Bank from implementing credit technologies that would lower operational costs and make savings rates more attractive to clients.

Poor Regulation and Supervision

Many countries around the world have limited capacity to regulate and supervise their traditional financial institutions, and developing countries in particular are often accused of poor regulation and supervision of the formal financial system. Given that microfinance is especially needed in developing countries, many countries are ill equipped to provide the additional oversight needed to regulate and supervise microfinance institutions (MFIs) that mobilize deposits. For regulation and supervision of microfinance institutions to be effective, the regulators must understand the differences between traditional finance and microfinance. Common regulatory adaptations for microfinance institutions are as follows:

- *Lower capital requirements.* Minimum capital requirements should be low enough to attract new entrants into microfinance but high enough to ensure the creation of a sound financial institution.
- *Waiver of usury rates.* Regulators should allow MFIs to charge higher interest rates in order to cover higher transactions costs associated with microfinance lending. China and India are two countries with huge potential microfinance markets that are greatly inhibited by laws regulating usurious interest rates.
- *Risk weighting of assets for unsecured loans.* Regulators should assess the riskiness of MFIs based on overall portfolio quality and repayment history rather than on the value of traditional guarantees.

Table 1: MicroFinance Network Members' Savings Mobilization (End of Fiscal Year 1999)

MFI Name	Country	No. of Active Savers	Voluntary passbook and time deposit savings (US\$)	Average Savings Deposit (US\$)	Total loan portfolio (\$)	Portfolio Funded by Savings
		(no.)	(US\$)	(US\$)	(US\$)	(%)
ACEP (1998)	Senegal	13,327	\$73,519	\$6	\$10,920,514	0.67%
BRI	Indonesia	24,235,588	\$2,429,608,541	\$100	\$847,971,530	286.52%
Caja Los Andes	Bolivia	11,550	\$10,425,556	\$903	\$35,775,911	29.14%
ASA	Bangladesh	288,158	\$12,427,862	\$43	\$72,049,623	17.25%
BancoSol	Bolivia	17,268	\$54,899,130	\$3,179	\$82,273,383	66.73%
GERUDEB	Uganda	194,479	\$26,830,471	\$138	\$10,855,187	47.17%
BancoADEMI	Dominican Republic	4,850	\$13,414,642	\$2,766	\$41,807,212	32.09%
Bandesarrollo	Chile	1,530	\$956,604	\$625	\$13,330,189	7.18%
Citi S&L	Ghana	14,829	\$1,485,405	\$100	\$979,010	151.73%
Kafo Jiginew	Mali	42,358	\$4,577,778	\$108	\$7,546,329	60.66%

Source: MicroBanking Bulletin data published with permission of the MicroFinance Network members.

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- *Stricter provisioning.* Provisioning requirements should be based on the average loan maturity of the portfolio. Microfinance portfolios tend to have shorter average maturities, and they therefore require more aggressive provisioning.
- *Higher operating costs allowed.* Since MFIs manage small loans and deposits, they tend to have higher operational costs than do traditional banks. Regulators should not penalize MFIs for higher operating costs if they can demonstrate a reasonable average return on assets (Berenbach and Churchhill, 1997, p. 43).
- *Customized reporting requirements.* Not all the reporting requirements of traditional banks are applicable to MFIs, and microentrepreneurs usually cannot produce the same amount of documentation required of traditional lending.

Few MFIs Mobilize Savings

Most microfinance institutions that exist today operate as non-profit microfinance nongovernmental organizations (NGOs).¹ These NGOs are not regulated financial institutions and therefore are usually not permitted to mobilize client savings. Even among commercial microfinance institutions, few have mobilized a significant amount of voluntary client savings. Table 1 summarizes statistics for some of the most advanced microfinance institutions, including the amount to which they fund their loan portfolios with savings. Bank Rakyat Indonesia (BRI) is a good example of a microfinance provider that has grown significantly as a result of its strong commitment to savings mobilization. In fact, BRI has been so successful that its microfinance division has been cross-subsidizing its commercial loan division for years and has helped stabilize the institution through the recent economic crisis in Indonesia. The industry as a whole needs to learn more about microsavings mobilization and can benefit from the lessons learned by BRI, credit unions, and other institutions that have successfully satisfied the demand for microsavings accounts.

Limited Management Capacity in MFIs.

Since many of the MFIs began as NGOs with a social mission to reduce poverty through the provision of loans, few MFIs have the management capacity to successfully manage a commercial financial intermediary. One of the greatest needs to develop a commercial microfinance industry is the building of management capacity in the following areas:

- *Risk management.* As MFIs take on the additional risk involved with savings mobilization, including increased liquidity risk, fiduciary risk, interest rate risk, and exchange rate risks, more risk management expertise is needed at the board and senior management levels.
- *Management information and internal control.* As MFIs grow, they need to ensure that their management and internal control systems are responsive to the MFI's changing risk profiles and management's changing needs for information to monitor and control these risks.
- *Marketing and customer responsiveness.* To satisfy demand and retain good clients, MFIs need to better understand and respond to their clients' diverse financial needs and customer service preferences.
- *Human resource development.* As the industry becomes more competitive, MFIs often lose their best employees to the competition. MFIs need help in developing sound human resource policies and incentive systems to ensure that they retain the best employees in a cost-effective manner.

Institutional Inefficiencies

Over their history, many MFIs have found ways to increase productivity and efficiency and to lower costs. These efficiency improvements have helped several MFIs to achieve operational and financial self-sufficiency. Asia boasts some of the most efficient microfinance institutions, with both the Association for Social Advancement (ASA) (Bangladesh) and BRI (Indonesia) reporting administrative expense ratios² of only 10.5% and 14.1% in 1998 respectively (Campion, 2000, p. 3). The average administrative expense ratio of the 56 MFIs

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contained in the MicroBanking Bulletin in 1998 was 36.6%. However, more MFIs will need to lower operating costs further before the industry will be able to attract a significant amount of commercial capital. To improve efficiency and customer satisfaction, many MFIs are exploring the use of new technologies, such as Palm Pilots and smart cards to lower transactions costs and increase outreach.

Need for More Rural, Agricultural Microfinance Methodologies

Microfinance has been particularly successful in densely populated urban areas and in countries with large informal sectors. Past donor-supported agricultural lending programs were largely unsuccessful. However, new rural finance models are being explored, offering potential for addressing poverty in rural areas. Chemonics's Mindanao Assistance to Banks (MABS) project has helped set up microfinance units in private banks in the Philippines. From working on this project and others, Chemonics has learned that successful rural microfinance requires that financial officers be knowledgeable of local rural and agricultural markets, standard crop cycles, and seasonal fluctuations in revenues and expenditures. By building the capacity of rural loan officers, Chemonics's project in the Philippines has facilitated access to financial services to 19,000 borrowers and 53,000 savers in previously underserved rural areas. After just three years, 19 of the 20 rural bank units with which the project has worked are profitable. By demonstrating that microenterprise lending is profitable and that micro-savings can be a stable and low-cost source of funds, other banks are now interested in entering the rural finance market.

Conclusion

To summarize, the commercialization of the microfinance industry faces several obstacles that need to be addressed before world demand can be more adequately served. In general, donors should avoid using direct subsidies that will result in market distortions. Donors can support the continued development of the microfinance industry by paying for some

technical assistance and training, but it should limit direct subsidies to MFIs for on-lending. In addition, donors can help to improve the environments in which MFIs operate by building capacity in the regulatory and supervisory bodies, supporting the creation of credit bureaus, and creating other information support systems and networks. As donors move away from direct subsidies and toward capacity-building support, the industry will attract more commercial capital and be better equipped to satisfy unmet global demand. In satisfying this unmet demand for financial services, MFIs will support low-income people in their efforts to rise above poverty.

Notes

1. While some would rightfully argue that credit unions are commercial microfinance providers, few credit unions are dedicated primarily to microfinance and therefore are not categorized here as MFIs.

2. Administrative expense ratio is measured here as administrative expenses over total loan portfolio.

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